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Federal Taxes Affecting Real Estate

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What's New

1 Federal Taxes Affecting Real Estate Scope

Scope

HIGHLIGHTS

Release 44 November 2010

Federal Taxes Affecting Real Estate fully explains and illustrates the most important federal tax principles applicable to real estate transactions. It includes thorough and complete coverage of the tax consequences of all types of real estate transactions.

Release 44 contains new legislation and other relevant material enacted since the last release. Highlights of the release include the following:

- Extension of the maximum \$250,000 *IRC* § 179 expensing through 2010. See *IRC* § 179(b), discussed in Chapter 5.
- Repeal of the foreign targeted obligation exception to the denial of a deduction for interest on bonds not issued in registered form, and repeal of the treatment as portfolio interest of interest paid on bonds that are not issued in registered form but meet the foreign targeting requirements of *IRC* § 163(f)(2)(B). See *IRC* §§ 163(f)(2), 871(h)(2), discussed in Chapter 19.
- A revenue procedure providing a safe harbor method of reporting gain or loss for certain taxpayers who initiate a like-kind exchange under *IRC* § 1031, but fail to complete it because a qualified intermediary defaults on its obligation to acquire and transfer replacement property to the taxpayer. See Revenue Procedure 2010-14, discussed in Chapter 8.
- Codification of the economic substance doctrine, effective for transactions entered into after March 30, 2010 [see *IRC* § 7701(o)], along with a strict liability penalty regime to enforce the standard [see *IRC* §§ 6662(b)(6), 6664(c)(2), (d)(2)]. See Chapter 1 at § 1.03[2] for a detailed discussion.

1 Federal Taxes Affecting Real Estate Scope

- A 3-month extension--to October 1, 2010--for taxpayers to close on home purchases and still qualify for the first-time homebuyer credit. The extension applies only for purchases for which there was a binding contract before May 1, 2010 [*IRC § 36(h)(2), amended by Pub Law 111-198*]. See Chapter 5 at § 5.09[1] for a discussion.

- A divided Tax Court case holding that taxpayers who demolished their old home (which they had used as a principal residence for more than two years) and constructed a new house on the property but never lived in it, could not exclude gain under *IRC § 121* upon selling the house and underlying property. The court's rationale was that the taxpayers failed to satisfy the use requirement with respect to the new house. See *Gates v Commissioner*, discussed in Chapter 9 at § 9.02[3][a].

- The release also contains new detailed coverage of the home office deduction. See Part Two of Chapter 9.

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1-1 Federal Taxes Affecting Real Estate 1.syn

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[2] Leverage of Investment--Equity Financing

[3] Interest, Taxes, and Carrying Charges

[4] Expensing Repairs and Maintenance

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CHAPTER 1 Tax Advantages and Problem Areas in Real Estate

1-1 Federal Taxes Affecting Real Estate § 1.00

§ 1.00 Introduction

The inherent economics of real estate, including the inflation hedge provided and the tax advantages available, historically have sustained real estate as a leading industry in the United States.

Proper utilization of the tax benefits and advantages available in real estate will allow a greater return on capital and potential for capital growth than for most other forms of investment. Tax advantages are available to the investor incident to the construction, purchase, and holding of real estate, and many tax options and benefits are available when the investor disposes of real property.

In recent years the income tax laws have frequently been amended to hit hard at "artificial-loss" provisions. On each specific transaction, nevertheless, competent tax advice should be obtained to avoid turning a potentially favorable real estate investment into an unfavorable situation because of the unfavorable tax consequences it engenders.

In this book, the authors have attempted to explain the more important tax principles applicable to real estate transactions, together with the related tax advantages available to real estate developers, purchasers, and sellers, as well as a discussion of the problem areas to be avoided.



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CHAPTER 1 Tax Advantages and Problem Areas in Real Estate

1-1 Federal Taxes Affecting Real Estate § 1.01

§ 1.01 Advantages Available to the Investor

[1] Depreciation

The purchaser of real estate (other than land) may recover a substantial portion of his cost through the depreciation deduction. n1 Depending upon the depreciation method involved, deductions equal to or greater than debt amortization are usually available. The amount subject to depreciation includes funds invested and may include funds borrowed to acquire the property. This allows an investor to purchase real estate through partial debt financing and to fund debt repayment, in part, with cash generated by the depreciation tax deduction. In many instances, the depreciation deduction has caused properties to sustain a loss position for tax purposes yet maintain a positive cash flow to the investors.

Limitations on methods of depreciation apply on certain types of real property and certain depreciation is subject to recapture as ordinary income upon sale. n2 A full discussion of depreciation is found in Chapters 5 and 6.

[2] Leverage of Investment--Equity Financing

Historically, few investments have offered as great an opportunity to use borrowed funds as real estate. Using borrowed funds allows an investor to benefit from the use of another's money and is commonly referred to as "leverage." This leverage can substantially increase the rate of return on invested capital. For instance, if an investor purchases a \$10,000 property with \$2,000 equity (his own money) and \$8,000 in borrowed funds, he stands to profit on the increase in value of the property attributable to both investment and borrowed funds. If the value of the property increases to \$11,000, he has earned 50 percent on his \$2,000 investment. In contrast, had the investor purchased the property with \$10,000 equity the \$1,000 gain would have produced only a 10 percent return on his equity. This illustration does not take into account the after-tax interest cost of the leverage, which naturally must be considered.

When interest rates become highly cyclical, long-term fixed-cost financing becomes more difficult to arrange. Many lenders require additional interest income in the form of participation in rentals or proceeds of sale or require interest rates that are variable or renegotiable at certain times during the debt term. It has also become more common for lenders to require an equity participation in the real estate. Despite these factors and the resultant tax considerations they create, real estate continues to be subject to greater leverage than most other forms of investment. Severe restrictions apply to the tax aspects of nonrecourse financing for investing in oil, farming, cattle, equipment leasing, and certain other forms of tax shelter. n3 However, as discussed in Chapter 13, real estate investments are afforded favorable treatment by this "at-risk" restriction.

[3] Interest, Taxes, and Carrying Charges

The major out-of-pocket costs to carry real estate, whether improved or unimproved, are deductible and help to create some of the tax benefits applicable to the holding of real estate for investment or for a trade or business. These costs include interest, n4 taxes, n5 insurance, management fees, and other carrying charges. n6 Certain interest paid on passive-investment real estate can be subject to a limited deduction.

Interest, real property taxes, and most overhead items incurred during construction are required to be capitalized to the basis of the property. n7 (See Chapter 3.)

[4] Expensing Repairs and Maintenance

The owner of investment or business real estate can deduct all costs for repairs, operations, and maintenance (properly classifiable as noncapital expenditures) to keep the property in sound condition. n8 An aggressive maintenance and repair policy can result in keeping the property at a sound value and maximizing capital appreciation to the owner (see Chapter 4).

[5] Tenant Improvements

Improvements made by the lessee of property do not constitute income to the owner of real estate unless the improvements are intended to disguise or reduce a normal and fair rental. n9 Thus, the owner of real estate is allowed another means of increasing the property's capital value when tenant improvements revert to the owner upon termination of a lease. In effect, by careful planning with lessees, a lessor may realize an increase in net worth at no tax cost. For further discussion, see Chapter 4.

[6] Election to Capitalize Certain Carrying Charges

Further flexibility is available to an owner of unimproved and unproductive real estate, or certain real estate during the construction period, in that an election is available to capitalize carrying costs, such as interest, taxes, and other charges. n10 A different election is available each year for certain types of property, and such elections may be used to the owner's advantage, depending upon his particular tax position. Thus, the owner can choose the method that will result in the greatest tax benefit, an option normally not available with other forms of investment. For further discussion, see Chapter 3.

[7] Flexibility of Title and Ownership

Investment in real estate offers an opportunity for a number of investors to pool their resources through the use of a syndicate, partnership, LLC, or some other form of joint ownership of property. Such capital pooling enables an investor to participate in the purchase of prime property that the investor alone could not afford and to obtain the assistance of experienced real estate management in the acquisition and operation of property. Title to real estate can be held in a number of different ways, depending upon the intent of the parties and their tax objectives. For further discussion of various entities that may own real estate, see Chapters 14 (partnerships and limited liability companies), 15 (corporations), 16 (REITs, REMICs and other special forms of holding property), and 17 (foreign investment in US real estate).

[8] Investment in Low-Income Housing and Old or Historic Structures

A low-income housing credit is available for investments in low-income housing. n11 For the rehabilitation of old or historic structures, a one-time credit is available in the year of the rehabilitation. n12 These matters are covered in detail in Chapter 5.

[9] Expenditures to Improve Access for Disabled and Elderly Persons

All taxpayers may elect to deduct, rather than capitalize, the cost of qualified architectural and transportation barrier removal expenses, subject to an annual limit of \$15,000. n13 See Chapter 4 for a discussion. Eligible small businesses are eligible for a credit equal to 50 percent of qualifying expenditures that are incurred to remove architectural, communication, physical or transportation barriers that prevent the business from being accessible to individuals with disabilities. n14 See Chapter 5 for a discussion.

[10] Deduction Related to US Construction, Engineering, and Architectural Services

The percentage deduction relating to income attributable to domestic production activities n15 applies to gross receipts from the following services related to real estate: n16

- For taxpayers engaged in the active conduct of a construction trade or business, the construction of real property performed in the United States by the taxpayer in the ordinary course of that trade or business, or
- For taxpayers engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services performed in the United States by the taxpayer in the ordinary course of that trade or business with respect to the construction of real property in the United States.

Gross receipts from the lease, rental, license, sale, exchange, or other disposition of land are excluded in computing the deduction. n17

The deduction is equal to a specified percentage of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this deduction) for the taxable year. n18

The deduction percentages are as follows: n19

Taxable years beginning in 2005 and 2006	3 percent
Taxable years beginning in 2007, 2008, and 2009	6 percent
Taxable years beginning after 2009	9 percent

The deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in that taxable year. n20 The Service has issued detailed interim guidance in *Notice 2005-14*, upon which taxpayers may rely until the issuance of regulations. n21

The deduction is discussed in detail in Chapter 3.

FOOTNOTES:

(n1)Footnote 1. *IRC §§ 167, 168.*

(n2)Footnote 2. *IRC §§ 1245, 1250.*

(n3)Footnote 3. *IRC § 465.*

(n4)Footnote 4. *IRC § 163.*

(n5)Footnote 5. *IRC § 164(a).*

(n6)Footnote 6. *IRC § 162; Treas Reg § 1.162-1(a).*

(n7)Footnote 7. *IRC § 263A.*

(n8)Footnote 8. *Treas Reg § 1.162-1(a).*

(n9)Footnote 9. *IRC § 109; Treas Reg § 1.109-1(a).*

(n10)Footnote 10. *IRC § 266.*

(n11)Footnote 11. *IRC § 42.*

(n12)Footnote 12. *IRC §§ 46(1), 47.*

(n13)Footnote 13. *IRC § 190(a), (c).*

(n14)Footnote 14. *IRC § 44(a).*

(n15)Footnote 15. *IRC § 199.*

(n16)Footnote 16. *IRC §§ 199(c)(4)(A)(ii), (iii).*

(n17)Footnote 17. *IRC § 199(c)(4)(B)(iii).*

(n18)Footnote 18. *IRC § 199(a)(1).*

(n19)Footnote 19. *IRC § 199(a)(1), (2).*

(n20)Footnote 20. *IRC § 199(b)(1).*

(n21)Footnote 21. *Notice 2005-14, 2005-1 CB 498 .*



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CHAPTER 1 Tax Advantages and Problem Areas in Real Estate

1-1 Federal Taxes Affecting Real Estate § 1.02

§ 1.02 Advantages Available to a Seller

[1] Capital Gains

A primary advantage for noncorporate taxpayers in owning real estate is the comparatively favorable tax rate imposed on capital gains following the sale of such property. The maximum tax rate on net capital gains is generally 15 percent. n22 For taxpayers who are otherwise taxed at the lowest regular income tax rate, the maximum tax rate on net capital gains is 5 percent. n23 The maximum rate of tax attributable to gains from the sale of depreciable *IRC Section 1250* property is 25 percent. n24 In contrast, ordinary income is subject to a maximum tax rate of 35 percent after 2002. n25

When improved real property is sold, a bifurcation of tax rates will occur. The 25-percent maximum tax rate would apply to any long-term gain attributable to the depreciable improvements, but gain from the sale of the nondepreciable land would be subject only to the maximum 15-percent (or 5-percent) rate. n26

The 5-, 15-, and 25-percent capital gains rates are available only for property held for more than one year. n27

For all taxpayers, an advantage to the characterization of income as capital gain is that capital gains can be used to offset capital losses. For corporations, losses from sales or exchanges of capital assets are allowed only to the extent of capital gains. n28 For other taxpayers, capital losses are allowed only to the extent of capital gains, plus \$3,000 per year (\$1,500 for married individuals filing separate returns). n29

[2] Tax-Deferred Exchanges

One of the most important advantages to a real estate owner is the right to change an investment position by exchanging property held for investment or the production of income for other property of a like kind. As discussed in Chapter 8, an investor may trade equity for an equity in a more expensive property at no tax cost. Thus, the real estate investor can parlay his equity and appreciation with no dilution by income taxes. n30 On the other hand, the change of investment position by a stock investor normally offers no similar advantages but, rather, results in current tax on profits realized.

[3] Condemnation

Real estate may be condemned in whole or in part by a governmental authority. The purpose of the condemnation may be to provide for a school site, a new road, or for other public purposes. An owner of condemned appreciated property

has considerable flexibility and, as explained in Chapters 6 and 8, can treat the proceeds in one of three ways:

- (1) Realize a profit on the condemnation and pay the tax.
- (2) Use the proceeds to purchase other real estate within a specified period of time. By acquiring property of a like kind or property similar or related in use, the owner pays no current tax on the gain from the condemnation. Tax is paid only when the replacement property is sold. n31
- (3) Reinvest a part of the condemnation proceeds and in many situations defer the tax relating to the gain inherent in the portion so reinvested. n32

Further discussion appears in Chapter 8.

[4] Deferring Tax on Sale of Property

Real estate is often sold on a deferred payout basis. The seller may receive from the buyer a note secured by a mortgage or trust deed payable over a number of years. Taxpayers may use the installment method to report gain and match the payment of tax with the receipt of cash, n33 or may elect otherwise if that proves more beneficial. n34 These subjects are covered in Chapter 7.

FOOTNOTES:

(n1)Footnote 22. *IRC § 1(h)*, in effect for tax years ending after May 6, 1997. For prior years, the maximum tax rate for net capital gains is 28 percent (*IRC § 1(h)*, before amendment by Pub L No 105-34).

(n2)Footnote 23. *IRC § 1(h)(1)(B)*; a 0-percent rate replaces the 5-percent rate for taxable year beginning after Dec 31, 2007.

(n3)Footnote 24. *IRC § 1(h)(1)(D)*, eff for tax years ending after May 6, 1997.

(n4)Footnote 25. *IRC § 1(a) through (e), (i)*.

(n5)Footnote 26. See *IRC § 1(h)(1)(B), (C), (D)*.

(n6)Footnote 27. See *IRC §§ 1(h)(1)(B), (C), (D), 1222(3), (11)*.

(n7)Footnote 28. *IRC § 1211(a)*.

(n8)Footnote 29. *IRC § 1211(b)*.

(n9)Footnote 30. *IRC § 1031*.

(n10)Footnote 31. *IRC § 1033(a)(1), (g)*.

(n11)Footnote 32. *IRC § 1033(a)(2)*.

(n12)Footnote 33. *IRC § 453(a)*.

(n13)Footnote 34. *IRC § 453(d)*.



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CHAPTER 1 Tax Advantages and Problem Areas in Real Estate

1-1 Federal Taxes Affecting Real Estate § 1.03

§ 1.03 Problem Areas in Real Estate

[1] In General

While there are many tax advantages to real estate investment, a number of disadvantages and pitfalls may trap the unwary taxpayer. However, it is difficult to enumerate such problems because of the different tax positions of various taxpayers. A situation that may be disadvantageous to one taxpayer may have no effect on another taxpayer. Some of the more significant problem areas are:

- There may be an inadvertent crossing of the line which separates an investor in real estate from a dealer in real estate. When a taxpayer has more than a nominal number of real estate transactions or when his intent is to hold for sale a newly acquired piece of real estate, the proceeds may be taxed as ordinary income rather than as a capital gain. n35 Furthermore, a dealer is not entitled to the benefits of tax-deferred exchanges. n36 This problem is discussed more fully in Chapter 10.
- Any transaction involving real estate must have a business purpose or economic substance, in order for tax benefits from the transaction to be allowed. The codification of the economic substance doctrine in *IRC Section 7701(o)*, and the strict liability penalty that may be imposed if a transaction lacks economic substance must be kept in mind with respect to real estate investments. n36.1 Because reasonable cause and good faith exceptions are not available as a defense to the penalty, n36.2 even outside opinions or in-house analysis will not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law. The circumstances under which this new statutory regime will be applied to real estate transactions are uncertain, but circular sale-leaseback transactions will surely be likely targets. It is also uncertain how to guarantee that a taxpayer's evaluation of profit potential of a particular real estate transaction will pass IRS muster under the statutory economic substance standard. See § 1.03[2], below, for a discussion of the codified economic substance standard, and penalties that may apply.
- Corporations that primarily hold rental property together with other investments producing even relatively nominal amounts of dividends, interest, or royalties may inadvertently become personal holding companies. n37 Corporations that become personal holding companies will be subject to a penalty tax. n38 See Chapter 15 for further discussion.

■ A taxpayer who holds stock in a company engaged in real estate development may consider his stock a capital asset and assume that any profit on the sale will be treated as a capital gain. However, the profit may be considered ordinary income if the corporation comes under the "collapsible" corporation provisions discussed in Chapter 15. n39 The collapsible corporation rules, however, have been temporarily repealed and do not apply effective for tax years beginning after December 31, 2002, and before January 1, 2011. n40

■ Although under the elective entity classification rules, an entity's choice of entity classification will almost always be respected, n41 the determination of whether an entity exists separate and apart from its owners is a matter of federal, not state, law. n42 Accordingly, there may be occasions when an entity organized as a separate entity under state law will be unable to elect its entity classification for federal tax purposes because it is not considered an entity separate from its owners under federal law. For example, if an LLC with a single individual owner is disregarded as an entity separate from its owner under *Regulation Section 301.7701-3*, its individual owner is subject to federal tax as if the LLC's business were operated as a sole proprietorship, and the LLC will not be able to elect an entity classification for federal tax purposes. n43 The federal entity classification rules are discussed in detail in Chapter 14.

■ Another possible area of concern involving entity classification may arise when a taxpayer wishes to take the position that certain arrangements regarding the acquisition of undivided fractional interests in real property do not constitute separate entities for federal tax purposes and therefore the fractional interests may be the subject of tax--free exchanges under *IRC Section 1031*.

■ The IRS has issued a revenue procedure in which it specifies the conditions under which it will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property) is not an interest in a business entity for tax purposes. n44 The procedure details the guidelines for submitting ruling requests, the information to be submitted, and conditions for obtaining rulings. n45 The procedure applies to co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common. It should be noted that the guidelines provided are only issued for the purpose of assisting taxpayers in preparing ruling requests; they are not intended to be substantive rules, and are not to be used for audit purposes. n46

■ The depreciation recapture provisions applicable to both real and personal property can bunch significant amounts of ordinary income into one year unless proper tax planning steps are taken. n47 Chapters 5 and 6 contain a complete discussion of recapture problems.

■ Noncapital expenditures incurred by a newly formed entity during the construction, reconstruction, or rehabilitation phase may be limited as to current deductibility. n48 See Chapter 3.

■ Provisions of the tax law may reduce the desirability of certain taxpayers' owning real estate. These provisions primarily relate to the adverse effect on tax preferences, n49 passive loss limitations, n50 and the investment interest limitation n51 (see Chapters 4 and 13).

■ While one of the principal advantages of real estate investment is the use of leverage (see § 1.01[2], above), high interest rates during some years have demonstrated the possibility of reverse leverage to an investor; i.e., the interest on the debt obligation required to purchase the property may exceed the earnings and/or incremental increase in value of the property. This can seriously impair the value of the invested equity. Also, when property is sold, the seller may, of necessity, furnish mortgage financing to the buyer, thus allowing the buyer the use of the seller's equity for future profit potential. Such use may

be at an interest rate less than the rate which would be charged by a third-party mortgagor to facilitate the sale of the property.

- Real estate that has generated significant tax shelter in prior years often has debt outstanding that exceeds the tax basis of the property. A large built-in gain can be realized on the sale, foreclosure, or other disposition of such property, which could result in a tax that is disproportionate to the actual proceeds received (see Chapter 12).

These are some of the more significant tax problem areas for taxpayers who invest in real estate. Others are discussed throughout this book. All these problem areas, as well as areas of advantage, must be considered and correlated by the investor to minimize income tax costs and to maximize return on investment.

[2] Codification of Economic Substance Doctrine

[a] In General

Any transaction entered into must have economic substance separate and distinct from economic benefit achieved solely by tax reduction. If a transaction serves no economic purpose for the parties involved other than to generate tax savings, courts have traditionally refused claimed tax benefits resulting from the transaction. n51.1 For real estate, sale-leaseback transactions, and transactions involving inflated prices, nonrecourse financing, or related parties can be given especially close scrutiny.

Effective for transactions entered into after March 30, 2010, the economic substance doctrine has been codified as part of the Internal Revenue Code. n51.2 For purposes of the codified provision, the economic substance doctrine means the common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. n51.3 In the case of any transaction (or series of transactions) to which the economic substance doctrine is relevant, the transaction is treated as having economic substance only if: n51.4

- the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position; and
- the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if *IRC Section 7701(o)* had never been enacted. Thus, the statute does not change existing standards in determining when to use an economic substance analysis. n51.5

Under the statute, the economic substance doctrine involves a conjunctive analysis: n51.6

- there must be an inquiry regarding the objective effects of the transaction on the taxpayer's economic position; and
- there must be an inquiry regarding the taxpayer's subjective motives for engaging in the transaction.

Any transaction subject to the economic substance doctrine must satisfy both tests--i.e., it must change in a meaningful way (apart from federal income tax effects) the taxpayer's economic position and the taxpayer must have a substantial non-federal-income-tax purpose for entering into it. Otherwise, it will not be treated as having economic substance, and claimed tax benefits from it may be denied. n51.7

Furthermore, a taxpayer's non-federal-income-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial." n51.8 For purposes of this analysis, any state or local income tax effect which is related to a federal income tax effect is treated in the same manner as a federal income tax effect. n51.9 Also, a purpose of achieving a favorable accounting treatment for financial reporting purposes is not taken into account as a non-federal-income-tax purpose if the origin of the financial accounting benefit is a reduction of federal income tax. n51.10

A taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-federal-income-tax purpose for entering into the transaction. The statutory economic substance doctrine does not require or establish a minimum return that will satisfy the profit potential test. However, if a taxpayer relies on a profit potential, the present value of the reasonably expected *pre-tax* profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. n51.11 Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit. The Secretary is to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. n51.12

For individuals, the statutory economic substance doctrine applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income. It does not apply for personal transactions. n51.13 Beyond the purchase of a taxpayer's personal residence, it is not clear what, if any, transactions involving real estate might fall within the "personal transaction" category so as to avoid application of the doctrine.

COMMENT:

There are many unanswered questions in connection with the codification of the economic substance doctrine. Regarding the first prong of the test, there is no benchmark for determining whether a change in a taxpayer's position is "meaningful." n51.14 Also, in assessing profit potential, it is unclear when the present value of the "reasonably expected" pre-tax profit will be "substantial" in relation to the present value of the expected net tax benefits. n51.15 The uncertainty as to whether a particular transaction will meet the statutory economic substance test has caused some practitioners to urge Treasury to provide a safe harbor list of transactions that will do so, or other specific guidance. This guidance seems essential, in light of the strict liability penalties that can come into play if a transaction is found on audit not to have economic substance. n51.16 No such guidance has been forthcoming yet, however, and for now, requesting a private letter ruling is likely to be the safest course.

The explanation of the provision by the Joint Committee on Taxation indicates that the codification is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. These transactions include the following: n51.17

- the choice between capitalizing a business enterprise with debt or equity;
- a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;
- the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C of the Code; n51.18 and
- the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of *IRC Section 482* and other applicable concepts are satisfied.

[b] Strict Liability Penalty when Transaction Lacks Economic Substance

A strict liability penalty applies when there is an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in new *IRC Section 7701(o)*, or failing to meet the requirements of any similar rule of law. n51.19 The penalty rate is 20 percent of the underpayment. The penalty is increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return. n51.20 If the 40-percent penalty is imposed, no accuracy related penalty under *IRC Section 6662A* will apply. n51.21

The reasonable cause and good faith exceptions are not available as a defense to the non-economic substance penalty. Thus, outside opinions or in-house analysis will not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law. n51.22

A claim for refund or credit that is excessive under *IRC Section 6676* due to a claim that is lacking in economic substance or failing to meet the requirements of any similar rule of law is also subject to the 20-percent penalty under that section, and the reasonable basis and good faith exceptions are not available. n51.23

FOOTNOTES:

(n1)Footnote 35. See *IRC § 1221(a)(1)*.

(n2)Footnote 36. See *IRC §§ 453(b)(2)(A), 1031(a)(2)(A)*.

(n3)Footnote 36.1. See *IRC § 6662(b)(6)*.

(n4)Footnote 36.2. *IRC § 6664(c)(2), (d)(2)*.

(n5)Footnote 37. See *IRC § 542*.

(n6)Footnote 38. *IRC § 541*.

(n7)Footnote 39. *IRC § 341*.

(n8)Footnote 40. Pub Law No 108-27, § 302(e)(4)(A), *repealing IRC § 341*; see Pub Law No 108-27, §§ 302(f)(1), 303 (effective date and sunset provisions for repeal of collapsible corporation rules).

(n9)Footnote 41. *Treas Reg §§ 301.7701-1 through 301.7701-6*.

(n10)Footnote 42. *Treas Reg § 301.7701-1(a)(1)*.

(n11)Footnote 43. *Treas Reg §§ 301.7701-1(a)(3), 301.7701-3(a)*; *TD 8697, 61 Fed Reg 66585* (Dec 18, 1996).

(n12)Footnote 44. *Rev Proc 2002-22, 2002-1 CB 733*.

(n13)Footnote 45. *Rev Proc 2002-22*, §§ 4, 5, 6, *2002-1 CB 733*.

(n14)Footnote 46. *Rev Proc 2002-22*, § 3, *2002-1 CB 733*.

(n15)Footnote 47. See *IRC §§ 1245, 1250*.

(n16)Footnote 48. See *IRC §§ 248, 263A*.

(n17)Footnote 49. See *IRC §§ 55 through 57*.

(n18)Footnote 50. See *IRC § 469*.

(n19)Footnote 51. See *IRC § 163(d)*.

(n20)Footnote 51.1. *Sacks v Commr*, 69 F3d 982 (9th Cir 1995) ; see *Frank Lyon Co v United States*, 435 US 561 (1978).

(n21)Footnote 51.2. *IRC § 7701(o)*; see Pub Law No 111-152 § 1409(e)(1).

(n22)Footnote 51.3. *IRC § 7701(o)(5)(A)*.

(n23)Footnote 51.4. *IRC § 7701(o)(1)*.

(n24)Footnote 51.5. *IRC § 7701(o)(5)(C)*.

(n25)Footnote 51.6. *IRC § 7701(o)(1)*.

(n26)Footnote 51.7. *IRC § 7701(o)(1)*.

(n27)Footnote 51.8. *IRC § 7701(o)(1)(B)*.

(n28)Footnote 51.9. *IRC § 7701(o)(3)*.

(n29)Footnote 51.10. *IRC § 7701(o)(4)*.

(n30)Footnote 51.11. *IRC § 7701(o)(2)(A)*.

(n31)Footnote 51.12. *IRC § 7701(o)(2)(B)*.

(n32)Footnote 51.13. *IRC § 7701(o)(5)(B)*.

(n33)Footnote 51.14. See *IRC § 7701(o)(1)*.

(n34)Footnote 51.15. See *IRC § 7701(o)(2)(B)*.

(n35)Footnote 51.16. See *IRC § 6662(b)(6)*; *IRC § 6664(c)(2)*, *IRC § (d)(2)*; see [b], below, for a discussion.

(n36)Footnote 51.17. See JCX-18-10.

(n37)Footnote 51.18. See *IRC §§ 301-385*.

(n38)Footnote 51.19. *IRC § 6662(b)(6)*, effective for underpayments, understatements, and refunds and credits attributable to transactions entered into after March 30, 2010 [Pub Law No 111-152 § 1409(e)].

(n39)Footnote 51.20. *IRC § 6662(a), (i)*. An amended return or supplement to a return is not taken into account for this purpose if it is filed after the taxpayer has been contacted for audit or such other date as is specified by the Secretary [*IRC § 6662(i)(3)*].

(n40)Footnote 51.21. *IRC § 6662A(e)(2)(B)*.

(n41)Footnote 51.22. *IRC § 6664(c)(2), (d)(2)*.

(n42)Footnote 51.23. *IRC § 6676(c)*.



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Federal Taxes Affecting Real Estate

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CHAPTER 1 Tax Advantages and Problem Areas in Real Estate

1-1 Federal Taxes Affecting Real Estate § 1.04

§ 1.04 Tax-Related Benefits for Taxpayers Affected by 2005 Hurricanes

[1] In General

Congress enacted legislation in 2005 (the Katrina Emergency Tax Relief Act of 2005) n52 in response to Hurricane Katrina in order to provide special tax breaks to those affected. Many of the provisions in the Katrina legislation were later expanded by the Gulf Opportunity Zone Act of 2005 n53 to cover those affected by Hurricanes Rita and Wilma as well. Because of the unique nature of the legislation, its specific focus, and the limited time frame of the duration of some of the provisions, all aspects of the legislation that affect real estate are discussed here. The following subsections discuss the tax benefits provided the legislation that can affect real estate.

[2] Additional Exemption for Providing Housing Individuals Displaced by Hurricane Katrina

An exemption is allowed to individual taxpayers who provide free housing in their principal residence for certain persons displaced from their abode by Hurricane Katrina. n54 The exemption is allowed once per taxpayer for a specific individual in 2005 or 2006, but not in both years. n55 An exemption of \$500 is allowed for each displaced person for whom housing is provided, n56 but the maximum exemption that can be claimed for all displaced persons is \$2,000 (\$1,000 for a married taxpayer filing a separate return). n57 If two or more taxpayers share the same main home, only one taxpayer can claim the additional exemption amount for a specific displaced individual. A taxpayer must have a legal interest in the principal abode (i.e. must own or rent the home) in order to be able to claim the exemption. n58 Temporary regulations clarify various aspects of the legislative provision. n58.1

The exemption is allowed only if housing is provided for at least 60 consecutive days, ending in the tax year in which the exemption is claimed. The deduction is not available for housing provided to a spouse or dependent. n59 In addition, the exemption is allowed only if the taxpayer does not receive any rent or other amount from any source in connection with providing the housing. n60 A taxpayer claiming an exemption may, however, receive payments or reimbursements that do not relate to normal housing costs, such as food, clothing, or personal items used by the displaced individual, and reimbursements of phone or gasoline costs incurred by the displaced individual. n61

The exemption is claimed on Form 8914. To claim the exemption, the taxpayer must report the displaced person's social security number or individual taxpayer ID number. n62

[3] Exclusion of Certain Cancellation of Indebtedness Income by Reason of Hurricane Katrina

Certain cancellations of indebtedness incurred as a result of Hurricane Katrina are excluded from gross income. n63 The exclusion is available to an individual whose principal place of abode on August 25, 2005 was located in the Hurricane Katrina disaster area. If the abode was located outside the core disaster area, the exclusion is available only if the person also suffered economic loss by reason of Hurricane Katrina. n64 Examples of economic loss include, but are not limited to, the following n65

- loss, damage to, or destruction of real or personal property from fire, flooding, looting, vandalism, theft, wind, or other cause;
- loss related to displacement from the taxpayer's home; or
- loss of livelihood due to temporary or permanent layoffs.

The exclusion is available only for cancellations made on or after August 25, 2005, and before 2007, n66 and only for discharges made by specified governmental agencies or financial entities. n67 The exclusion is not available for cancellations of indebtedness incurred in connection with a trade or business, n68 or for any discharge of indebtedness to the extent that real property constituting security for the indebtedness is located outside of the Hurricane Katrina disaster area. n69

No double tax benefit may result from the exclusion. Therefore, a taxpayer may need to reduce tax attributes by the amount excluded. n70

[4] Special Rules for Mortgage Revenue Bonds Used to Provide Loans to Residences Affected by Hurricane Katrina

Interest on qualified mortgage revenue bonds is tax-exempt. n71 A bond the proceeds of which provides financing before 2011 n72 with respect to a qualified Hurricane Katrina recovery residence can be a qualified mortgage revenue bond if other statutory requirements are also met. n73 A "qualified Hurricane Katrina recovery residence" is any residence in the core disaster area. It also includes any other residence of a mortgagor if it (1) is located in the same State as the principal residence of that mortgagor, and (2) the mortgagor owned a principal residence on August 28, 2005, which was located in the Hurricane Katrina disaster area, and was rendered uninhabitable by reason of Hurricane Katrina. n74

[5] Special Rules for Recapture of Mortgage Subsidy

Subject to several exceptions, a taxpayer who refinances a home under a federally subsidized program (i.e. with a loan from a tax-exempt qualified mortgage bond or a loan with a mortgage credit certificate) must recapture all or part of the benefit received from the program when the home is disposed of. n75 Recapture does not apply, however, to qualified home improvement loans of not more than \$15,000. n76 The \$15,000 amount is increased to \$150,000 if the loan is provided before 2011 and is used to do one of the following: n77

- repair damage caused by Hurricane Katrina to a residence located in the Hurricane Katrina disaster area; or
- alter, repair, or improve an existing owner-occupied residence in the GO Zone, Rita GO Zone, or Wilma GO Zone.

[6] Extension of Involuntary Conversion Replacement Period for Property Located in Hurricane Katrina Disaster Area

A taxpayer generally does not have to recognize gain from an involuntary conversion if the involuntarily converted property is replaced within two years. n78 The replacement period is four years in the case of damage to a principal residence that is located in a disaster area and is compulsorily or involuntarily converted as a result of a federally declared disaster. n79 For property that was involuntarily converted after August 24, 2005 by reason of Hurricane Katrina, however, a taxpayer has 5 years to replace the property without recognition of gain. This extension of time applies only if substantially all of the use of the replacement property is in the Hurricane Katrina disaster area. n80

[7] Gulf Opportunity Zone Benefits

[a] In General

In response to hurricanes occurring in 2005, Congress designated a Gulf Opportunity Zone or "GO Zone," n81 and also a Rita GO Zone and Wilma GO Zone. n82 Any of the GO Zones include that portion of the disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina, Rita, or Wilma. n83 A variety of tax benefits are available to taxpayers in the GO Zones. n84 The following subsections discuss benefits provided by the legislation that may relate to real estate.

[b] Tax-Exempt Bond Financing

Specified bonds issued by Alabama, Louisiana, or Mississippi, or their political subdivisions qualify as exempt facility bonds or qualified mortgage bonds, depending on the particular issue. n85 Provided that specified statutory requirements related to the issuance of the bonds are satisfied, n86 interest from the bonds will be tax-exempt. n87 Among the qualified project costs for which the proceeds of a bond may be used are the following: n88

- qualified residential rental projects n89 located in the GO Zone; and
- costs of acquisition, construction, reconstruction, and renovation of nonresidential real property (including fixed improvements associated with that property) located in the GO Zone, and public utility property n90 located in the GO Zone.

Numerous, detailed modifications are made to existing statutory provisions related to tax-exempt bond financing requirements in applying them to any qualified GO Zone bond. n91 One advance refunding of certain tax-exempt bonds before 2011 may be allowed. n92 The IRS has provided guidance with respect to the information reporting requirements applicable to the above bonds, and has also detailed the credit rate and arbitrage requirements applicable to Gulf Tax Credit Bonds and the treatment of the credit by holders of those bonds. n92.1

Several special rules come into play regarding revenue bond financing before 2011 n93 for owner-occupied residences affected by Hurricane Katrina, Rita, or Wilma:

- Owner-occupied residences in the GO Zone, the Rita GO Zone, or the Wilma GO Zone, are treated as targeted area residences. n94 This allows bond proceeds to finance residences without regard to ownership in the prior three years; n95
- All financing may be provided to mortgagors whose family income is 140 percent or less of the applicable median family income; n96

- Qualified home improvement loans of up to \$150,000 may be made; n97 and

- A qualified GO Zone repair or reconstruction is treated as a qualified rehabilitation under both *IRC Sections 143 and 1400N*. n97.1 This allows proceeds from the bonds to be used for repairs by individuals with an ownership interest in their home. A qualified GO Zone repair or reconstruction is any repair of damage caused by Hurricane Katrina, Hurricane Rita, or Hurricane Wilma to a building located in the GO Zone, the Rita GO Zone, or the Wilma GO Zone (or reconstruction of such a building in the case of damage constituting destruction). To qualify, the expenditures for the repair or reconstruction must be at least 25 percent or more of the mortgagor's adjusted basis in the residence. For this purpose, a mortgagor's adjusted basis is determined as of the completion of the repair or reconstruction or, if later, the date on which the mortgagor acquires the residence. n97.2

[c] Increase in Low-Income Housing Credit

For calendar years 2006-2008, the state low-income housing credit ceiling is increased by specified amount for each state located in the GO Zone. n98 The manner of making allocations for purpose of the credit carryover provisions is also specified. n99 For property located in the GO Zone and damaged by Hurricane Katrina, an extended period of time is allowed to restore qualified basis under *IRC Section 42(j)(4)(E)*, in order to avoid recapture. For property damaged by Hurricane Katrina and located in the GO Zone, the restoration period may be as long as 48 months after the end of calendar year 2005. n99.1

For purposes of *IRC Section 42*, for property placed in service from January 1, 2006 to December 31, 2010, the GO Zone, the Rita GO Zone, and the Wilma GO Zone are generally treated as difficult development areas; n100 therefore, buildings in those areas are eligible for an increase in eligible basis for which the credit is available. n100.1 They are not, however, taken into account for purposes of applying the 20 percent limitation regarding the designation of metropolitan statistical areas. n101 For property placed in service during 2006, 2007, or 2008 in the GO Zone, and in a non-metropolitan area, the 20-50 and 46-60 percent gross income tests are used with the national non-metropolitan median gross income, rather than area median gross income as a benchmark. n102

In addition, the usual requirement that an allocation to a building must be made not later than the close of the calendar year in which the building is placed in service n102.1 is eliminated. This modification is effective for allocations of housing credit dollar amounts to buildings located in the GO Zone, the Rita GO Zone, or the Wilma GO Zone. The modification applies only if the allocation is made in 2006, 2007, or 2008, and the building is placed in service before 2011. n102.2

Finally, in determining whether a building which is placed in service in the GO Zone, the Rita GO Zone, or the Wilma GO Zone from 2006 through 2010 is federally subsidized, certain community development block grants are not taken into account. Specifically, a loan is not treated as a below market Federal loan n102.3 solely by reason of any assistance provided under Section 106, 107, or 108 of the Housing and Community Development Act of 1974 by reason of section 122 of that Act or any provision of the Department of Defense Appropriations Act, 2006, or the Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery, 2006. n102.4

[d] Special Depreciation Allowance for GO Zone Property

Taxpayers may take a special depreciation allowance for qualified GO Zone property placed in service after August 27, 2005. n103 The special depreciation is allowed in the tax year the property is placed in service, and is equal to 50 percent of the adjusted basis of the property. n104 The amount allowed as a deduction under this provision is determined after and *IRC Section 179* deduction and before computing the amount otherwise allowable as a depreciation deduction. The adjusted basis of the qualified GO Zone property must be reduced by the amount of the special depreciation before computing the amount of the depreciation deduction otherwise allowable for that year or any

later tax year. n105 The deduction is allowed both for regular tax and alternative minimum tax purposes. n106 *Notice 2008-25* , n106.1 *Notice 2006-77* , and *Notice 2007-36* provide detailed guidance regarding the deduction. n106.2

GO Zone property includes the following property: n107

- nonresidential real property and residential rental property;
- qualified leasehold improvement property; n108
- tangible property with a recovery period of 20 years or less;
- water utility property; and
- certain computer software.

Property is GO Zone property only if it also meets the following requirements: n109

- it must be acquired by the taxpayer by purchase after August 27, 2005, and no written binding contract for the acquisition can have been in effect before August 28, 2005;
- it must be placed in service by the taxpayer before 2008 (2009, in the case of nonresidential real property and residential rental property, or 2011 for "specified Gulf Opportunity Zone extension property"; n109.1
- substantially all of the use of the property must be in the GO Zone and in the active conduct of the taxpayer's trade or business in the GO Zone; and
- the original use of the property must begin with the taxpayer after August 27, 2005, in the GO Zone. *Notice 2007-36* provides guidance with respect to the original use requirement. n109.2

The following property cannot be GO Zone property under any circumstances: n110

- property that must be depreciated using the alternative depreciation system; n111
- property any portion of which is financed with the proceeds of a tax-exempt obligation; n112
- property for which the taxpayer claims a commercial revitalization deduction; n113
- property in the same class as that for which the taxpayer elected not to claim the special GO Zone depreciation allowance;
- any property used in connection with a private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, or any store, the principal business of which is the sale of alcoholic beverages for consumption off premises; n114
- any gambling or animal racing property; n115
- property that is placed in service and disposed of during the same taxable year; n115.1 or
- property that is converted from business or income-producing use to personal use in the same taxable

year in which the property is placed in service by a taxpayer.

Gambling or animal racing property includes the portion of any real property (determined by square footage) that is dedicated to gambling, the racing of animals, or the on-site viewing of that animal racing, unless the portion is less than 100 square feet. It also includes any equipment, furniture, software, or other property used directly in connection with gambling, the racing of animals, or on-site viewing of animal racing. n116

Self-constructed property used by the taxpayer who manufactured, constructed, or produced it can qualify as GO Zone property, provided that the manufacture, construction, or production begins after August 27, 2005, and is placed in service by December 31, 2010. n117

A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service after August 27, 2005 by a person and that is sold to the taxpayer and leased back to that person by the taxpayer within three months after the date that the property was placed in service, the property is treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. n118

A special rule allows "specified Gulf Opportunity Zone extension property" to qualify for the additional first-year depreciation deduction for an extended period. n118.1 "Specified Gulf Opportunity Zone extension property" is property substantially all the use of which is in one or more specified portions of the Gulf Opportunity Zone and which is either: (1) nonresidential real property or residential rental property which is placed in service by the taxpayer on or before December 31, 2010, or (2) in the case of a taxpayer who places in service a building described in (1), property described in *IRC § 168(k)(2)(A)(i)* if substantially all the use of that property is in that building and the property is placed in service within 90 days of the date the building is placed in service. n118.2 (Generally, property described in *IRC § 168(k)(2)(A)(i)* is (1) property to which the general MACRS depreciation applies with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by *IRC § 197*, (3) water utility property (as defined in *IRC § 168(e)(5)*), or (4) certain leasehold improvement property.) Although qualifying property placed in service before 2011 may qualify for this special rule, in the case of nonresidential real property or residential rental property, only the adjusted basis of that property attributable to manufacture, construction, or production before 2010 ("progress expenditures") is eligible for the additional first-year depreciation. n118.3

Separate rules apply to the syndication of a lease by the lessor. If property is originally placed in service after August 27, 2005 by a lessor (including by reason of self-construction of the property), n119 the property is sold within three months after the date that the property was placed in service, and the user of the property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of that sale. n120 For multiple units of property subject to the same lease, property is treated as placed in service on the date of sale for purposes of qualifying for the special depreciation allowance for GO Zone property if it is sold within three months after the final unit is placed in service, so long as the period between the time the first and last units are placed in service does not exceed 12 months. n121

Limitations apply for GO Zone property that was subject to prior contracts or was being constructed on or before August 27, 2005. GO Zone property qualifying for the special depreciation allowance does not include any property if the user or a related party to the user or owner of that property had a written binding contract in effect for the acquisition of the property at any time on or before August 27, 2005 (or, in the case of self-constructed property, the manufacture, construction, or production of the property began on or before August 27, 2005). For example, if a taxpayer sells to a related party property that was under construction on or prior to August 27, 2005, the property does not qualify for the special depreciation allowance. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract on or prior to August 27, 2005, the property does not qualify for the special depreciation allowance. Furthermore, if a taxpayer sells property and leases the property back in a sale-leaseback arrangement, and the lessee had a binding written contract in effect for the acquisition of that property on or prior to August 27, 2005, then the lessor is not entitled to the special depreciation allowance. n122

If, in any year after the year the special allowance is claimed, the property ceases to be qualified GO Zone property, the taxpayer may have to recapture as ordinary income any excess benefit received from claiming the special allowance. Regulations are to provide details regarding recapture. n123

NOTE:

Apart from this special depreciation allowance for GO Zone property, the IRS has also extended the placed-in-service-date for certain property that is eligible for additional first-year depreciation under *IRC Section 168(k)*. See § 1.04[7][k], below, for a discussion. n123.1

[e] Increased Expensing Under *IRC Section 179*

The otherwise applicable dollar limit on the *IRC Section 179* deduction (\$105,000 for 2005, n124 \$108,000 for 2006, n125 \$125,000 for 2007, n125.1 and \$250,000 for 2008 n125.2) is increased by the smaller of the following: n126

- \$100,000; or
- the cost of qualified *IRC Section 179* GO Zone property placed in service during the year (including GO Zone property placed in service by the taxpayer's spouse, even if the taxpayer files a separate return).

The amount for which a taxpayer may make a *IRC Section 179* election is reduced if the cost of all *IRC Section 179* property placed in service during the year exceeds \$420,000 for 2005, n127 \$430,000 for 2006, n128 \$500,000 for 2007, and \$800,000 for 2008. n128.1 For qualified *IRC Section 179* GO Zone property, this amount is increased by the smaller of the following: n129

- \$600,000; or
- the cost of qualified *IRC Section 179* GO Zone property placed in service during the year.

Qualified *IRC Section 179* GO Zone property generally is *IRC Section 179* property that is qualified GO Zone property. n130 Therefore, it must generally be placed in service before 2008. n130.1 Otherwise qualifying property placed in service before 2009, however, is eligible for the increased expensing, if substantially all the use of the property is in specified portions of the GO Zone. The extension of the placed in service date does not apply for Gulf Opportunity Zone extension property described *IRC Section 1400N(d)(6)*. n130.2 The specified portions of the GO Zone where the property must be used are counties or parishes listed in *Notice 2007-36*, § 3 or on page 2 of IRS Publication 4492, *Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma*.

For purposes of the empowerment zone and the renewal community expensing provisions n131 qualified *IRC Section 179* GO Zone property cannot be treated as qualified zone property or qualified renewal property, unless the taxpayer elects not to take that property into account for purposes of this increased expensing provision. n132

If, in any year after the year the increased expensing is claimed as a deduction special allowance is claimed, the qualified *IRC Section 179* GO Zone property ceases to be qualified *IRC Section 179* GO Zone property, the taxpayer may have to recapture as ordinary income any excess benefit received from claiming the expensing deduction. Regulations are to provide details regarding recapture. n133

[f] Expensing of Certain Demolition and Clean-up Costs

Taxpayers may elect to currently deduct, rather than capitalize, 50 percent of any qualified GO Zone clean-up cost in

the tax year in which the costs are paid or incurred. n134 Qualified GO Zone clean-up costs include any amounts paid or incurred during after August 27, 2005 and before 2008 for the removal of debris from, or the demolition of structures on, real property that is located in the Gulf Opportunity Zone and which is held by the taxpayer for use in a trade or business or for the production of income, or is inventory or other property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. n135

[g] Extension of Expensing for Environmental Remediation Costs

Environmental remediation expenditures n136 incurred after August 27, 2005 and before 2010 that are incurred in connection with a qualified contaminated site located in the GO Zone may be expensed rather than capitalized, in accordance with *IRC Section 198*. n137 Petroleum products may generally be treated as a hazardous substance for this purpose. n138

[H] Increase in Rehabilitation Credit and Extension of Time for Completing Rehabilitation

The rehabilitation credit n139 is increased for qualified rehabilitation expenditures paid or incurred after August 27, 2005 and before 2010 on qualifying buildings located in the GO Zone. For pre-1936 buildings other than certified historic structures, the credit percentage is increased from 10 percent to 13 percent. For certified historic structures, the percentage is increased from 20 percent to 26 percent. n140

The IRS has also announced relief from recapture of the rehabilitation credit by extending the time for making rehabilitations. Persons who have rehabilitation credit property in areas affected by Hurricanes Katrina, Rita, or Wilma have a safe harbor period of three years to repair rehabilitation credit property that was placed in service prior to the hurricanes and was damaged by the hurricanes. During that 3-year period, the property will not be subject to rehabilitation credit recapture, provided that the repairs to the property are actively ongoing. In addition, for property on which the rehabilitation had begun but was not yet placed in service on the date that the President declared a major disaster in the area in which the property is located, the running of the 24-month or 60-month period for making the rehabilitation n140.1 is tolled for a period of 12 months. n140.2

[i] Increase in Deduction of Reforestation Costs and 5-Year NOL Carryback for Small Timber Producers

Small timber producers may elect to deduct certain reforestation costs for each qualified timber property. The deduction for any tax year generally is limited to \$10,000 (\$5,000 if married filing separately, \$0 for a trust). n141 However, this limit is increased if the taxpayer pays or incurs reforestation costs after the applicable date below and any portion of the qualified timber property is located in one of the following areas: n142

- August 27, 2005, if any portion of the property is located in the GO Zone;
- September 22, 2005, if any portion of the property is located in the Rita GO Zone (but not in the GO Zone); or
- October 22, 2005, if any portion of the property is located in the Wilma GO Zone.

The limit for each qualified timber property is increased by the smaller of the following: n143

- \$10,000 (\$5,000 if married filing separately, \$0 for a trust), or
- the amount of reforestation costs paid or incurred by the taxpayer after the applicable date for the qualified timber property, any portion of which is located in the zone described above.

The increase in the limit applies only to costs paid or incurred before 2008. n144 However, these rules do not apply to any timber producer who (a) held more than 500 acres of qualified timber property at any time during the tax year, (b) is a corporation with stock publicly traded on an established securities market, or (c) is a real estate investment trust. n145

Certain timber losses incurred before 2007 n146 may be carried back for 5 years as a farming business NOL. n147 This rule applies only if a portion of the timber property is located in the GO Zone, Rita GO Zone, or Wilma GO Zone, and the income and deductions are allocable to the part of the taxpayer's tax year which is after the applicable date below: n148

- August 27, 2005, if any portion of the property is located in the GO Zone;
- September 22, 2005, if any portion of the property is located in the Rita GO Zone (but not in the GO Zone); or
- October 22, 2005, if any portion of the property is located in the Wilma GO Zone (but not in the GO Zone or Rita GO Zone).

The 5-year NOL carryback is available only to a timber producer who meets all the following requirements: n149

- held qualified timber on the applicable date (August 28, 2005, if any portion of the property is located in the GO Zone; September 23, 2005, if any portion of the property is located in the Rita GO Zone (but not in the GO Zone); and October 23, 2005, if any portion of the property is located in the Wilma GO Zone (but not in the GO Zone or Rita GO Zone);
- held no more than 500 acres of qualified timber property at any time during the tax year;
- is not a corporation with stock publicly traded on an established securities market; and
- is not a real estate investment trust.

[j] 5-Year NOL Carryback for Qualified GO Zone Losses

The portion of any NOL that is a qualified GO Zone loss may be carried back 5 years. n150 In addition, the 90 percent limit on the alternative minimum tax NOL deduction does not apply to that portion of the NOL. n151

A qualified GO Zone loss is the smaller of the following: n152

- the excess of the NOL for the year over the specified liability loss for the year to which a 10-year carryback applies; or
- the total of the following deductions (to the extent they are taken into account in computing the NOL for the tax year):
 - qualified GO Zone casualty loss (as defined below);
 - moving expenses paid or incurred after August 27, 2005, and before January 1, 2008, for the employment of an individual whose main home was in the GO Zone before August 28, 2005, who was unable to remain in that home because of Hurricane Katrina, and whose main job location (after the move) is in the GO Zone;

- temporary housing expenses paid or incurred after August 27, 2005, and before January 1, 2008, to house employees of the taxpayer whose main job location is in the GO Zone;
- depreciation or amortization allowable for any qualified GO Zone property (even if you elected not to claim the special GO Zone depreciation allowance for such property) for the year placed in service; and
- repair expenses (including expenses for the removal of debris) paid or incurred after August 27, 2005, and before January 1, 2008, for any damage from Hurricane Katrina to property located in the GO Zone.

A qualified GO Zone casualty loss is any deductible *IRC Section 1231* loss of property located in the GO Zone if the loss was caused by Hurricane Katrina. n153 For this purpose, the amount of the loss is reduced by any recognized gain from an involuntary conversion caused by Hurricane Katrina of property located in the GO Zone. n154 Any such loss taken into account in figuring the qualified GO Zone loss is not eligible for the election to be treated as having occurred in the previous tax year. n155

[k] Extension of Placed-in-Service Date for Certain Property Eligible for Special Depreciation Allowances under Prior *IRC Section 168(k)*

IRC Section 168(k), as in effect before amendment by Pub Law No 110-185, allows additional first-year depreciation deduction for qualified property and a 50-percent bonus depreciation for certain property. To be eligible for this depreciation, certain property must generally be placed in service by January 1, 2006. n155.1 This placed-in-service date applies for property with longer-production periods (property with a recovery period of at least 10 years, certain transportation property, and property that is subject to the uniform capitalization rules because it has an estimated production period exceeding 2 years or an estimated production period exceeding 1 year and a cost exceeding \$1 million), n155.2

The IRS has extended the placed-in-service date for the above property to January 1, 2007, for property that is either placed in service by the taxpayer or manufactured by a person in the GO Zone, the Rita GO Zone, or the Wilma GO Zone. The extension applies only if the taxpayer was unable to meet the prior placed-in-service deadline for the property as a result of Hurricane Katrina, Rita, or Wilma. To apply the extended date, the taxpayer must write "Extension under *Announcement 2006-29* " across the top of its Form 4562, Depreciation and Amortization, for the placed-in-service year of the property. n155.3

[8] Housing Tax Benefits Related to Hurricane Katrina

Qualified employees affected by Hurricane Katrina may exclude from gross income the value (up to \$600 per month) n156 of in-kind lodging furnished to them, their spouses, and dependents by qualified employers. n157 The exclusion applies only for lodging furnished from January 1, 2006 through June 30, 2006. n158

A qualified employer providing the lodging is entitled to the Hurricane Katrina housing credit, which is part of the general business credit. n159 The credit is equal to 30 percent of any amount which is excludable from the gross income of a qualified employee of the employer and not otherwise excludable under *IRC Section 119*. n160

A qualified employee is an individual who had a principal residence n161 in the GO Zone on August 28, 2005, and who performs substantially all employment services in the GO Zone for a qualified employer who furnishes lodging to the individual. n162 A qualified employer is any employer with a trade or business located in the GO Zone. n163 The exclusion and credit are not available for certain related taxpayers. n164

[9] Tax-Favored Qualified Hurricane Distributions from Retirement Plans

[a] In General

A new statutory provision provides new rules for tax-favored withdrawals, repayments and loans from certain retirement plans for taxpayers who suffered economic losses as a result of Hurricane Katrina, Wilma, or Rita, and whose principal place of abode was located in a designated disaster area related to one of those hurricanes. n165 Qualifying economic losses include, but are not limited to the following: n166

- loss, damage to, or destruction of real or personal property from fire, flooding, looting, vandalism, theft, wind, or other cause;
- loss related to displacement from the taxpayer's home; or
- loss of livelihood due to temporary or permanent layoffs.

A detailed discussion of the taxation of qualified hurricane distributions from retirement plans is beyond the scope of this publication. The primary aspect dealing with real estate involves the treatment of the repayment of certain distributions that were made for the purchase or construction of a principal residence. n167

[b] Repayment of Qualified Distributions for the Purchase or Construction of a Principal Residence

A taxpayer who received a qualified distribution to purchase or construct a principal residence in the Hurricane Katrina, Rita, or Wilma disaster area could repay that distribution before March 1, 2006, to an eligible retirement plan after August 24, 2005 (Katrina); after September 22, 2005 (Rita); or after October 22, 2005 (Wilma). n168 For this purpose, an eligible retirement plan is any plan, annuity, or IRA to which a qualified rollover can be made. n169

To be a qualified distribution, the distribution had to meet all of the following requirements: n170

- the distribution was a hardship distribution from a 401(k) plan, a hardship distribution from a tax-sheltered annuity contract, or a qualified first-time homebuyer distribution from an IRA;
- the distribution was received in 2005 after February 28 and before (a) August 29 for Hurricane Katrina, (b) September 24 for Hurricane Rita; or (c) October 24 for Hurricane Wilma; and
- the distribution was to be used to purchase or construct a main home in the Hurricane Katrina, Rita, or Wilma disaster area that was not purchased or constructed because of Hurricane Katrina, Rita, or Wilma.

Amounts that were repaid before March 1, 2006, are treated as a qualified rollover and are not included in gross income. Also, for purposes of the one-rollover-per-year limitation for IRAs, a repayment to an IRA is not considered a qualified rollover. n171

A qualified distribution not repaid before March 1, 2006, may be taxable for 2005 and subject to the additional 10% tax (or the additional 25% tax for certain SIMPLE IRAs) on early distributions. n172

Taxpayers who receive a qualified distribution that they repay, in whole or in part, before March 1, 2006 must file a Form 8915, Qualified Hurricane Retirement Plan Distributions and Repayments.

[10] Temporary Suspension of Limits on Charitable Contributions

[a] Individuals

Qualified charitable contributions are not subject to the overall limit on itemized deductions or the 50% adjusted gross income (AGI) limit. n173 A qualified contribution is a charitable contribution paid in cash or by check after August 27, 2005, and before 2006, to a 50% limit organization (other than certain private foundations) n174 if the taxpayer makes an election to have the 50% limit not apply to these contributions. n175 In the case of a partnership or S corporation, the election to have the appropriate limit not apply must be made separately by each partner or shareholder. n176

An individual taxpayer's deduction for qualified contributions is limited to AGI minus deductions for all other charitable contributions. n177 Any excess can be carried over to 2006. In 2006, the unused qualified contributions are treated as a carryover of contributions subject to the 50% limit. n178

Qualified contributions do not include a contribution to a segregated fund or account for which the taxpayer or any person the taxpayer appoints or designates has or expect to have advisory privileges with respect to distributions or investments based on the taxpayer's contribution. n179

NOTE:

Although the suspension of the charitable contribution limits was enacted in response to Hurricanes Katrina, Rita, and Wilma, there is no requirement that amounts contributed by individuals be used in connection with relief efforts for those hurricanes in order to be a qualified contribution that can avoid the charitable contribution limits. n180 In contrast, a contribution paid by a corporation must be for relief efforts related to Hurricane Katrina, Rita, or Wilma in order to be a qualified contribution. n181

[b] Corporations

A corporation may elect to deduct qualified cash contributions without regard to the 10% taxable income limit if the contributions were made after August 27, 2005, and before 2006, to a qualified charitable organization (other than certain private foundations). n182 In addition, the contributions must be for Hurricane Katrina, Rita, or Wilma relief efforts. n183 The corporation's deduction for these qualified contributions is limited to 100% of taxable income (as modified for the 10% limit) minus the corporation's deduction for all other charitable contributions. n184 Any qualified contributions over this limit can be carried over to the next 5 years, subject to the 10% limit. n185

[11] Special Rules for 2005 Hurricane Casualty Losses

The \$100 limitation and 10% of AGI limitation n186 do not apply to personal casualty losses attributable to Hurricanes Katrina, Rita, and Wilma, and located in their respective disaster areas. n187 In the case of any other losses, the 10% of AGI limitation n188 is applied without regard to the above hurricane losses. n189 This rule applies whether the hurricane losses are claimed in 2005 or in 2004 under the disaster loss election provision. n190

The IRS has issued a revenue procedure that provides three safe harbor methods that individuals may use to determine the decrease in fair market value of personal-use residential real property. The procedure also provides a safe harbor method that individuals may use to determine the fair market value of their personal belongings immediately before the 2005 Gulf hurricanes. n191 If one of the safe harbors is used, a taxpayer cannot use an appraisal or cost of repair method to determine a loss with respect to other items on the same parcel of property. n191.1

A taxpayer who claimed a casualty loss to a principal residence resulting from Hurricane Katrina, Hurricane Rita, or Hurricane Wilma and in a subsequent year receives a grant as reimbursement of that loss may elect to file an amended return for the taxable year to which that deduction was allowed. The casualty loss deduction is reduced, but not below zero, by the amount of the reimbursement. The time for filing the amended return is the later of three years after the

original due date for filing the tax return or November 30, 2008. Any underpayment of tax is subject to one year of interest, but no penalty or additional interest is imposed if that interest is paid not later than one year after the filing of the amended return. n192

[12] Benefits Extended to Kiowa County, Kansas

Uncodified legislation enacted in 2008 provides extensive temporary tax relief to taxpayers in Kiowa County, Kansas and the surrounding area, in response to tornado damage occurring in 2007. The relief provisions incorporate by reference many of the Gulf Opportunity Zone tax relief provisions, but with different effective dates and geographic coverage. n193

[13] Temporary Tax Relief for Midwestern Disaster Area and Hurricane Ike Disaster Area

Uncodified legislation provides extensive temporary tax relief to taxpayers in areas in the Midwest damaged by severe storms, tornados and flooding. n194 Covered areas include parts of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin. n195 The relief provisions incorporate by reference many of the Gulf Opportunity Zone tax relief provisions n196 and uncodified provisions of the Katrina Emergency Tax Relief Act of 2005, n197 but with different effective dates and geographic coverage.

Uncodified legislation also provides temporary tax-exempt bond financing and low-income housing tax relief for areas damaged by Hurricane Ike. n198

FOOTNOTES:

(n1)Footnote 52. Pub Law No 109-73.

(n2)Footnote 53. Pub Law No 109-135.

(n3)Footnote 54. Public Law No 109-73, § 302; see Pub Law No 109-73, § 302(c) for the definition of "Hurricane Katrina displaced individual."

(n4)Footnote 55. Public Law No 109-73, § 302(b)(2).

(n5)Footnote 56. Public Law No 109-73, § 302(a).

(n6)Footnote 57. Public Law No 109-73, § 302(b)(1).

(n7)Footnote 58. Public Law No 109-73, § 302. See IRS Publication 4492.

(n8)Footnote 58.1. *Temp Treas Reg § 1.9300-1T*.

(n9)Footnote 59. Public Law No 109-73, § 302(c).

(n10)Footnote 60. Public Law No 109-73, § 302(c)(3), (d).

(n11)Footnote 61. See IRS Publication 4492.

(n12)Footnote 62. Public Law No 109-73, § 302(b)(3).

(n13)Footnote 63. Public Law No 109-73, § 401.

(n14)Footnote 64. Public Law No 109-73, § 401(b).

(n15)Footnote 65. IRS Publication 4492.

- (n16)Footnote 66. Public Law No 109-73, § 401(e).
- (n17)Footnote 67. Public Law No 109-73, § 401(a); see *IRC § 6050P(c)(1)*.
- (n18)Footnote 68. Public Law No 109-73, § 401(c)(1).
- (n19)Footnote 69. Public Law No 109-73, § 401(c)(2).
- (n20)Footnote 70. Public Law No 109-73, § 401(d); see *IRC § 108(b)*.
- (n21)Footnote 71. *IRC § 103(a), (b)(1)*; see *IRC §§ 141(e)(1)(B), 143(a)(2), (d)*.
- (n22)Footnote 72. Public Law No 109-73, § 404(d), as amended by Pub Law No 109-135, § 104.
- (n23)Footnote 73. Public Law No 109-73, § 404(a).
- (n24)Footnote 74. Public Law No 109-73, § 404(b).
- (n25)Footnote 75. *IRC § 143(m)(1)*.
- (n26)Footnote 76. *IRC § 143(k)(4), (m)(3)(B)*.
- (n27)Footnote 77. Public Law No 109-73, § 404(c), (d); see *IRC §§ 143(k)(4), 1400T(a)(3)*.
- (n28)Footnote 78. *IRC § 1033(a)(2)(B)(i)*.
- (n29)Footnote 79. *IRC § 1033(h)(1)(B)*.
- (n30)Footnote 80. Public Law No 109-73, § 405; *IRC § 1033(a)(2)(B)(i)*.
- (n31)Footnote 81. *IRC § 1400M(1)*.
- (n32)Footnote 82. *IRC § 1400M(3), (5)*.
- (n33)Footnote 83. *IRC § 1400M(1), (3), (5)*.
- (n34)Footnote 84. *IRC § 1400N*.
- (n35)Footnote 85. *IRC § 1400N(a)(1)*.
- (n36)Footnote 86. See *IRC § 1400N(a)(2), (3)*.
- (n37)Footnote 87. *IRC § 103(a)*.
- (n38)Footnote 88. *IRC § 1400N(a)(4)*.
- (n39)Footnote 89. See *IRC § 142(d)*. See *IRC § 1400N(a)(5)* (special definition for GO bond purposes). See also *IRC § 1400N(n)* (operator of a project may rely on income representations of certain would-be tenants).
- (n40)Footnote 90. See *IRC § 168(i)(10)* for a definition.
- (n41)Footnote 91. *IRC § 1400N(a)(5)*.
- (n42)Footnote 92. *IRC § 1400N(b)*.

(n43)Footnote 92.1. *Notice 2006-41, 2006-1 CB 857 .*

(n44)Footnote 93. *IRC § 1400T(b).*

(n45)Footnote 94. *IRC § 1400T(a)(1).*

(n46)Footnote 95. *See IRC § 143(d)(1), (2)(A).*

(n47)Footnote 96. *IRC § 1400T(a)(2); see IRC § 143(f)(3).*

(n48)Footnote 97. *IRC § 1400T(a)(3); see IRC § 143(k)(4).*

(n49)Footnote 97.1. *IRC § 1400N(a)(7)(A), effective for owner-financing provided after May 25, 2007 and before 2011 [IRC § 1400N(a)(7)(C)].*

(n50)Footnote 97.2. *IRC § 1400N(a)(7)(B).*

(n51)Footnote 98. *IRC § 1400N(c)(1); the ceilings for Texas and Florida are increased by \$3.5 million for 2006 [IRC § 1400N(c)(2)].*

(n52)Footnote 99. *IRC § 1400N(c)(1)(C).*

(n53)Footnote 99.1. *Notice 2007-66, 2007-34 IRB 387 .*

(n54)Footnote 100. *IRC § 1400N(c)(3)(A)(i); see IRC § 42(d)(5)(B)(iii)(I); see IRC § 1400N(c)(3)(B) for application of this rule.*

(n55)Footnote 100.1. *IRC § 1400N(c)(3)(A)(i), 1400N(c)(3)(B); see IRC § 42(d)(5)(B)(iii)(I).*

(n56)Footnote 101. *IRC § 1400N(c)(3)(A)(ii); see IRC § 42(d)(5)(B)(iii)(II).*

(n57)Footnote 102. *IRC § 1400N(c)(4).*

(n58)Footnote 102.1. *See IRC § 42(h)(1)(B).*

(n59)Footnote 102.2. *IRC § 1400N(c)(5).*

(n60)Footnote 102.3. *See IRC § 42(i)(2)(D), before amendment by Pub Law No 110-289.*

(n61)Footnote 102.4. *IRC § 1400N(c)(6).*

(n62)Footnote 103. *IRC § 1400N(d).*

(n63)Footnote 104. *IRC § 1400N(d)(1)(A).*

(n64)Footnote 105. *IRC § 1400N(d)(1)(B).*

(n65)Footnote 106. *IRC § 1400N(d)(4); see IRC § 168(k)(2)(G).*

(n66)Footnote 106.1. *Notice 2008-25, 2008-9 IRB 484 (depreciation recapture rules when property is transferred in a like-kind exchange or as the result of an involuntary conversion).*

(n67)Footnote 106.2. *Notice 2006-77, 2006-2 CB 590 , clarified, modified, and amplified by Notice 2007-36, 2007-17 IRB 1000 .*

(n68)Footnote 107. *IRC § 1400N(d)(2)(A)(i).*

(n69)Footnote 108. *See IRC § 168(k)(3).*

(n70)Footnote 109. *IRC § 1400N(d)(2)(A).*

(n71)Footnote 109.1. *See IRC § 1400N(d)(6), discussed below.*

(n72)Footnote 109.2. *Notice 2007-36, 2007-17 IRB 1000 .*

(n73)Footnote 110. *IRC § 1400N(d)(2)(B), (p)(1).*

(n74)Footnote 111. *See IRC § 168(k)(2)(D)(i).*

(n75)Footnote 112. *See IRC § 103.*

(n76)Footnote 113. *See IRC § 1400I(a)(1), (2).*

(n77)Footnote 114. *See IRC § 1400N(p)(3)(A)(i).*

(n78)Footnote 115. *See IRC § 1400N(p)(3)(A)(ii).*

(n79)Footnote 115.1. *See Notice 2006-77, 2006-2 CB 590 (rules similar to those involving the technical termination of a partnership [IRC § 708(b)(1)(B); Treas Reg § 1.168(k)-1(f)(1)(ii), (iii)] and certain carryover basis transactions [see IRC § 168(i)(7)] apply.*

(n80)Footnote 116. *See IRC § 1400N(p)(3)(B).*

(n81)Footnote 117. *IRC § 1400N(d)(3); see IRC § 168(k)(2)(E)(i), before amendment by Pub Law No 110-185.*

(n82)Footnote 118. *IRC § 1400N(d)(3); see IRC § 168(k)(2)(E)(ii), before amendment by Pub Law No 110-185.*

(n83)Footnote 118.1. *IRC § 1400N(d)(6).*

(n84)Footnote 118.2. *IRC § 1400N(d)(6)(B).*

(n85)Footnote 118.3. *IRC § 1400N(d)(6)(D). See Rev Proc 2008-54 , § 6.01(2), 2008-38 IRB 722 (clarification of interaction of IRC §§ 168(k) and 1400N(d) for 2008).*

(n86)Footnote 119. *See IRC § 168(k)(2)(E)(i), before amendment by Pub Law No 110-185.*

(n87)Footnote 120. *IRC § 1400N(d)(3); see IRC § 168(k)(2)(E)(iii), before amendment by Pub Law No 110-185.*

(n88)Footnote 121. *IRC § 1400N(d)(3); see IRC § 168(k)(2)(E)(iii)(II), before amendment by Pub Law No 110-185.*

(n89)Footnote 122. *IRC § 1400N(d)(3); see IRC § 168(k)(2)(E)(iv), before amendment by Pub Law No 110-185.*

(n90)Footnote 123. *IRC § 1400N(d)(5); see IRC § 179(d)(10).*

(n91)Footnote 123.1. *Announcement 2006-29, 2006-1 CB 879 .*

(n92)Footnote 124. *Rev Proc 2004-71 , § 3.18, 2004-2 CB 974 .*

(n93)Footnote 125. *Rev Proc 2005-70 , § 3.18, 2005-2 CB 979 .*

(n94)Footnote 125.1. *IRC § 179(b)(1)*.

(n95)Footnote 125.2. See *IRC § 179(b)(7)(A)*.

(n96)Footnote 126. *IRC § 1400N(e)(1)*. See Rev Proc 2008-54 , § 6.01(1), 2008-38 IRB 722 (clarification of interaction of *IRC §§ 179* and *1400N(e)* for 2008).

(n97)Footnote 127. *Rev Proc 2004-71* , § 3.18, 2004-2 CB 974 .

(n98)Footnote 128. *Rev Proc 2005-70* , § 3.18, 2005-2 CB 979 .

(n99)Footnote 128.1. *IRC § 179(b)(7)(B)*.

(n100)Footnote 129. *IRC § 1400N(e)(2)*.

(n101)Footnote 130. *IRC § 1400N(e)(2)*; see [d], above, for a discussion of property that qualifies as GO Zone property.

(n102)Footnote 130.1. See *IRC § 1400N(d)(2)(A)*, *(e)(2)(A)*.

(n103)Footnote 130.2. *IRC § 1400N(e)(2)(B)* see *IRC § 1400N(d)(6)*.

(n104)Footnote 131. See *IRC §§ 1397A*, *1400J*.

(n105)Footnote 132. *IRC § 1400N(e)(3)*.

(n106)Footnote 133. *IRC § 1400N(e)(4)*; see *IRC § 179(d)(10)*.

(n107)Footnote 134. *IRC § 1400N(f)(1)*.

(n108)Footnote 135. *IRC § 1400N(f)(2)*.

(n109)Footnote 136. See *IRC § 198(b)* for a definition.

(n110)Footnote 137. *IRC § 1400N(g)(1)*.

(n111)Footnote 138. *IRC § 1400N(g)(2)*.

(n112)Footnote 139. See *IRC § 47*.

(n113)Footnote 140. *IRC § 1400N(h)*.

(n114)Footnote 140.1. See *IRC § 47(c)(1)(C)(i)*, *(ii)*.

(n115)Footnote 140.2. *Notice 2006-38*, 2006-1 CB 877 .

(n116)Footnote 141. *IRC § 194(b)(1)(B)*.

(n117)Footnote 142. *IRC § 1400N(i)(1)*.

(n118)Footnote 143. *IRC § 1400N(i)(1)*.

(n119)Footnote 144. *IRC § 1400N(i)(5)(A)(ii)(I)*.

(n120)Footnote 145. *IRC § 1400N(i)(3)*, *(4)(A)*.

(n121)Footnote 146. *IRC § 1400N(i)(5)(A)(ii)(II).*

(n122)Footnote 147. *See IRC § 172(i).*

(n123)Footnote 148. *IRC § 1400N(i)(2), (4)(B).*

(n124)Footnote 149. *IRC § 1400N(i)(3), (4)(B).*

(n125)Footnote 150. *IRC § 1400N(k)(1)(A)(i).*

(n126)Footnote 151. *IRC § 1400N(k)(1)(B); see IRC § 56(d)(1).*

(n127)Footnote 152. *IRC § 1400N(k)(2).*

(n128)Footnote 153. *IRC § 1400N(k)(3)(A).*

(n129)Footnote 154. *IRC § 1400N(k)(3)(B).*

(n130)Footnote 155. *IRC § 1400N(k)(3)(C).*

(n131)Footnote 155.1. *IRC § 168(k)(2)(A)(iv), before amendment by Pub Law No 110-185, 168(k)(4)(B)(iii), before repeal by Pub Law No 110-185.*

(n132)Footnote 155.2. *See IRC § 168(k)(2)(B), before amendment by Pub Law No 110-185.*

(n133)Footnote 155.3. *Announcement 2006-29, 2006-1 CB 879 .*

(n134)Footnote 156. *IRC § 1400P(a)(2).*

(n135)Footnote 157. *IRC § 1400P(a)(1).*

(n136)Footnote 158. *IRC § 1400P(f).*

(n137)Footnote 159. *IRC §§ 38(b)(27), 1400P(b).*

(n138)Footnote 160. *IRC § 1400P(b).*

(n139)Footnote 161. *See IRC § 121.*

(n140)Footnote 162. *IRC § 1400P(c).*

(n141)Footnote 163. *IRC § 1400P(d).*

(n142)Footnote 164. *IRC § 1400P(e); see IRC §§ 51(i)(1), 52.*

(n143)Footnote 165. *IRC § 1400Q.*

(n144)Footnote 166. *See IRS Publication 4492.*

(n145)Footnote 167. *IRC § 1400Q(b); see [b], below, for a discussion.*

(n146)Footnote 168. *IRC § 1400Q(b)(1), (3).*

(n147)Footnote 169. *IRC § 1400Q(b)(3).*

(n148)Footnote 170. *IRC § 1400Q(b)(1)(A), (2).*

(n149)Footnote 171. *IRC § 1400Q(b)(1)(B); see IRC § 1400Q(a)(3)(B), (C).*

(n150)Footnote 172. *IRC § 72(t).*

(n151)Footnote 173. *IRC § 1400S(a)(1), (3).*

(n152)Footnote 174. *See IRC § 509(a)(3).*

(n153)Footnote 175. *IRC § 1400S(a)(4)(A).*

(n154)Footnote 176. *IRC § 1400S(a)(4)(C).*

(n155)Footnote 177. *IRC § 1400S(a)(2)(i); see IRC § 170(b)(1)(G).*

(n156)Footnote 178. *IRC § 1400S(a)(2)(ii).*

(n157)Footnote 179. *IRC § 1400S(a)(4)(B).*

(n158)Footnote 180. *IRC § 1400S(a)(4).*

(n159)Footnote 181. *IRC § 1400S(a)(4)(ii).*

(n160)Footnote 182. *IRC § 1400S(a)(1), (4). See IRC § 509(a)(3).*

(n161)Footnote 183. *IRC § 1400S(a)(4)(ii).*

(n162)Footnote 184. *IRC § 1400S(a)(2)(B)(i).*

(n163)Footnote 185. *IRC § 1400S(a)(2)(A)(ii), (B)(ii).*

(n164)Footnote 186. *See IRC § 165(h)(1), (2)(A).*

(n165)Footnote 187. *IRC § 1400S(b).*

(n166)Footnote 188. *See IRC § 165(h)(2)(A).*

(n167)Footnote 189. *IRC § 1400S(b).*

(n168)Footnote 190. *See IRC §§ 165(i), 1400S(b).*

(n169)Footnote 191. *Rev Proc 2006-32, 2006-2 CB 61 .*

(n170)Footnote 191.1. CCA 200849014 (taxpayers who used a safe harbor to claim a loss to residential property could not use regulations to claim additional loss for damage to a wharf that was located on the same property).

(n171)Footnote 192. Pub Law 110-289, § 3082(a).

(n172)Footnote 193. Pub Law No 110-234, § 15345. See Rev Proc 2008-54 , § 6.02, 2008-38 IRB 722 (clarification of provisions for 2008).

(n173)Footnote 194. Pub Law No 110-343, § 702. See Notice 2008-109, 2008-50 IRB 1282 for additional guidance with respect to the relief.

(n174)Footnote 195. Pub Law No 110-343, § 702(b)(1).

(n175)Footnote 196. See *IRC §§ 1400N through 1400T*.

(n176)Footnote 197. See Pub Law No 109-73.

(n177)Footnote 198. Pub Law No 110-343, § 704. See Notice 2008-109, *2008-50 IRB 1282* for additional guidance with respect to the relief.



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Federal Taxes Affecting Real Estate

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CHAPTER 1 Tax Advantages and Problem Areas in Real Estate

-1 Federal Taxes Affecting Real Estate § 1.05

§ 1.05 Special Rules for Losses in Connection with Federally Declared Disasters

[1] Overview of Special Disaster Loss Rules

Apart from the special provisions discussed above that were enacted to address specifically identified hurricanes and natural disasters, n199 a number of other disaster loss rules come into play more generally for losses from non-specified disasters. They cover both the timing and tax treatment of the loss deduction itself and the treatment of various expenses that may be incurred as a result of the loss.

The tax provisions sometimes refer to losses occurring in a disaster area and/or attributable to a federally declared disaster. A "federally declared disaster" is any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. n200 A "disaster area" is the area so determined to warrant that assistance. n201

The following provisions should be noted:

- Taxpayers may elect to claim a disaster loss in the year immediately before the year in which the loss occurred. n202
- Special loss deduction rules apply for losses related to federally declared disasters. n203 A taxpayer's standard deduction is increased by the amount of the disaster loss deduction, n204 and this portion of the standard deduction is also allowed for AMT purposes. n205
- Taxpayers may elect to carry back qualified disaster losses for 5 years as a net operating loss. n206 Carrybacks and carryovers of qualified disaster losses are also allowed for AMT purposes. n207
- A temporary provision allows a deduction for qualified disaster expenses. n208
- Certain mortgage bond revenue requirements are temporarily waived for principal residences that are destroyed in disasters. n209
- Additional 50-percent first-year depreciation for qualified disaster assistance property. n210

- Increased *IRC Section 179* expensing for qualified disaster assistance property. n211

[2] Special Election for Disaster Losses

A special rule applies for losses occurring in a disaster area n212 and attributable to a federally declared disaster. n213 Taxpayers may elect to deduct these losses for the tax year immediately preceding the tax year in which the disaster occurred. n214

PLANNING TIP:

In deciding whether to make the election, taxpayers should consider the advantage of obtaining the tax benefit in an earlier year. In addition, for years in which the 10-percent of AGI rule for deducting losses resulting from a federal disaster is not waived, n215 taxpayers must take into account the effect of the rule that, to be deductible, casualty losses must exceed 10 percent of adjusted gross income. n216

The election may be made in the return for the tax year immediately preceding the tax year of the disaster. The election is made by attaching a statement to the return that clearly shows that the election is being made. If a return for the preceding tax year has already been filed, the loss may be claimed by filing an amended return for that year or by filing a claim for a refund. n217 The election must be made by the later of: (1) the due date for filing the income tax return for the year in which the disaster occurred (determined without regard to extensions for filing); or (2) the due date for filing the income tax return for the year immediately preceding the tax year in which the disaster occurred (determined with regard to extensions for filing). n218 The Service may grant an extension of time for making the election by private letter ruling. n219 The amount of the disaster loss taken into account for the preceding tax year by virtue of the election cannot exceed the uncompensated amount (determined on the basis of facts existing at the date the taxpayer claims the loss). n220

[3] Loss Deduction Rules for Losses Due to Federally Declared Disasters

Several rules allow more extensive deduction of losses related to federally declared disasters than for other casualty losses. First, the 10-percent of AGI rule the generally applies for deducting casualty losses n221 is temporarily waived for certain losses resulting from a federal disaster. Any "net disaster loss" is deductible without regard to whether it exceeds 10 percent of a taxpayer's adjusted gross income. n222 A "net disaster loss" is the excess of the personal casualty losses (1) attributable to a federally declared disaster occurring before January 1, 2010, and (2) occurring in a disaster area, over personal casualty gains. n223

A taxpayer's standard deduction is increased by the amount of this net disaster loss deduction. n224 This portion of the standard deduction is also allowed for AMT purposes. n225 The disaster loss deduction is equal to the "net disaster loss." n226 The above provisions are effective for disasters declared in taxable years beginning after December 31, 2007. n227

[4] Five-Year NOL Carryback for Qualified Disaster Losses

Qualified disaster losses may be carried back for 5 years as a net operating loss (NOL). n228 Carrybacks and carryovers of these qualified disaster losses are also allowed for AMT purposes. n229 A "qualified disaster loss" is the lesser of (1) otherwise deductible losses for the taxable year attributable to federally declared disasters occurring in 2008 or 2009, plus the allowable deduction for qualified disaster expenses under *IRC Section 198A* (discussed in § 1.05[5], below), or (2) the net operating loss for the taxable year. n230 The provision does not apply to golf courses, hot tub and sun tan facilities, gambling or animal racing property, or certain property used primarily for sale of alcoholic beverages. n231 In addition, a "farming loss" cannot be a qualified disaster loss. n232

A taxpayer may elect not to take advantage of the 5-year carryback period. The election must be made in the manner

prescribed by the Secretary and must be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss. Any election made for a taxable year is irrevocable. n233

[5] Deduction for Qualified Disaster Expenses

Taxpayers may elect to deduct qualified disaster expenses, effective for amounts paid or incurred after December 31, 2007 in connection with disasters declared after that date and occurring before 2010. n234 To be deductible the expenditure must meet the following requirements: n235

- it must be incurred in connection with a trade or business or with business-related property;
- it must be for (1) the abatement or control of hazardous substances that were released on account of a federally declared disaster; (2) the removal of debris from, or the demolition of structures on, real property which is business-related property damaged or destroyed as a result of a federally declared disaster; or (3) the repair of business-related property damaged as a result of a federally declared disaster; and
- it must otherwise chargeable to capital account.

Any deduction taken under *IRC Section 198A* is treated as a depreciation deduction which is recaptured in the case of a sale or other disposition of the property. n236 Other statutory provisions dealing with expensing of environmental remediation expenditures, n237 capitalization of demolition costs, n238 and certain mining and solid waste costs n239 do not apply to costs expensed under *IRC Section 198A*. n240

[6] Waiver of Certain Mortgage Revenue Bond Requirements for Principal Residences Destroyed in Disasters

A bond can qualify as a mortgage revenue bond only if at least 95 percent of its proceeds are used to finance residences of owners who did not own a home for three years before executing the mortgage. n241 Effective for disasters occurring after 2007, taxpayers may elect to waive this requirement if their principal residence is rendered unsafe as the result of a federally declared disaster occurring before January 1, 2010, or if the home is demolished or relocated as the result of an order of a state or local government in response to a federally declared disaster before that date. The waiver applies for the 2-year period beginning on the date of the disaster declaration. n242

Another requirement for mortgage revenue bonds is that the acquisition cost of each financed residence generally cannot exceed 90 percent of the average area purchase price applicable to that residence. n243 For residences destroyed as described in the above paragraph, this provision is applied using 110 percent, rather than 90 percent. n244 The increased percentage applies for the 2-year period beginning on the date of the disaster declaration. n245

In addition, at the election of the taxpayer, if the taxpayer's principal residence was damaged as the result of a federally declared disaster occurring before January 1, 2010, any owner-financing provided in connection with the repair or reconstruction of the residence--up to \$150,000--is treated as a qualified rehabilitation loan. n246

Any election under the above provisions cannot be revoked without IRS consent. n247 Taxpayers who make an election under the above provisions cannot also claim the benefits for residences in disaster areas provided by *IRC Section 143(k)(11)*. n248 Those benefits include a waiver of the 3-year prior ownership requirement n249 and the treatment of the home as a targeted area residence for purposes of applying the purchase price and income requirements n250 for two years after the date of the disaster declaration. n251

NOTE:

The citations given above to *IRC Section 143(k)(12)* are the citations added by Public Law 110-343. The provision added by Public Law 110-343, however, duplicates an existing *IRC Section 143(k)(12)*, which was not repealed. A future technical correction amendment to eliminate the unintended duplication is likely.

[7] 50-Percent First-Year Bonus Depreciation Allowed for Qualified Disaster Assistance Property

Additional 50-percent first-year bonus depreciation is allowed for qualified disaster assistance property in the year the property is placed in service. n252 The depreciation is available only for property that replaces or rehabilitates property that is destroyed or condemned in a disaster occurring in 2008 or 2009. n253 The deduction is allowed both for regular and AMT purposes. n254 The adjusted basis of the property is reduced by the amount of the deduction taken. n255 Details relating to the deduction can be found in Chapter 5, at § 5.02[12].

[8] Increased *IRC Section 179* Expensing Allowed for Qualified Disaster Assistance Property

The amount that can be expensed under *IRC Section 179* is increased by \$100,000 for qualified Section 179 disaster assistance property placed in service during a taxable year. n256 The phase-out threshold for reducing the amount that can be expensed with respect to qualified *IRC Section 179* disaster assistance property is increased by \$600,000. n257 Qualified *IRC Section 179* disaster assistance property is *IRC Section 179* property n258 that is also qualified disaster assistance property that is eligible for 50-percent additional first-year depreciation under *IRC Section 168(n)*. n259 Property for which this expensing is claimed cannot be treated as qualified zone property or qualified renewal property under *IRC Sections 1397A* and *1400J*. n260

FOOTNOTES:

(n1)Footnote 199. See § 1.04, above.

(n2)Footnote 200. *IRC § 165(h)(3)(C)(i)*. For disasters declared in tax years beginning before Jan 1, 2008, the term "Presidentially declared disaster" was used [see *IRC §§ 165(i)(4), 1033(h)(3), 7508A, before amendment* by Pub Law No 110-343].

(n3)Footnote 201. *IRC § 165(h)(3)(C)(ii)*.

(n4)Footnote 202. *IRC § 165(i)(1)*; see § 1.05[2], below, for a discussion.

(n5)Footnote 203. *IRC § 165(h)(3)*; see § 1.05[3], below, for a discussion.

(n6)Footnote 204. *IRC § 63(c)(1)(D)*.

(n7)Footnote 205. *IRC § 56(b)(1)(E)*.

(n8)Footnote 206. *IRC § 172(b)(1)(J), (j)*; see § 1.05[4], below, for a discussion.

(n9)Footnote 207. *IRC § 56(d)(3)*.

(n10)Footnote 208. *IRC § 198A*; see § 1.05[5], below, for a discussion.

(n11)Footnote 209. *IRC § 143(k)(12)*; see § 1.05[6], below, for a discussion.

(n12)Footnote 210. *IRC § 168(n)*; see § 1.05[7], below, for a discussion.

(n13)Footnote 211. *IRC § 179(e)*; see § 1.05[8], below, for a discussion.

- (n14)Footnote 212. See *IRC § 165(h)(3)(C)(ii)*.
- (n15)Footnote 213. *IRC § 165(i)(1)*. See *IRC § 165(h)(3)(C)(i)*.
- (n16)Footnote 214. *IRC § 165(i)(1)*.
- (n17)Footnote 215. See *IRC § 165(h)(2)(A)(ii)*, (3)(A); see [3], below, for a discussion.
- (n18)Footnote 216. *IRC § 165(h)(2)*.
- (n19)Footnote 217. *Treas Reg § 1.165-11(e)*.
- (n20)Footnote 218. *Treas Reg § 1.165-11(e)*.
- (n21)Footnote 219. See Ltr Rul 9752056 .
- (n22)Footnote 220. *IRC § 165(i)(3)*.
- (n23)Footnote 221. *IRC § 165(h)(2)(A)(ii)*.
- (n24)Footnote 222. *IRC § 165(h)(3)(A)*; see *IRC § 165(h)(2)(A)(ii)*.
- (n25)Footnote 223. *IRC § 165(h)(3)(B)*.
- (n26)Footnote 224. *IRC § 63(c)(1)(D)*, (c)(8).
- (n27)Footnote 225. *IRC § 56(b)(1)(E)*.
- (n28)Footnote 226. *IRC § 63(c)(8)*.
- (n29)Footnote 227. Pub Law No 110-343, § 706(d)(1).
- (n30)Footnote 228. *IRC § 172(b)(1)(J)*.
- (n31)Footnote 229. *IRC § 56(d)(3)*.
- (n32)Footnote 230. *IRC § 172(j)(1)*.
- (n33)Footnote 231. *IRC §§ 172(j)(4)*, 1400N(p)(3).
- (n34)Footnote 232. *IRC § 172(i)(1)*. See *IRC § 172(b)(1)(F)(ii)* (3-year carryback period for farming disaster losses).
- (n35)Footnote 233. *IRC § 172(j)(3)*.
- (n36)Footnote 234. *IRC § 198A(a)*.
- (n37)Footnote 235. *IRC § 198A(b)*.
- (n38)Footnote 236. *IRC § 198A(d)*; see *IRC § 1245*.
- (n39)Footnote 237. See *IRC § 198*.
- (n40)Footnote 238. See *IRC § 280B*.

(n41)Footnote 239. See *IRC* § 468.

(n42)Footnote 240. *IRC* § 198A(e).

(n43)Footnote 241. *IRC* § 143(d)(1).

(n44)Footnote 242. Treasury Regulation Section 301.9100.

(n45)Footnote 243. *IRC* § 143(e)(1).

(n46)Footnote 244. *IRC* § 143(k)(12)(A).

(n47)Footnote 245. *IRC* § 143(k)(12)(A).

(n48)Footnote 246. *IRC* § 143(k)(12)(B)(i), (ii).

(n49)Footnote 247. *IRC* § 143(k)(12)(D)(i).

(n50)Footnote 248. *IRC* § 143(k)(12)(D)(ii).

(n51)Footnote 249. See *IRC* § 143(d).

(n52)Footnote 250. See *IRC* § 143(e), (f).

(n53)Footnote 251. *IRC* § 143(k)(11).

(n54)Footnote 252. *IRC* 168(n)(1)(A), effective for property placed in service after Dec 31, 2007, with respect to disasters declared after that date.

(n55)Footnote 253. *IRC* § 168(n)(2)(A)(ii)(I).

(n56)Footnote 254. *IRC* § 168(n)(2)(D); see *IRC* § 168(k)(2)(G).

(n57)Footnote 255. *IRC* § 168(n)(1)(B).

(n58)Footnote 256. *IRC* § 179(e)(1)(A).

(n59)Footnote 257. *IRC* § 179(e)(1)(B).

(n60)Footnote 258. See *IRC* § 179(d).

(n61)Footnote 259. *IRC* § 179(e)(2). See Chapter 5, at § 5.02[12], for a detailed discussion of *IRC* § 168(n).

(n62)Footnote 260. *IRC* § 179(e)(3).



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CHAPTER 2 Acquisition of Real Estate *

1-2 Federal Taxes Affecting Real Estate 2.syn

§ 2.syn Synopsis to Chapter 2: Acquisition of Real Estate *

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[2] Effect of Debt Financing

[a] Concept of "Leverage"

[b] Inclusion of Mortgages, Liens and Other Related Obligations in Basis

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[b] Valuations

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CHAPTER 2 Acquisition of Real Estate *

1-2 Federal Taxes Affecting Real Estate § 2.01

§ 2.01 Tax Planning in Connection with the Acquisition of Real Property

Once the decision is made to acquire specific real property and consideration is given both to the future impact of the passive activity loss rules (if any) and the type of entity that will be used for holding the property, the prospective owner will need to consider the best method for arranging the acquisition so as to obtain maximum tax benefits. The prospective owner should first consider the three classes of costs relevant to the acquisition of real property:

- (1) costs that may be deducted as expenses in the year of expenditure; n1
- (2) costs that must be capitalized n2 and may be periodically deducted (e.g., via cost recovery n3 or amortization), n4 generally over an arbitrarily-predetermined period provided by the Code; and
- (3) costs that must be capitalized, may not be deducted periodically, but may later be used as an offset against amounts realized on the eventual disposition of the property, and which either increase the tax loss or decrease the taxable gain recognizable upon a taxable disposition of the property.

Costs that must be capitalized and are associated either with land or improvements to real property create what is called "basis." See § 2.02 for a discussion of basis and § 2.03 for a discussion of typical acquisition costs that must be capitalized and included in basis.

FOOTNOTES:

(n1)Footnote 1. See, eg, §§ 4.03 or 12.05.

(n2)Footnote 2. See *IRC* § 263(a)(1).

(n3)Footnote 3. See Chapter 5.

(n4)Footnote 4. See, eg, *IRC* § 178 or loan costs discussed in Chapter 12.

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CHAPTER 2 Acquisition of Real Estate *

1-2 Federal Taxes Affecting Real Estate § 2.02

§ 2.02 Basis of Property upon Acquisition

"Basis" is the amount, expressed in dollars, used to represent the capital investment of a taxpayer in property for purposes of income taxation. n5 The determination of basis is a necessary first step in the determination of the tax consequences of a proposed real estate investment. Gain on the sale or other disposition of property is measured by the amount by which the amount realized *exceeds* basis, since it is fundamental principle of taxation that only income (i.e., an increase in wealth) is subject to Federal income tax; the return of capital is not. n6 Conversely, where the amount realized is less than basis, a loss is sustained. Similarly, depreciation deductions also are determined with reference to basis; only the basis of depreciable property may be recovered through depreciation deductions. n7

The basis of property at the time of acquisition is known as "unadjusted basis," and every item of property initially has its own unadjusted basis. The manner in which a taxpayer acquires property determines the unadjusted basis of that property. As discussed below, unadjusted basis is generally the original cost of the property, n8 but this rule varies where the owner acquires the property other than by purchase. n9 "Adjusted basis" is the unadjusted basis of property increased or decreased for certain adjustments made after acquisition, such as for depreciation, amortization, obsolescence, capital additions, etc. n10 These adjustments are discussed in Chapter 5. Following conventional terminology, when the term "basis" is used here, it will refer to unadjusted basis, and adjusted basis will be identified as such.

Planning Tip:

Real estate acquisitions frequently include the acquisition of ancillary personal property, such as machinery, furniture, office equipment and the like. Separate values must be assigned to such property in order to determine its initial basis in the hands of the purchaser for purposes of cost recovery deductions (when available) under *IRC Section 168*, and for calculation of gain or loss in the future. It is often easy to forget this important step since the bulk of the acquisition consists generally of the real property and improvements. n11

Specific rules are provided by the Code for determining basis when property is acquired by gift, n12 inheritance, n13 tax-free exchange n14 or involuntary conversion. n15 In order to determine basis, therefore, it is necessary to determine *how* the property was acquired. In addition, in certain circumstances, it also is important to determine *when* the property was acquired.

[1] Property Acquired by Purchase

The basis of property obtained by purchase is its cost, namely, the price paid in cash or other property (determined by reference to the fair market value of the other property), plus any acquisition expenses. However, the total amount paid at the time of purchase or closing is often not entirely included in the basis of the property, since certain items paid by or charged to the purchaser may be treated as deductible or nondeductible expenses and are not added to initial basis (e.g., real estate taxes treated as imposed on the purchaser).ⁿ¹⁶ In addition, certain costs may relate to acquisition loans necessary to buy the property; these costs are treated as related to amounts *borrowed* and are not included in the basis of the property. Instead of being added to basis, these amounts are amortized over the term of the loan.ⁿ¹⁷

It is generally necessary to prorate certain items, between the buyer and the seller as of the closing date. These items include, for example, real estate taxes, unexpired real property insurance, and prepaid fuel costs, none of which are included in the basis of the property purchased. The allocation of these items generally is set forth in a "closing" or "settlement" statement. Only the portion of deductible expenses allocated to each party is deductible by that party, even though one party may pay the entire expense for both. Any excess over the allocated amount is an adjustment to the purchase price. For example, if the seller has paid property taxes for a period that extends beyond the closing date, only the portion allocable to the period before the closing is deductible by the seller; the portion allocable to the period after the closing is allocable to and deductible by the purchaser. Conversely, if the purchase agreement requires the purchaser to pay tax applicable to the pre-sale period, this amount is treated as an increase to the amount realized by the seller (generally subject to an offsetting deduction for taxes paid), is included in the capitalized cost of the property to the purchaser, and is added to basis.ⁿ¹⁸⁻¹⁹ Typical acquisition costs that are included in the capitalized cost of real property are discussed in § 2.03, below.

[2] Effect of Debt Financing

Real estate in the United States is often acquired through the use of borrowed funds, typically resulting in the grant of a security interest to the lender in the form of a mortgage or deed of trust. Such financing may be obtained by the purchaser from a third party lender, may be taken back by the seller, or may already exist with respect to the property and may be assumed or taken subject to by the purchaser (e.g., financing obtained by the seller when it bought the property). Sometimes existing debt that encumbers the property is not assumed, but instead the new owner will acquire that property "subject to" the mortgage or deed of trust lien securing the antecedent debt. This simply means that if the existing secured debt is not repaid according to its terms, the lender may be able to exercise remedies of foreclosure granted in the security agreement. While the terminology pertaining to real estate loans varies among states, the term "mortgagee" is generally used here to describe the secured lender.

[a] Concept of "Leverage"

"Leverage," though a popular word among real estate buyers, is a concept often misunderstood and misapplied. Leverage is the increased purchasing power obtained by combining the purchaser's own funds (known as "equity") with borrowed funds. If the total return from the property acquired with borrowed funds (i.e., net income before interest, and any appreciation in the value of the property) is *greater* than the cost of the borrowed funds (i.e., the interest payments on the debt), then the leverage provided by the debt financing allows a greater return on the purchaser's capital than if the property were acquired solely with equity. Further, and equally important, the use of leverage enables purchasers to acquire properties costing more than the amount of their available equity. As is discussed below, however, leverage can also increase a property owner's loss, if the property declines in value.

Real estate offers an opportunity for greater use of borrowed funds than many other types of investment. For example, stock margin requirements may permit an investor to borrow only 50 percent of the funds required to purchase securities.ⁿ²⁰ By contrast, buyers of real estate have traditionally been able to borrow up to 80 or 90 percent of the purchase price using a combination of:

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- (1) first mortgage financing from banks, savings and loans or other "institutional" lending sources;
- (2) additional "junior" (i.e., secondary) financing; or
- (3) purchase money financing provided by sellers.

While the opportunity to borrow this high a percentage of the purchase price has disappeared somewhat since the savings and loan crisis of the early 1990s, single family home purchasers are still able to utilize high degrees of leverage. The effect of leverage is illustrated by the following example comparing a purchase with only equity and one using "4 to 1" leverage, i.e., \$4 of borrowed funds for each \$1 of equity:

Example:

	Without Leverage	With Leverage
	_____	_____
Purchase price of land	\$100,000	\$100,000
Amount invested	100,000	\$ 20,000
Amount borrowed	--	\$ 80,000
Selling price after three years	\$140,000	\$140,000
Mortgage satisfied	--	(80,000)
Balance	\$140,000	\$ 60,000
Interest cost for three years at 10 per- cent	--	(\$24,000)
Net cash to investor	\$140,000	\$ 36,000
Original investment	\$100,000	\$ 20,000
Cash Profit	\$ 40,000	\$ 16,000
Return on equity		
investment before tax	40%	80%

In this scenario, the investor realizes a profit on both the \$20,000 it invested, and a profit created by the leverage on the \$80,000 that was borrowed.

The benefit of leverage on borrowed funds may be even greater because of tax benefits created by being able to deduct interest expense against income otherwise taxed at ordinary income rates. ⁿ²¹ To again use the example above, assume that an individual taxpayer in a 35-percent tax bracket ⁿ²² claims a tax deduction for the interest expense of \$24,000. Also assume that this interest is fully deductible and not limited by the passive activity loss ⁿ²³ or other rules. ⁿ²⁴ The calculated return on its investment (before calculating the tax on the profit) increases from 80 percent to 120 percent (!), computed as follows:

Selling price	\$.....140, 000
Mortgage satisfied	(80,000)

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Balance	\$.....	60,000
Interest paid for three years	\$24,000	
Income tax savings by deducting interest at a 35% tax rate	\$8,400	
Net after tax carrying cost		(\$15,600)
Net to cash owner before tax on profit	\$.....	44,000
Original investment		20,000
Cash profit		\$
		24,000
Return on investment before tax on profit		120%

The example shows the power of leverage when property values increase, but what happens when this doesn't occur? As many real estate investors found out during the late 1980s and early 1990s, leverage creates problems, rather than profits, when property value growth does not surpass the costs of debt service and other carrying costs. If the cost to carry the debt (i.e., mortgage interest) plus property taxes, upkeep, etc., exceeds the increase in value and the income derived from the property, the owner loses money and realizes "reverse leverage." In the above example, if the property's rise in value to \$140,000 took nine years rather than three, the loan interest costs of \$72,000 eliminate any profit—even taking into account the tax savings from the interest expense. Stated differently, appreciation in value would have failed to exceed the cost to carry the loan. Rather than making a \$40,000 profit on a \$100,000 investment, the owner would suffer a complete loss of its \$20,000 equity investment, as shown below:

Selling price of land	\$.....	140,000
Purchase price		100,000

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Gain		\$
		40,000
		0
Cost to carry the property--interest for nine years	\$72,000	
Less--Income tax savings from deducting interest cost at 35% tax rate	25,200	(\$46,800)
Net cash to owner		(\$6,800)

Additional factors that generally must be taken into account when considering the effect of leverage include: (1) rental income from the property; and (2) non-interest expenses of ownership and maintenance. For improved property, another element must be considered--depreciation. Under *IRC Section 168*, depreciation is deductible in computing taxable income. In claiming depreciation deductions, the purchaser of real estate is free to depreciate not only that portion of the property purchased with its own funds, but also the portion of the property obtained through mortgage lending. Through careful planning, the combination of leverage and the deduction of carrying costs and depreciation can make the rate of return on improved property an attractive investment from the standpoint of both rental-income realization and eventual disposition of the property. See Chapters 4 and 5 for further discussion of the tax aspects of these factors.

Where leverage is used, however, a careful review of the anticipated carrying costs must be made. The most important factors to be considered include:

- the down payment required by the lender;
- the rate of interest and other terms of the debt obligations;
- the anticipated rate of growth in the value of the property;
- the anticipated length of time the investment will be held; and
- the anticipated rental income from the property.

The significant difference between the 20 percent maximum capital gains tax rate generally applicable to non-corporate taxpayers n25 and the maximum tax rate on ordinary income of non-corporate taxpayers n26 should also be factored into the above example to determine the return on real estate ownership where the purchase is leveraged.

It should also be noted that the illustrations above, depicting the results of leverage, did not consider the effects of deduction limitations, such as the limitations on the interest expense deduction under Section 163 and the passive loss rules of Section 469. These two sections are discussed in Chapters 4 and 13, respectively. For some taxpayers, particularly those whose incomes are below the maximum income tax rates and who manage their own rental properties, these provisions will have no effect, while for others they may result in reduced tax benefits or even adverse tax consequences from leveraging of a real estate investment.

[b] Inclusion of Mortgages, Liens and Other Related Obligations in Basis

[i] General Rule

Leverage has an effect on basis. When real property is acquired with borrowed funds and the purchaser is *personally* liable to repay the loan, the purchaser's basis is the price of the property, which includes the amount of the debt. The liability for which the purchaser is personally liable is said to be "recourse." In the event of a default by the purchaser on the mortgage loan, the borrower's personal assets (in addition to the collateral) can generally be seized to cover the debt. n27

For example, if a purchaser agrees to pay \$50,000 for property, and utilizes \$10,000 in cash and the proceeds from a \$40,000 bank loan secured by a mortgage on the land, the basis of the land is \$50,000. If the purchaser assumes liability for an existing mortgage rather than obtaining new financing to replace the existing loan, the amount of debt assumed is included in the seller's amount realized, and logically should be included in the purchaser's cost basis. n28 This will also be true if the loan is made by the seller of property (i.e., a purchase money mortgage), and the buyer is personally liable to repay the debt regardless of the value of the property. *In short, the existence of personal liability justifies the inclusion of the full amount of the debt in the purchaser's cost basis.*

[ii] Non-Recourse Debt

If the purchaser is not personally liable to repay funds borrowed to acquire property, the situation is different. If the property declines in value below the amount of the debt, the borrower may refuse to repay the loan, and the lender's only remedy is to foreclose on the lender's security interest in the property. Questions may be raised about whether the full amount of such a "non recourse" debt should be included in basis, since the borrower will have an incentive to repay the loan only if it has an equity interest in the mortgaged property. If the property's value declines below the amount of the loan, the owner will have no equity; and unless future appreciation is expected or there is current net rental income, the owner has little incentive to repay the loan. As a result, a continuing dispute has developed over whether and under what circumstances non-recourse debt should be treated in the same manner as recourse debt and be included in a purchaser's basis.

A taxpayer who sells property encumbered by a nonrecourse mortgage may include that mortgage in the basis of property and must include the remaining amount of unpaid debt in the amount realized. This rule applies whether the mortgage is less than n29 or greater than n30 the value of the property and applies whether the seller acquired the property by purchase, by gift, from a decedent or otherwise.

Examples of this type of indebtedness include loans which are:

- (1) contractually non-recourse;
- (2) purchase money mortgages in certain states;
- (3) existing mortgages on acquired property that are not assumed by purchasers;
- (4) tax liens; and
- (5) contractors' liens.

In addition to the general rules for establishing basis discussed above, the at-risk rules also limit the deductibility of losses in connection with real estate. Under these provisions, certain non-recourse debt does not contribute toward "basis" for purposes of the at-risk rules, n31 but it does provide cost basis. See 12 CFR Part 220 for further information.

[iii] Contingent or Uncertain Debt

In certain rare situations, the purchaser of real estate is not allowed to include the amount of any lien or obligation in determining basis if it is so contingent or indefinite that either the amount or the very existence of the debt cannot be determined with certainty. Only when and if the contingency is eliminated will an adjustment be appropriate. n32

[iv] Effect of Debt that Exceeds Value on Acquisition

Debt may also be excluded from the basis of property when the debt is greater than the fair market value of the property at the time the property is acquired or when the debt-financed transaction is held to be a sham. n33 This prevents the abusive artificial inflating of basis on which depreciation and other deductions are based.

[v] Effect of Subsequent Financing on Basis

The mortgaging of property *after* acquisition has no effect on the tax basis of the property. n34 However, the amount of the subsequent mortgage will be taken into account in determining gain if the property is sold subject to that mortgage.

[c] Effect of Reduction of Indebtedness

Circumstances can arise in which indebtedness on real estate is satisfied at less than its full principal amount. For example, where a seller take back a purchase money mortgage, a dispute about the seller's representations and warranties may be settled by a reduction in the purchase money note due to the seller. Alternatively, a lender having a long term business relationship with a borrower may be willing to reduce its mortgage on a troubled property because of an expectation that over the long term, the relationship will remain profitable. Either event can have tax consequences.

[i] Subsequent Reduction of Purchase Money Debt

Sometimes a purchase money mortgage on property (i.e., a mortgage held by the seller) is reduced, or satisfied at less than the face value of the debt. When a purchase money mortgage of a solvent purchaser is reduced or satisfied at less than face value, no cancellation of indebtedness income or gain is recognized at that time by the purchaser. Rather, the debt reduction is treated as a purchase price adjustment. This has the effect of reducing the basis of the property in the hands of the purchaser by the amount of the debt reduction. n35 This result occurs only if the reduction in the purchase-money debt does not occur in a Title 11 case or when the purchaser is insolvent. n36

[ii] Adjustment for Debt Reductions of Non-Purchase Money Debt

Whenever a taxpayer is able to exclude income from a discharge in indebtedness from gross income under *IRC Section 108(a)*, a basis adjustment usually comes into play. The provisions that are used to apply the basis adjustment and the ordering in which the basis adjustment occurs vary, depending on the particular type of exclusion that is involved.

In the case of discharges of indebtedness in Title 11 or insolvency cases, or discharges of qualified farm indebtedness, a reduction of basis is one of several tax attributes that must be reduced. n37 Unless a taxpayer makes an election discussed below, n38 the reduction in tax attributes for these exclusions is done in a specified order. Under the default ordering of the statute, a reduction in the basis of the depreciable and non-depreciable property of the taxpayer occurs after a reduction in the taxpayer's NOLs, general business credit, minimum tax credit, and capital loss carryovers, and before a reduction in the taxpayer's passive activity loss and credit carryovers and foreign tax credit carryovers. n39

A taxpayer may, however, make an election in Title 11 or insolvency cases, or in discharges of qualified farm indebtedness, to alter the default statutory ordering of the reduction of tax attributes. If the election is made, a taxpayer may apply any portion of the reduction of tax attributes to first reduce the basis of the taxpayer's depreciable property. The election cannot be used to reduce the basis of non-depreciable property. n40 The election is made by filing a completed Form 982. The election must be attached to a timely-filed (including extensions) federal income tax return

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for the year in which the taxpayer has discharge of indebtedness income that is excluded from gross income under *IRC Section 108*. Any election may be revoked only with IRS consent. n41 If an election is not timely filed, a taxpayer may nevertheless request IRS consent to file a late election under Treasury Regulation Section 301.9100. The reduction in the basis of depreciable property is applied to the basis of depreciable property held by the taxpayer at the beginning of the tax year following the tax year in which the discharge occurs, in accordance with *IRC Section 1017*. n42 See § 12.10[6][d], below, for a discussion of *IRC Section 1017* basis reductions.

Different rules apply when a taxpayer excludes gross income from discharges of qualified real property indebtedness. n43 In this case, the basis of a taxpayer's depreciable property must be reduced by the amount excluded from gross income. The reduction is done in accordance with *IRC Section 1017*, n44 and is applied to the basis of depreciable property held by the taxpayer at the beginning of the tax year following the tax year in which the discharge occurs. n45 There are no other reductions of tax attributes applied for this type of indebtedness discharge. n46 See § 12.10[7][c], below, for a discussion.

Separate rules also apply when a taxpayer excludes income from the discharge of qualified principal residence indebtedness. n47 In these cases, the basis of the individual's principal residence must be reduced (but not below zero) by the amount excluded from gross income. n47.1 There are no other reductions of tax attributes applied for this type of indebtedness discharge. n47.2

[3] Property Acquired by Gift

The donee (recipient) of property acquired by gift takes the donor's adjusted basis as its basis (this is known as "carryover" basis), although for purposes of determining loss on a subsequent disposition of the property by the donee, basis is limited to the fair market value of the property on the date of the transfer.

Example:

"Father" has property for which he originally paid \$100. Depreciation of \$20 has been deducted, leaving an adjusted basis of \$80. At that time, he gifts the property to "Son". Son's basis is \$80 (although there are potential exceptions to this rule). If the property is subsequently sold at a profit, Son's basis for determining gain is \$80. If the property is subsequently sold at a loss, Son's basis for purposes of computing the loss is the lesser of: (1) Father's basis; or (2) the fair market value at the time of the gift. n48 An example of this computation follows:

	Gain on Sale	Loss on Sale	Neither Gain nor Loss
Property at date of gift--basis to father (donor)	\$ 80	\$ 80	\$ 80
Fair market value	\$ 70	\$ 70	\$ 70
Computation of gain (loss)--			
Selling price	\$100	\$ 65	\$ 75
Basis	80	70	80-70

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Taxable gain (loss) to Son (donee)	\$ 20	\$ (5)	\$ --

As the third column demonstrates, there is no gain or loss recognized to a donee who sells property acquired by gift if the selling price falls between the basis to the donor and the fair market value of the property at the date of the gift.

"Fair market value" is the value at which the property gifted is appraised for purposes of the federal gift tax or, if no federal gift tax is imposed, the appraisal value for state gift tax purposes. n49 If neither tax is imposed, the fair market value of the property generally may be difficult to determine. Unless an appraisal was obtained at the time of the gift, the value of the property must be determined well after acquisition and often with inadequate information.

Proving that an asserted fair market value is correct is generally the responsibility of the taxpayer, although, as a result of the *IRS Restructuring and Reform Act of 1998*, the burden of proof will be on the IRS if the taxpayer has complied with substantiation and record-keeping requirements, presents credible evidence, and cooperated with the IRS in any audit and, if applicable, meets the net worth requirements applicable to the awarding of attorneys fees. n50 This provision is applicable to audits (or if there is no audit, court proceedings) commencing after July 22, 1998. Credible evidence will likely include an independent appraisal of the property as of the date of the gift, or evidence of the selling prices of similar properties (known as "comparables") located in the general vicinity of the gifted property and occurring at or near the date of the gift. Although other probative means may be employed, these two methods are those generally used in determining fair market value for gift tax purposes. n51

The basis of property acquired by gift may be increased in whole or in part by the amount of federal gift tax paid with respect to such gift, but not to an amount in excess of fair market value at the time of the gift. For gifts made after 1976, the increase in a donee's basis is limited to the amount of gift tax attributable to the "net appreciation" on the gift. n52 Net appreciation is defined as the amount by which the fair market value immediately before the gift exceeds the donor's adjusted basis. n53 As a result, the increase in the donee's basis with respect to gift tax paid by the donor is equal to the ratio of the net appreciation in the gifted property to the total fair market value of the property, multiplied by the amount of tax paid.

Example:

If A gifts to B in 1995 undeveloped land with a fair market value of \$15,000 for which A paid \$10,000 many years ago, the net appreciation in the value of the property is \$5,000. Assume that A paid a gift tax of \$2,700 on the transfer. B's unadjusted basis in the property would be A's basis of \$10,000, plus the gift tax attributable to the net appreciation, computed as follows:

Net appreciation

_____ x gift tax = basis increase

Fair market value

\$5,000

_____ x \$2700 = \$900

\$15,000

Therefore, B's unadjusted basis would be \$10,900.

For gifts made prior to 1977, although the proration is not required, basis still cannot be increased to an amount in excess of fair market value at the time of the gift. n54

Thorough planning in making gifts is important. For example, a donor who is considering making a gift of one of two properties with comparable fair market values but significantly different adjusted bases must analyze the basis implications of the selection. Gifting the property that has undergone greater appreciation will allow the donee to increase its basis by a larger percentage of the gift tax paid, but retaining the other property (i.e., the higher basis property) will reduce the potential benefit of the basis increase at death that would otherwise be available. n55 In each case, the basis increase after the gift or after death will reduce taxable gain on a subsequent sale by the transferee. Stating this another way, a donor may achieve a greater immediate tax advantage for its donee by gifting low-basis, rather than high-basis, property if a gift tax is paid with respect to the gift, because the donee's basis for the gifted property will increase by a larger percentage of the gift tax paid.

A technique that is frequently used to transfer highly-appreciated real property is the "net gift". This type of transfer requires the donee/recipient to pay the gift tax that would have been paid by the donor. The donor does not realize income or a taxable gain when the donee pays the gift tax, unless the gift taxes paid by the donee exceed the donor's adjusted basis in the property. n56

Donors generally have many varying motives, other than taxes, for transferring property. These include, among others:

- (1) witnessing firsthand the satisfaction a loved one receives when enjoying a gift;
- (2) altruism;
- (3) a desire to reduce the confusion that may arise after death if property is then distributed;
- (4) a desire to manipulate the donor to act (or not act) in a certain fashion.

All of these factors, together with the tax ramifications, should be considered carefully before making any transfers of property.

[4] Bargain Sales

A special problem arises when a transfer of property is treated partly as a sale and partly as a gift. This situation usually occurs when there is a "bargain" sale between two parties who have a sufficient affiliation or relationship to suggest a donative intent in conjunction with a desire for a sale. In such cases, the transferee's unadjusted basis in the property is the greater of: (1) the amount paid; or (2) the transferor's adjusted basis at the time of the transfer. n57 As in the case of the "ordinary" gift discussed above (and subject to the same limitations), the transferee's basis may be increased for any federal gift tax attributable to net appreciation of the property. n58 A special rule applies to part sale/part gift transactions involving charitable transferees. n59

Example (1):

A sells property to B for \$30,000, a bargain price with a gift intended. Assume A's basis in the property

is \$90,000, and the fair market value is \$60,000. Assume that no gift tax is currently payable because A has not used up its unified credits. n60 B's unadjusted basis will be \$90,000 for all purposes except for determining a loss on a subsequent sale, in which case B's unadjusted basis will be \$60,000. n61

Example (2):

If A transfers property to his son in a bargain sale transaction for \$30,000, and at the time of the transfer, the property has an adjusted basis of \$30,000 in A's hands (and a fair market value of \$60,000). Assume that no gift tax is payable on the transfer. The unadjusted basis of the property in the hands of the son is \$30,000. n62

Example (3):

On the same assumption, A transfers property to his son for \$60,000, and the property at the time of the transfer has an adjusted basis of \$30,000 in A's hands (and a fair market value of \$90,000), the unadjusted basis of such property in the hands of the son is \$60,000. n63

Example (4):

On the same assumption, A transfers property to his son for \$30,000, and the property at the time of the transfer has an adjusted basis in A's hands of \$60,000 (and a fair market value of \$90,000), the unadjusted basis of such property in the hands of the son is \$60,000. n64

[5] Property Acquired on Transfer in Trust

The basis of property acquired by a transfer in trust (other than by a transfer in trust by gift, bequest or devise) is the same as it would be in the hands of the grantor. However, the transferee's basis is increased in the amount of any gain, or decreased in the amount of any loss, recognized by the grantor on the transfer. n65 (The basis of property acquired by a transfer in trust by gift is determined according to the rules described above relating to gifts; and the basis for property acquired in trust by bequest or devise is similarly determined according to the rules pertaining to the basis of property acquired from a decedent, as described below.) If a taxpayer acquires property by a transfer in trust, the basis is that of the grantor, adjusted for gain or loss, regardless of whether the property is in the hands of a trustee or a beneficiary of the trust, and regardless of whether the property is acquired before or after the termination of the trust and distribution of its property. n66

If property acquired by trust consists of an investment made by a fiduciary (such as a trustee), the cost or other basis in the hands of the fiduciary is used. n67 For example, assume Grantor transfers Property 1 to a trust, and the trustee sells the property for \$100,000. The trustee reinvests the proceeds in Property 2. The basis of Property 2 is its cost of \$100,000, and the basis of Property 1 in the hands of the Grantor is not relevant to the calculation of Property 2's basis.

[6] Property Acquired from a Decedent**[a] Generally****Note:**

For decedents dying after 2009, after repeal of the estate and generation-skipping transfer taxes, the existing rules providing for a fair market value (i.e., stepped-up) basis for property acquired from a decedent are repealed. n68

For decedents dying after 2009, a modified carryover basis regime generally applies, under which

recipients of property transferred at the decedent's death receive a basis equal to the lesser of the adjusted basis of the decedent in the property or the fair market value of the property on the date of the decedent's death. n69

For a decedent dying before 2010, the basis of property acquired from a decedent by bequest, devise or inheritance is the fair market value of the property at the time of the decedent's death n70 or at the alternate valuation date, if such date is properly elected for estate tax purposes. n71 The alternate valuation is the fair market value of the decedent's property six months after the date of death, or at the date of disposition of the property (if earlier). The election is intended to afford limited tax relief to estates that have experienced a decline in the value of assets during the six-month period. n72 Property acquired from a decedent includes, principally, property acquired by bequest, devise or inheritance, and property acquired by reason of death which is includible in determining the value of the decedent's gross estate, n73 whether or not an estate tax return is required. n74 Property acquired from a decedent that is specially valued under *IRC Section 2032A* (certain family farm property) must be valued at its special use value as determined under that section. n75 Property acquired from a decedent has a carryover basis to the extent of the applicability of the estate tax exclusion for property subject to a qualified conservation easement. n76

[b] Valuations

The value assigned to the property for purposes of the federal estate tax is the property's fair market value. n77 However, this value is only prima facie evidence in determining the basis of property acquired from a decedent. n78 If no federal estate tax return is required to be filed, the fair market value generally is considered to be the appraised value of the property at the date of death that was used for probate purposes or in filing the state inheritance tax return. No alternate valuation date is available. n79

[c] Community Property and Joint Tenancy

For a decedent dying before 2010, n80 if property was held by a decedent and surviving spouse as community property, then the *surviving spouse's* one-half share in the property is considered as having been acquired by the surviving spouse from the decedent. The basis of that one-half share is stepped up to fair market value at the time of the decedent's death), but only if at least one-half of the whole community interest in the property is includable in determining the value of the decedent's gross estate for federal estate tax purposes or, if no return is required, would be includible if a return were required. n81 Thus, if at least one-half of the value of the community property of a decedent and surviving spouse is includable in the decedent's gross estate, the basis of *both* the decedent's portion and the surviving spouse's portion is stepped up to the fair market value at the date of death (or alternate valuation date). n82

For this treatment to apply, the property must be held as community property at the time of the decedent-spouse's death. n83 Property once held as community property but later converted to separately-owned property prior to the death of the decedent-spouse is not considered community property for purposes of the rule. n84

The stepped-up basis rule does not apply where the decedent and surviving spouse held property as joint tenants with right of survivorship, or as tenants by the entirety. In such circumstances, only the basis of the *decedent's* one-half interest that is included in the decedent's estate tax return is stepped up. The basis of the surviving spouse's interest, which is not included in the decedent's estate, is not. n85

Whether or not property constitutes community property is determined in accordance with state law, and such characterization controls whether or not the decedent and surviving spouse treated the property as community property prior to the decedent's death. n86

Planning Tip:

The difference between basis adjustments applicable to community property, on the one hand, and joint tenancy property and tenancy by the entirety property, on the other, following the death of a spouse makes choosing between the two forms of ownership--in those jurisdictions in which a choice is possible--an important decision. n87

[d] Property Acquired Before Decedent's Death

Property is considered to be "acquired from a decedent" if, by reason of death, form of ownership or other conditions, the value of the property must be included in the decedent's gross estate for estate tax purposes. n88 Subject to certain exceptions, gifts made within three years of death are not included in the decedent's estate. The exceptions that will cause property transferred within three years of the decedent's death to be included in the gross estate include:

- the transferor retains a life estate in the transferred property;
- the transfer takes effect only upon the transferor's death;
- the transfer is revocable; or
- the transfer creates a power of appointment. n89

The basis of property acquired by a taxpayer prior to the decedent's death and that is deemed to be property "acquired from a decedent" must be adjusted for depreciation, obsolescence, amortization and depletion deductions actually allowed the taxpayer during the period before the decedent's death. Thus, the adjusted basis in the hands of the taxpayer is the property's fair market value at the decedent's death, or the applicable alternate valuation date, less the amount allowed to the taxpayer as deductions for the period the property is held by the taxpayer prior to the decedent's death. n90

[e] Multiple Interests Transferred at Death

The basis of property acquired from a decedent is the same whether the property is possessed by an executor, administrator, heir, trustee or trust beneficiary. n91 This is known as the "principle of uniform basis". The principle provides that the basis of property acquired from a decedent is its value at the date of death (or alternate valuation date), no matter when the subject property is eventually distributed. When more than one person has an interest in property acquired from a decedent (for example, a life tenant and a remainderman), the basis of the entire property must be determined without regard to the multiple interests. n92 The basis of the entire property is then allocated to the various interests in the manner provided in the Code and Regulations. The disposition by a life tenant or a remainderman of his interest will have no effect on the uniform basis of property in the hands of those who acquire the property from the decedent. n93

When an interest in property (such as a life estate) is acquired by gift or through a decedent's will, the taxpayers must use tables provided by the Service to determine the value of the gift, bequest or devise. The tables are based on mortality rates. n94 This subject is dealt with more fully in section 2.03[2].

[f] Basis Rules for Property Received From Decedents Dying After 2009

For decedents dying after 2009, a modified carryover basis regime generally applies, under which recipients of property transferred at the decedent's death receive a basis equal to the lesser of the adjusted basis of the decedent in the property or the fair market value of the property on the date of the decedent's death. n95 There is a generous exception to the carryover basis rules for certain property. Each decedent's estate generally is permitted to increase (i.e., step up) the basis of assets transferred by up to a total of \$1.3 million. n96 The \$1.3 million is increased by the amount of unused

capital losses, net operating losses, and certain "built-in" losses of the decedent. n97 In addition, the basis of property transferred to a surviving spouse can be increased by an additional \$3 million. Thus, the basis of property transferred to a surviving spouse can be increased by a total of \$4.3 million. n98 Nonresidents who are not U.S. citizens will be allowed to increase the basis of property by up to \$60,000, but may not increase that amount by any losses. n99 The \$60,000, \$1.3 million, and \$3 million amounts are adjusted annually for inflation after 2010. n100

In general, the basis of property may be increased above the decedent's adjusted basis in that property only if the property is owned, or is treated as owned, by the decedent at the time of the decedent's death. n101 In the case of property held as joint tenants or tenants by the entireties with the surviving spouse, one-half of the property is treated as having been owned by the decedent and is eligible for the basis increase. n102 In the case of property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished is treated as having been owned by the decedent and will be eligible for a basis increase. n103 The decedent also is treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent before death to a revocable trust that pays all of its income during the decedent's life to the decedent or at the direction of the decedent. n104 The decedent is not, however, treated as owning any property solely by reason of holding a power of appointment with respect to that property. n105

The decedent also is treated as having owned the surviving spouse's one-half share of community property (which will be eligible for a basis increase) if at least one-half of the property was owned by, and acquired from, the decedent. n106 Thus, similar to the present law rule, n107 both the decedent's and the surviving spouse's share of community property could be eligible for a basis increase. n108

Property not eligible for a basis increase includes the following:

- Property that was acquired by the decedent by gift or inter vivos transfer (other than from his or her spouse) during the three-year period ending on the date of the decedent's death; n109
- Property that constitutes a right to receive income in respect of a decedent; n110
- Stock or securities of a foreign personal holding company death; n111
- Stock of a domestic international sales corporation (or former domestic international sales corporation) death; n112
- Stock of a foreign investment company; n113 and
- Stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election). n114

Basis increase is allocable on an asset-by-asset basis (e.g., basis increase can be allocated to a share of stock or a block of stock). However, in no case can the basis of an asset be adjusted above its fair market value in the decedent's hands as of the date of the decedent's death. n115 If the amount of basis increase is less than the fair market value of assets whose bases are eligible to be increased under these rules, the executor may determine which assets and to what extent each asset receives a basis increase. n116

Any liabilities in excess of the decedent's basis in property are disregarded in determining whether gain is recognized on the acquisition of that property from a decedent by a decedent's estate or a beneficiary other than a tax-exempt beneficiary. Similarly, no gain is recognized by the estate on the distribution of that property to a beneficiary who is not tax-exempt by reason of the liability. Liabilities in excess of basis are also disregarded in determining the adjusted basis of the property. n117

Information returns containing specified information must be filed for transfers at death of non-cash assets in excess of \$1.3 million (\$60,000 for noncitizen nonresident decedents) and for any appreciated property received by a decedent as a gift within three years of death. n118 Statements must also be furnished to each person whose name must be set forth in the return. n119

A variety of amendments are made to Code provisions in connection with the carryover basis rules n120 that apply for decedents dying after 2009:

- If appreciated property is transferred in satisfaction of a pecuniary bequest, gain is recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis). To the extent provided in regulations, a similar rule applies where by reason of a decedent's death, a person has a right to receive from a trust a specific dollar amount which is the equivalent of a pecuniary request, and the trustee satisfies that right with property. n121
- The required recognition of gain on transfers to certain foreign trusts and estates is extended to transfers (other than lifetime transfers) to nonresident aliens. n122
- The definition of "capital asset" is clarified to state that the determination of the basis of artwork and other property in the taxpayer's hands under *IRC § 1022* will not prevent the asset from being a capital asset; n123
- A definition of "executor" is added; the term means an executor or administrator of a decedent, or if none is appointed, qualified and acting in the United States, then it means any person in actual or constructive possession of any property of the decedent; n124
- Split interest trusts are made subject to certain restrictions that are applicable to private foundations if an income tax charitable deduction, including an income tax charitable deduction by an estate or trust, was allowed with respect to transfers to the trust; n125
- Existing rules relating to gain on foreign investment company stock are repealed. n126

[7] Property Acquired in Common Forms of Tax-Deferred Exchanges

[a] *IRC Section 1031* Like-Kind Exchanges

The basis of replacement property received in a like-kind exchange under *IRC Section 1031* is determined by reference to the basis of the relinquished property. If a taxpayer transfers property, receives only like-kind property in exchange, and no gain is recognized in the completely tax-deferred exchange, then the replacement property will have a basis which is the same as the basis of the relinquished property. n127 For example, if A exchanges an unencumbered farm used in a trade or business or held for investment, worth \$100,000 and with a basis of \$50,000, for another unencumbered farm worth \$100,000, A's basis in the new farm will be \$50,000--the basis of the farm relinquished.

Where the taxpayer pays additional consideration (e.g., cash) in order to acquire the replacement property, the basis of the replacement property will be increased by the amount of that additional consideration (if cash), or by the fair market value of the additional property given (if the consideration is something other than cash). n128 The basis of replacement property in a like-kind exchange is also increased by the amount of any liabilities of the other party to the exchange that are assumed by the taxpayer. n129

Frequently, like-kind exchanges are partially taxable because properties being exchanged have different values, and the taxpayers seeking like-kind exchange treatment receive "boot", that is, cash or the property (including debt relief) in addition to the like-kind property. If cash or other property is received, gain on the exchange is recognized and taxable to the extent of the cash received or the fair market value of the non-cash property received. n130 When gain is recognized, the basis of the replacement property is equal to the basis of the relinquished property, reduced by other property or cash received, and increased by the amount of gain recognized. n131

The basis of replacement property received in a like-kind exchange is its "cost," that is, an amount equal to the fair market value of the replacement property at the time of the exchange. It was specifically noted in one court decision that the basis of the property received in a fully taxable exchange is properly measured by the fair market value of the property acquired, not by the fair market value of the property transferred. n132 This conclusion is correct, since gain or loss is measured by the difference between the fair market value of the property received and the basis of the property given up.

If multiple properties are acquired in a like-kind exchange, the basis of the relinquished property (and the adjustments for boot paid and gain recognized) must be allocated among the replacement properties in proportion to their relative fair market values at the date or dates of acquisition. n133

Like-kind exchanges are discussed in greater detail in Chapter 8.

[b] Involuntary Conversion

Taxpayers may defer gain realized on an involuntary conversion under *IRC Section 1033*. The basis of the replacement property is the same as the basis of the property converted, decreased in the amount of any money received that is not expended for the qualifying replacement property, increased by the amount of any additional consideration paid for the replacement property, and increased again in the amount of gain (or decreased in the amount of any loss) recognized upon the conversion. n134

Involuntary conversions are discussed further in Chapter 8A.

[8] Property Acquired under Option

The basis of property acquired pursuant to the exercise of an option includes both the cost or other basis of the option and the cost of the property. n135 Thus, if A pays B \$1,000 for the right to purchase B's property for \$100,000 within 90 days, and A exercises his option within the option period and pays \$100,000, A's basis in the property is \$101,000.

It should be noted that the mere granting of an option to purchase is not, in general, a sale, exchange or other disposition of the property, in the absence of the exercise of the option. n136 The option itself constitutes personal property in which the option holder has a cost basis.

In one private letter ruling, a taxpayer had an option to purchase a house under the terms of a will at a specified price below its market value. After the decedent's death, the taxpayer exercised the option, but the estate allowed the option to be exercised for a lower price than was stated in the will. The IRS ruled that the basis of the property acquired by the taxpayer from the estate was the sum of the following: (1) the basis of the option under *IRC Section 1014(a)* computed at the fair market value of the option property at the date of the decedent's death, less the option price stated in the will; plus (2) the actual option price paid by the taxpayer. Upon exercise of the option, the taxpayer's basis in the property was the sum of the basis of the option and the actual option price paid. n136.1

[9] Property Acquired as Payment for Services

The fair market value of property acquired in exchange for services must be included as ordinary income by the party rendering the services and acquiring the property. The basis of the property is that fair market value. n137 For example, if a real estate broker receives a parcel of property or an interest in property as a commission, the fair market value of the property is taxable as ordinary income at the time of receipt, and the basis upon subsequent sale is the same fair market value at the time of receipt.

In certain cases where retention of property received as compensation is subject to a "substantial risk of forfeiture," there may be no current basis in the property because no income is recognized until the risk of forfeiture lapses. n138

[10] Property Acquired by "Dealers"

Although "dealers" in real property hold such property primarily for sale to customers in the ordinary course of their trade or business, n139 the special rules for determining basis of inventory items, n140 such as the LIFO method, do not apply to real property held by dealers. Taxpayers engaged in the real estate business are not permitted to inventory real estate held for sale to customers. n141 The basis of such property in the hands of "dealers" is therefore determined under the same rules applicable to property held by non-dealers.

[11] Property Acquired in Satisfaction of a Debt or Other Claim

The basis of property received in payment of a debt or in satisfaction of a claim is the fair market value of the property on the date of transfer. n141.1 This rule applies even where the amount of the debt (or claim) satisfied is greater or less than the fair market value of the property transferred. In these situations, however, the transferee realizes a gain or a loss (as the case may be) at the time of transfer. That gain or loss is measured by the difference between the fair market value of the property transferred and the amount or basis of the debt satisfied. If the property acquired has no ascertainable market value, its basis may be determined by the amount or basis of the debt satisfied by the transfer. n142

The foregoing is not to be confused with the situation where a seller repossesses real estate from the buyer on foreclosure of a purchase money debt. Specific rules apply to this circumstance. See *section 2.02[12][b]* for a further discussion.

[12] Property Acquired On Foreclosure

Determining the basis of property acquired through foreclosure is a two-part issue. The rules are different, depending on whether the foreclosing mortgagee was an "outside" lender (i.e., a bank, savings and loan, or similar lending institution), or whether the mortgagee (i.e., the lender) was the seller of the property, that is, a seller who holds a purchase money mortgage.

[a] Non-Seller Lender

In the case of a lender-mortgagee who is not a seller and holding a purchase money obligation of the debtor, the basis of property acquired in a foreclosure (or by taking a deed in lieu of foreclosure) is the fair market value of the property at that time. Any excess of the basis of the mortgagee's loan over the fair market value of the property repossessed is a bad debt sustained by the mortgagee. If the fair market value of the property is greater than the basis of the debt, the lender realizes taxable income equal to the excess value. n143

[b] Seller Holding Purchase Money Debt

When the mortgagee is the seller and the property is reacquired by repossession or foreclosure in satisfaction of the indebtedness, as a general rule no gain or loss is recognized by the foreclosing seller, and no worthless or partially worthless bad debt deduction is realized. The basis of the property reacquired is the adjusted basis of the indebtedness at the time of repossession, increased by the amount of any gain resulting from the reacquisition, plus costs incurred by the

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mortgagee incident to the repossession. n144 In general, gain is recognized to the extent that the seller has received payment prior to the foreclosure in excess of the amount of gain on the sale taken into income prior to the foreclosure. The adjusted basis of the indebtedness is equal to the face value of the original debt, reduced by payments received and by the remaining unreported profit.

Example:

A taxpayer sells a building for \$50,000, resulting in a gain of \$10,000. The sale is reported on the installment method. After the purchaser pays \$30,000, he defaults and the seller repossesses the property, incurring \$500 in expenses. The seller realizes a \$3,500 gain on the repossession. The basis of the property is determined as follows:

Face value of debt at time of repossession (\$50,000 - \$30,000)	\$20,000
Less--Unreported profit (40% of \$10,000)	4,000
Seller's adjusted basis in buyer's obligation	\$16,000
Gain on repossession	3,500
Expenses of repossession	500
Basis of property	\$20,000

Chapter 7 discusses the method of determining gain on this and other types of repossessions.

[13] Personal Residences

The general rule for determining the basis of real property also applies to the principal residence of a taxpayer, namely, basis equals cost. The major exception to the general rule is the case where a principal residence was acquired as a "replacement residence" in a transaction subject to former IRC Section 1034. n145 A more unusual exception occurs when a principal residence is reacquired by foreclosure on a purchase money lien and then resold. n146

Under the now-repealed provisions of former IRC Section 1034(a), if a taxpayer disposed of his principal residence and within two years (either before or after the disposition) acquired and occupied another property as a principal residence, gain realized on the disposition of the first residence was recognized *only* to the extent that the adjusted sales price of the old residence exceeded the cost of acquiring the new one. n147

Where former IRC Section 1034 resulted in deferral of gain, the basis of the new residence was reduced by the amount of gain not recognized upon the disposition, which adjustment occurred following the disposition of the old residence. n148 Thus, the adjustment to basis could occur up to two years following actual purchase of the replacement residence.

Example:

A owns a home (home 1) which has an adjusted basis of \$50,000. In March, 1993, A bought a new home (home 2) for \$150,000. In February, 1995, A sold home 1 for \$125,000. Assuming A made no improvements or other additions to the basis of home 2, A's basis in home 2 is: \$150,000 from acquisition until February, 1995, and thereafter \$75,000 (\$150,000 less the \$75,000 gain realized, but not recognized, on the sale of home 1).

For further discussion of the consequences of personal residence sales and purchases, see Chapter 9.

[14] Property Acquired During Formation of a Corporation

[a] Basis of Property Transferred to Controlled Corporation

The basis of property transferred to a newly-formed corporation in exchange for capital stock is determined by reference to the basis of the property in the hands of the transferor if certain requirements are met. n149 The most important requirement is that the transferor(s) must own at least 80 percent or more of the voting stock, and at least 80 percent of the total number of all other outstanding shares immediately after the transfer. n150 If property is exchanged for stock upon incorporation in a transaction satisfying the above requirements, the basis of the property to the corporation is the transferor's basis in the property. n151

[b] Basis of Stock Received by Shareholder in Tax-Free Transfer of Property to Controlled Corporation

The basis of the stock received by the shareholder in a transfer of property to a newly-formed controlled corporation is the same as the shareholder's basis in the property transferred. n152 The shareholder's "substituted" basis in the stock is reduced by the sum of any money received, including relief of liabilities (whether recourse or nonrecourse) and the value of any other boot received. It is also increased by the amount of gain, if any, that the transferor recognizes in the transaction. n153

A statutory rule prevents duplication or acceleration of loss through the assumption of liabilities. n154 If the basis of the stock received by the transferor exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount of any liability that: n155

- is assumed by another person as part of the exchange; and
- did not otherwise reduce the transferor's basis of the stock by reason of the assumption.

Except as otherwise provided by the Secretary, this rule does not apply if the trade or business with which the liability is associated is transferred to the corporation as part of the exchange. n156 For exchanges occurring before May 9, 2008, n156.1 this rule also did not apply if substantially all the assets with which the liability is associated were transferred to the corporation as part of the exchange. n156.2 The Secretary has by regulation provided that *IRC Section 385(h)(2)(B)* does not apply to an exchange occurring on or after May 9, 2008. n156.3

For the above purposes, the term "liability" includes fixed or contingent obligations to make payments, without regard to whether those obligations are otherwise taken into account under provisions of the Internal Revenue Code n157 The determination of whether a liability has been assumed is made in accordance with *IRC Section 357(d)(1)*. Under that provision, a recourse liability is treated as assumed if, based on all facts and circumstances, the transferee has agreed to and is expected to satisfy that liability (or a portion of it), whether or not the transferor has been relieved of the liability. n158

For example, if a transferee corporation does not formally assume a recourse obligation or potential obligation of the transferor, but instead agrees and is expected to indemnify the transferor with respect to all or a portion of the obligation, then the amount that is agreed to be indemnified is treated as assumed, whether or not the transferor has been relieved of the liability. n159

Similarly, a nonrecourse liability is generally treated as assumed by the transferee of any asset subject to that liability. n160 The amount of nonrecourse liability treated as assumed by the transferee, however, is reduced by the lesser of the

following: n161

- the amount of that liability which an owner of other assets subject to that liability has agreed with the transferee, and is expected to satisfy to assume; or
- the fair market value of the assets.-fn- For this purpose, the value of the assets may be less than the amount of the nonrecourse indebtedness to which the property is subject (*IRC §§ 357(d)(2), 7701(g)*).

[c] Basis of Property Transferred to Newly-Formed Corporation When Requirements of *IRC Section 351* Are Not Met

If the requirements for a tax free transfer to a newly-formed corporation are not met (as when the control requirement of *IRC Section 351* is not met) and gain is recognized by the transferor, the basis of the property acquired by the corporation is equal to the transferor's basis in the stock received, plus the gain recognized. n162

[d] Basis of Stock Received by Shareholder in Transfer to Newly-Formed Corporation When Requirements of *IRC Section 351* Are Not Met

If the requirements for a tax-free transfer to a newly-formed corporation are not met (as when the control requirement of *IRC Section 351* is not met) and gain is recognized by the transferor of property to the corporation in exchange for stock, the transferor's basis in the stock is the same as his or her original basis in the property transferred, plus the gain recognized. n163

[e] Limitation on Corporation's Basis Attributable to Assumption of Liability

The basis of property received by the transferee-corporation in exchange for stock in the corporation or in connection with a reorganization cannot be increased above the fair market value of the property (determined without regard to *IRC Section 7701(g)*) by reason of gain recognized to the transferor as a result of the assumption of a liability. n163.1 *IRC Section 7701(g)* treats the fair market value of property as being not less than the amount of any nonrecourse indebtedness to which the property is subject.

An additional basis limitation applies if: (1) the transferor recognizes gain as a result of an assumption of a nonrecourse liability by a transferee that is also secured by assets not transferred to the transferee; and (2) no person is subject to tax on the gain. This restriction generally comes into play with respect to tax-exempt persons. In that case, for purposes of determining the transferee's basis, the amount of gain recognized by the transferee as a result of the assumption of the liability is determined as if the liability assumed by the transferee equaled the transferee's ratable portion of that liability determined on the basis of the relative fair market values (determined without regard to *IRC Section 7701(g)*) of all the assets subject to that liability. n163.2

[f] Gain Recognition When Liabilities Exceed Basis of Transferred Property

Whenever liabilities are assumed by a new corporation, the transfer of liabilities in excess of the basis of property transferred can result in the recognition of taxable income to the transferor shareholders. If the sum of the liabilities assumed exceeds the basis of the property transferred, the excess is recognized as a gain from the sale or exchange of an asset. n163.3 The character of the gain subject to recognition is determined by reference to the type of property transferred. If the property is a capital asset, then the gain will be a capital gain. n163.4 Even if a transferor remains personally liable for or guarantees the liabilities transferred to the corporation, the transferor must still recognize gain to the extent that the liabilities assumed by the corporation exceed the transferor's adjusted basis in the transferred assets. n163.4.1

Transferred liabilities, payment of which by the transferor would be deductible or would constitute distributive shares or

guaranteed payments made to retiring or deceased partners n163.5 are excluded from liabilities covered in *IRC Section 357*. n163.6 They are not considered in the determination of whether transferred liabilities exceed the basis of transferred assets. n163.7 However, if the liability has already been deducted by the transferor or if it has increased the transferor's basis in any property, then the liability is taken into account for purposes of *IRC Section 357(c)*. n163.8

[g] Limitation on Transfer of Built-In Losses in *IRC Section 351* Transactions

A special rule limits that transfer of built-in losses in *IRC Section 351* transactions. n163.9 If the aggregate adjusted bases of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceeds the aggregate fair market value of the property transferred in a tax-free incorporation, the transferee corporation's aggregate basis of the properties is limited to the aggregate fair market value of the transferred property. n163.10 This basis reduction rule applies regardless of the ownership percentage of the transferor in the stock of the transferee corporation. Any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction. n163.11

The transferor and transferee may, however, elect not to have the above rule apply. If the election is made, the basis in the stock received by the transferor is limited to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred. n163.12 The election to do so must be included with the tax returns of the transferor and transferee for the taxable year in which the transaction occurs. Once made, the election is irrevocable. n163.13

[h] Basis Limits Relating to Importation of Built-In Losses

If a net built-in loss is imported into the United States in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value. n163.14 A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary. n163.15 A net built-in loss is treated as imported into the United States if the aggregate adjusted bases of property received by a transferee corporation exceed the fair market value of the properties transferred. n163.16 Thus, for example, if in a tax-free incorporation, some properties are received by a corporation from U.S. persons subject to tax, and some properties are received from foreign persons not subject to U.S. tax, this provision applies to limit the adjusted basis of each property received from the foreign persons to the fair market value of the property. In the case of a transfer by a partnership (either domestic or foreign), this provision applies as if the properties had been transferred by each of the partners in proportion to their interests in the partnership. n163.17

The above rules apply to transactions after October 22, 2004. n163.18

[15] Basis of Property Distributed from a Corporation

[a] Prior to Corporate Liquidation

The basis of property, other than stock in the corporation making the distribution or rights to that stock, distributed by a corporation to a domestic shareholder with respect to its stock is equal to the fair market value of the property distributed. n163.19

[b] In Liquidation

If property is received by a distributee in complete liquidation of a corporation, and if gain or loss is recognized on the receipt of that property, the basis of the property in the hands of the distributee is the fair market value of the property at the time of the distribution. n163.20 A separate basis rule applies, however, to liquidations of controlled subsidiaries. If property is received by a corporate distributee in a distribution in complete liquidation of a subsidiary, n163.21 the basis of property in the hands of the distributee is the same as it was in the hands of the distributor. If the liquidating

corporation recognizes gain or loss with respect to the property, however, the distributee corporation's basis in the property is its fair market value at the time of the distribution. n163.22 The basis rule for liquidations of subsidiaries applies only if the distributee parent possesses at least 80 percent of the total voting power and at least 80 percent of the value of the stock of the subsidiary. n164

[16] Basis of Property Transferred to a Partnership

The basis of property contributed to a partnership in exchange for an interest in the partnership is the adjusted basis of the property to the contributing partner before the contribution. The basis of the interest in a partnership received by the contributing partner is equal to the amount of cash contributed, plus the adjusted basis of the contributed property before the contribution. In general, no gain or loss is recognized by a partnership or by any of the partners when property is contributed in exchange for an interest in a partnership. n165 However, when real estate subject to a mortgage is transferred to a partnership, the partners' bases for their partnership interests may be affected. The assumption of a mortgage by a partnership is considered a cash distribution to the transferor equal to the amount of his indebtedness effectively assumed by the other partners. n166 A distribution of money is a negative adjustment, that is, the distribution reduces the basis of a partner's interest. n167 If the negative adjustment exceeds basis, gain is recognized upon the transfer equal to the excess amount. n168 Similarly, the effective assumption of liabilities on property transferred by another partner increases the other partners' bases in their partnership interests. n169

[17] Basis of Property Distributed By a Partnership

The basis of property acquired in a distribution from a partnership depends first on the type of distribution (that is, whether it is a liquidating distribution or a nonliquidating distribution). n170 If the distribution is not in liquidation of the partner's entire interest, the partner's basis for the distributed property is the adjusted basis the partnership had in the property immediately before the distribution. This holds true as long as the basis of the property received does not exceed the basis of the partner's interest in the partnership. If the property's basis does exceed the basis of the partner's interest, then the basis of the property is determined by allocating the basis of the partnership interest among the properties received. n171 The Code provides special rules for the required allocation of basis. n172

If the distribution liquidates the partner's entire interest, then the partner's basis for the property received equals the adjusted basis of the partner's interest in the partnership, reduced by any money received in the distribution. n173 The allocation of basis among distributed partnership assets is specified by statute. n174

Special rules apply to distributions of property by a partnership to a partner who has previously contributed appreciated property to the partnership prior to recognition of "built-in gain" on the contributed property. n175 These rules are designed to keep partners from avoiding recognition of built-in gain by carrying out transactions through partnerships and relying on the general partnership tax principles affecting such transactions.

Special rules also apply if a partnership distributes to a corporate partner the stock of another corporation as part of the distribution. In such case, the corporate partner may have to reduce the basis in the assets of the corporation whose stock it received. The basis reduction is specified by statute and is required if, after the distribution, the corporate partner controls (generally speaking, an 80-percent vote and value requirement) n176 the distributed corporation, and the partnership's adjusted basis in the stock immediately before the distribution exceeded the corporate partner's adjusted basis in the stock after the distribution. n177

FOOTNOTES:

(n1)Footnote 5. See *IRC § 1012*.

(n2)Footnote 6. *IRC § 1001*.

(n3)Footnote 7. See, eg, *IRC § 167(c)*.

(n4)Footnote 8. *IRC § 1012(a)*.

(n5)Footnote 9. See, eg, the basis rule pertaining to a gift. *IRC § 1015* (donee's basis generally equals donor's basis, limited however for purposes of determining loss, to fair market value).

(n6)Footnote 10. *IRC § 1016*.

(n7)Footnote 11. Compare *IRC § 1060*.

(n8)Footnote 12. *IRC § 1015*; see [3], below, for a discussion.

(n9)Footnote 13. *IRC § 1014*; see [6], below, for a discussion.

(n10)Footnote 14. *IRC § 1031(d)*; see [7][a], below, for a discussion.

(n11)Footnote 15. *IRC § 1033(b)*; see [7][b], below, for a discussion.

(n12)Footnote 16. *IRC § 1012(b)*.

(n13)Footnote 17. *Lieber v Commr, TC Memo 1993-391, 66 TCM 529 (1993)* (mortgage guaranty fees); *Rev Rul 70-540, 1970-2 CB 101* (situation 3) (commitment fees). See Chapter 12.

(n14)Footnote 18-19. *IRC §§ 164(d); 1001(b); Treas Reg § 1.1012-1*

(n15)Footnote 20. See 12 CFR Part 220, colloquially known as "Reg T."

(n16)Footnote 21. *IRC § 163*.

(n17)Footnote 22. See *IRC § 1(a), (b), (c), (d), (i)*.

(n18)Footnote 23. *IRC § 469*; see Chapter 13.

(n19)Footnote 24. The interest expense may not always be deductible on a current basis. See *IRC §§ 263 and 263A*.

(n20)Footnote 25. *IRC § 1(h)*, in effect for tax years ending after May 6, 1997. For prior years, the maximum tax rate for net capital gains of non-corporate taxpayers is 28 percent (*IRC § 1(h)*, before amendment by Pub L No 105-34).

(n21)Footnote 26. *IRC § 1(a)-(d), (i)*.

(n22)Footnote 27. In some states, a lender is required to elect its remedies in the event of a default, either to foreclose on its security interest (in which case the borrower is released from personal liability) or to proceed against the borrower personally.

(n23)Footnote 28. *US v Hendler, 303 US 564 (1938)*.

(n24)Footnote 29. *Crane v Commr, 331 US 1 (1947)*; *Mayerson v Commr, 47 TC 340 (1966)*, *acq 1969-1 CB 21*.

(n25)Footnote 30. *Commissioner v Tufts, 461 US 300 (1983)*.

(n26)Footnote 31. *IRC § 465(b)(2), (4), (6)*.

(n27)Footnote 32. *Columbus & Greenville Ry Co v Commr, 42 TC 834 (1964)*, *affd per curiam 358 F2d 294 (5th Cir 1966)*, *cert denied 385 US 827 (1966)*; *Bryce's Mountain Resort, et al v Commr, TC Memo 1985-293*; *Rev Rul*

55-675, 1955-2 CB 567 .

(n28)Footnote 33. *Estate of Franklin v Commr*, 544 F2d 1045 (9th Cir 1976) ; *Rice's Toyota World v Commr*, 752 F2d 89 (4th Cir 1985) *affg*, *revg* and *remanding* 81 TC 184 (1983) .

(n29)Footnote 34. *Woodsam Assn v Commr*, 198 F2d 357 (2d Cir 1952) .

(n30)Footnote 35. *IRC § 108(e)(5)*.

(n31)Footnote 36. *IRC § 108(e)(5)*.

(n32)Footnote 37. *IRC § 108(b)(1)*.

(n33)Footnote 38. See *IRC § 108(b)(5)*.

(n34)Footnote 39. *IRC § 108(b)(2)*; see *IRC § 108(b)(2)(E)*.

(n35)Footnote 40. *IRC §§ 108(b)(5), 1017*.

(n36)Footnote 41. *Treas Reg § 1.108-4(b)*.

(n37)Footnote 42. *IRC § 1017(a)*.

(n38)Footnote 43. See *IRC § 108(a)(1)(D)*.

(n39)Footnote 44. *IRC § 108(c)(1)*.

(n40)Footnote 45. *IRC § 1017(a)*.

(n41)Footnote 46. See *Treas Reg § 1014(b)(9), (c)*.

(n42)Footnote 47. See *IRC § 108(a)(1)(E)*.

(n43)Footnote 47.1. *IRC § 108(h)(1)*.

(n44)Footnote 47.2. See *IRC § 108(b)(1), (h)*.

(n45)Footnote 48. *IRC § 1015(a)*.

(n46)Footnote 49. *Treas Reg § 1.1015-1(e)*.

(n47)Footnote 50. *IRC § 7491*, added by § 3001(a) of the *IRS Restructuring and Reform Act of 1998*, PL No 105-206.

(n48)Footnote 51. *Cullers v Commr*, 237 F2d 611 (8th Cir 1956) ; *Carlton v Commr*, 190 F2d 183 (5th Cir 1951) ; *Buck v US*, 154 F Supp 90 (D Del 1957) .

(n49)Footnote 52. *IRC § 1015(d)(6)*.

(n50)Footnote 53. *IRC § 1015(d)(6)(B)*.

(n51)Footnote 54. *IRC § 1015(d)(1)(A)*.

(n52)Footnote 55. *IRC §§ 1014(a), 1022* (basis of property acquired from decedents dying after 2009).

(n53)Footnote 56. *Diedrich v Commr*, 457 US 191 (1982) .

(n54)Footnote 57. *Treas Reg* § 1.1015-4(a).

(n55)Footnote 58. *Treas Reg* § 1.1015-4(a)(2); *IRC* § 1015(d).

(n56)Footnote 59. *IRC* § 170(e)(2); *Treas Reg* § 1.170A-4(c).

(n57)Footnote 60. *IRC* §§ 2010, 2505.

(n58)Footnote 61. *Treas Reg* § 1.1015-4(b).

(n59)Footnote 62. *Id.*

(n60)Footnote 63. *Id.*

(n61)Footnote 64. *Id.*

(n62)Footnote 65. *IRC* § 1015(b).

(n63)Footnote 66. *Treas Reg* § 1.1015-2(a)(1).

(n64)Footnote 67. *Treas Reg* § 1.1015-2(b).

(n65)Footnote 68. *IRC* § 1014(f).

(n66)Footnote 69. *IRC* § 1022; see [f], *below*, for a discussion.

(n67)Footnote 70. *IRC* § 1014(a)(1).

(n68)Footnote 71. *IRC* § 1014(a)(2); see *IRC* § 2032.

(n69)Footnote 72. See generally *TAM* 9349003 (purpose of the alternate valuation date is to allow a decedent's estate to pay a lesser tax if a reduction in fair market value is due to unfavorable market conditions, rather than voluntary acts changing the character of the property). Valuation decreases resulting from voluntary acts, such as the granting of a conservation easement, will not justify the use of the alternate valuation date. *Flanders v. US*, 347 F Supp 95 (DC Calif 1972) .

(n70)Footnote 73. *Treas Reg* §§ 1.1014-1(a); 1.1014-2(b)(1).

(n71)Footnote 74. *Treas Reg* § 1.1014-2(b)(2).

(n72)Footnote 75. *IRC* § 1014(a)(3).

(n73)Footnote 76. *IRC* § 1014(a)(4); see *IRC* § 2031(c) (applicable to estate of descendants dying after December 31, 1997).

(n74)Footnote 77. *Treas Reg* § 1.1014-3(a).

(n75)Footnote 78. *McEwan v. Commr*, 241 F2d 887, 889 (2d Cir 1957) .

(n76)Footnote 79. *Treas Reg* § 1.1014-3(a).

(n77)Footnote 80. See *IRC* § 1014(f).

(n78)Footnote 81. *IRC § 1014(b)(6); Treas Reg § 1.1014-2(a)(5).*

(n79)Footnote 82. *IRC § 1014(b)(6).*

(n80)Footnote 83. *Rev Rul 68-80, 1968-1 CB 348 .*

(n81)Footnote 84. *Murphy v Commr, 342 F2d 356, 359 (9th Cir 1965) .*

(n82)Footnote 85. *IRC § 2040(b).*

(n83)Footnote 86. *McCullum v US, 58-2 USTC P 9957 (ND Okla 1958); Crosby v Commr, TC Memo 1961-272 .*

(n84)Footnote 87. *See IRC §§ 1014(b)(6), 2040(b).*

(n85)Footnote 88. *IRC § 1014(b)(9).*

(n86)Footnote 89. *IRC § 2035(a)(2).*

(n87)Footnote 90. *Treas Reg § 1014(b)(9); § 1014-6(a)(1).*

(n88)Footnote 91. *Treas Reg § 1.1014-4(a)(1).*

(n89)Footnote 92. *Treas Reg § 1.1014-4(b).*

(n90)Footnote 93. *Treas Reg § 1.1014-4(a)(1).*

(n91)Footnote 94. *Treas Reg § 20.2031-7(d).*

(n92)Footnote 95. *IRC § 1022(a).*

(n93)Footnote 96. *IRC § 1022(b)(1), (2)(B).*

(n94)Footnote 97. *IRC § 1022(b)(2)(C).*

(n95)Footnote 98. *IRC § 1022(c)(1), (2)(B).*

(n96)Footnote 99. *IRC § 1022(b)(3).*

(n97)Footnote 100. *IRC § 1022(d)(4).*

(n98)Footnote 101. *IRC § 1022(d)(1)(A).*

(n99)Footnote 102. *IRC § 1022(d)(1)(B)(i)(I).*

(n100)Footnote 103. *IRC § 1022(d)(1)(B)(i)(II).*

(n101)Footnote 104. *IRC § 1022(d)(1)(B)(ii).*

(n102)Footnote 105. *IRC § 1022(d)(1)(B)(iii).*

(n103)Footnote 106. *IRC § 1022(d)(1)(B)(iv).*

(n104)Footnote 107. *See IRC § 1014(b)(6).*

(n105)Footnote 108. *See IRC § 1022(d)(1)(B)(iv).*

(n106)Footnote 109. *IRC § 1022(d)(1)(C)*.

(n107)Footnote 110. *IRC § 1022(f)*.

(n108)Footnote 111. *IRC § 1022(d)(1)(D)(i)*.

(n109)Footnote 112. *IRC § 1022(d)(1)(D)(ii)*.

(n110)Footnote 113. *IRC § 1022(d)(1)(D)(iii)*.

(n111)Footnote 114. *IRC § 1022(d)(1)(D)(iv)*.

(n112)Footnote 115. *IRC § 1022(d)(2)*.

(n113)Footnote 116. *IRC § 1022(d)(3)*.

(n114)Footnote 117. *IRC § 1022(g)*.

(n115)Footnote 118. *IRC §§ 6018, 6075(a), 6716*.

(n116)Footnote 119. *IRC § 6018(e)*.

(n117)Footnote 120. See *IRC § 1022*.

(n118)Footnote 121. *IRC § 1040(a), (b)*.

(n119)Footnote 122. *IRC § 684*.

(n120)Footnote 123. *IRC § 1221(a)(3)(C)*.

(n121)Footnote 124. *IRC § 7701(a)(47)*.

(n122)Footnote 125. *IRC § 4947(a)(2)*.

(n123)Footnote 126. See *IRC §§ 1291(e), 1296(i)*.

(n124)Footnote 127. *IRC § 1031(d)*.

(n125)Footnote 128. *Treas Reg § 1.1031(d)-1(a), (e)*. The basis increase with respect to additional consideration in the form of other property not eligible for non-recognition treatment occurs in two steps; the basis of the replacement property is increased by the adjusted basis of the additional property and by the gain recognized on the transaction, which will include the gain on the disposition of the other property.

(n126)Footnote 129. *Treas Reg § 1.1031(d)-2, Ex (2)*.

(n127)Footnote 130. *IRC § 1031(b)*.

(n128)Footnote 131. *IRC § 1031(d)*.

(n129)Footnote 132. *Williams v Commr, 37 TC 1099 (1962), acq 1963-1 CB 4*.

(n130)Footnote 133. *Rev Rul 68-36, 1968-1 CB 357*.

(n131)Footnote 134. *IRC § 1033(b)(1); Treas Reg § 1.1033(b)-1(a)*.

(n132)Footnote 135. *Rev Rul 78-182, 1978-1 CB 265* .

(n133)Footnote 136. *Ltr Rul 9325029* (property, subject to an option to purchase and exercisable only after grantor's death, would be included in grantor's estate for federal income and estate tax purposes).

(n134)Footnote 136.1. *Ltr Rul 20034019* .

(n135)Footnote 137. *Treas Reg § 1.61-2(d)(2)(i)*.

(n136)Footnote 138. *IRC § 83(a)*.

(n137)Footnote 139. See Chapter 10.

(n138)Footnote 140. *IRC §§ 471; 472; 1013*.

(n139)Footnote 141. *Rev Rul 86-149, 1986-2 CB 67* .

(n140)Footnote 141.1. *Commr v Spreckels, 120 F2d 517 (9th Cir 1941)* ; *Kohn v Commr, 16 TC 960 (1951)* , *affd 197 F2d 480 (2nd Cir 1952)* ; *Sargent v Commr, TC Memo 1970-214* ; *McFadden v Commr, TC Memo 2002-166* .

(n141)Footnote 142. *Gould Securities Co v US, 96 F2d 780 (2d Cir 1938)* ; *Second Nat'l Bldg Co v Commr, BTA Memo Dec 12,048-A*.

(n142)Footnote 143. *Treas Reg § 1.166-6(a)*.

(n143)Footnote 144. *IRC § 1038(c)*. For further discussion, see § 7.10.

(n144)Footnote 145. See Chapter 9.

(n145)Footnote 146. *IRC § 1038(e)*; see Chapter 7 for a discussion of *IRC § 1038*.

(n146)Footnote 147. *IRC § 1034(a)*, before repeal by Pub L No 105-34.

(n147)Footnote 148. *IRC § 1034(e)*, before repeal by Pub L No 105-34.

(n148)Footnote 149. *IRC § 362(a)*.

(n149)Footnote 150. *IRC § 351(a), 368(c)*.

(n150)Footnote 151. *IRC § 362*.

(n151)Footnote 152. *IRC § 358(a)*.

(n152)Footnote 153. *IRC § 358(a)(1)*.

(n153)Footnote 154. *IRC § 358(h)*.

(n154)Footnote 155. *IRC § 358(h)(1)*.

(n155)Footnote 156. *IRC § 358(h)(2)(A)*.

(n156)Footnote 156.1. *Treas Reg § 1.358-5(b)*.

(n157)Footnote 156.2. *IRC § 358(b)(2)(B)*.

(n158)Footnote 156.3. *Treas Reg § 1.358-5(a)*.

(n159)Footnote 157. *IRC § 358(h)(3)*

(n160)Footnote 158. *IRC § 357(d)(1)*.

(n161)Footnote 159. *IRC § 357(d)(1)(A)*.

(n162)Footnote 160. *IRC § 357(d)(1)(B)*.

(n163)Footnote 161. *IRC § 357(d)(2).*

(n164)Footnote 162. *IRC § 362(a)*.

(n165)Footnote 163. *IRC § 358(a)(2)*.

(n166)Footnote 163.1. *IRC § 362(d)(1)*, effective for transfers after Oct 10, 1998.

(n167)Footnote 163.2. *IRC § 362(d)(2)*, effective for transfers after Oct, 18, 1998.

(n168)Footnote 163.3. *IRC § 357(c)(1)*.

(n169)Footnote 163.4. *IRC § 357(c)(1)*.

(n170)Footnote 163.4.1. *Owen v Commr, TC Memo 1987-375, affd 881 F2d 832 (9th Cir 1989); Rosen v Commr, 62 TC 11 (1974), affd without published opinion 515 F2d 507 (3rd Cir 1975); Seggerman Farms, Inc, et al v Commr, TC Memo 2001-99, affd 2002-2 USTC 50,728 (7th Cir 2002); Tester v Commr, 327 F2d 788 (7th Cir 1964); see Chapter 15 for a detailed discussion.*

(n171)Footnote 163.5. *See IRC § 736(a)*.

(n172)Footnote 163.6. *IRC §§ 357(c)(3), 736(a)*.

(n173)Footnote 163.7. *See IRC § 357*.

(n174)Footnote 163.8. *IRC § 357(c)(3)(B)*.

(n175)Footnote 163.9. *IRC § 362(e)*, effective for transactions liquidations occurring after Oct 22, 2004 (Pub L No 108-357, § 836(c)).

(n176)Footnote 163.10. *IRC § 362(e)(2)(A)*.

(n177)Footnote 163.11. *IRC § 362(e)(2)(B)*.

(n178)Footnote 163.12. *IRC § 362(e)(2)(C)(i)*.

(n179)Footnote 163.13. *IRC § 362(e)(2)(C)(ii)*.

(n180)Footnote 163.14. *IRC § 362(e)(1)(A)*.

(n181)Footnote 163.15. *IRC § 334(b)(1)*.

(n182)Footnote 163.16. *IRC § 362(e)(1)(C)*.

(n183)Footnote 163.17. *IRC § 362(e)(1)(B)*.

(n184)Footnote 163.18. Pub L No 108-357, § 836(c).

(n185)Footnote 163.19. *IRC § 301(d)*.

(n186)Footnote 163.20. *IRC § 334(a)*.

(n187)Footnote 163.21. See *IRC § 332*.

(n188)Footnote 163.22. *IRC § 334(b)(1)*.

(n189)Footnote 164. *IRC § 334(b)(2)*; see *IRC §§ 332(b), 1504(a)(2)*.

(n190)Footnote 165. *IRC § 721*.

(n191)Footnote 166. *IRC § 752(b)*.

(n192)Footnote 167. *IRC § 733*.

(n193)Footnote 168. *IRC § 731*.

(n194)Footnote 169. *IRC § 752(a)*.

(n195)Footnote 170. *IRC § 732(a)*.

(n196)Footnote 171. *IRC § 732(a)(2)*.

(n197)Footnote 172. *IRC § 732(c)*. In addition, the Service has ruled that if a partnership acquires indebtedness of a partner and distributes it to that partner, the distribution-of-property rules apply to determine the consequences for the partnership, and the partner recognizes gain or loss to the extent that the value of the debt differs from its basis under *IRC § 732*. *Rev Rul 93-7, 1993-1 CB 125*.

(n198)Footnote 173. *IRC § 732(b)*; *Treas Reg § 1.732-1(b)*.

(n199)Footnote 174. *IRC § 732(c)*.

(n200)Footnote 175. *IRC §§ 704(c)(1)(B); 707(a)(2)(B); 737*.

(n201)Footnote 176. See *IRC § 1504(a)(2)*.

(n202)Footnote 177. *IRC § 732(f)*, eff generally for distributions made after July 14, 1999 (PL No 106-170, § 538(b)); see Chapter 14 for a detailed discussion.

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Federal Taxes Affecting Real Estate

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CHAPTER 2 Acquisition of Real Estate *

1-2 Federal Taxes Affecting Real Estate § 2.03

§ 2.03 Capital Expenditures

[1] Tax Treatment of Capital Expenditures

Costs incurred in the acquisition of real estate (or other capital assets) are capital expenditures. As such, they generally cannot be deducted currently, but must be capitalized n177.1 and added to the basis of asset acquired. n177.2 Capital expenditures are recovered for tax purposes either through depreciation or deductions n177.3 or through the reduction in capital gain (or increase in loss) when the asset is sold. n177.4

Certain costs incurred in acquiring real estate may be currently deducted, including certain interest payments n177.5 and real property taxes. n177.6

Costs incurred after the acquisition of an asset may be treated as capital expenditures incurred in connection with the purchase of the property. n177.7

Expenditures may be capitalized and added to the basis of a taxpayer's property even if the expenditures are made to other property not owned by the taxpayer. For example, taxpayers have been permitted to capitalize the cost of bulkheads, bluff reconstruction, jetties, and similar items on property they do not own in order to prevent erosion or other damage to their own property. n177.8

[2] Items Treated as Capital Expenditures

The types of acquisition costs that must be capitalized are not specified in detail in the Code or regulations. Regulations state only that capitalized costs include the costs of acquiring buildings and similar property having a useful life substantially beyond the taxable year. n177.9 Whether a cost is incurred in connection with the purchase of buildings or real property is determined by the origin of the cost. If the cost originates within the acquisition process, it is usually a capital expenditure. Under this reasoning, legal, brokerage, accounting, litigation expenses, and similar costs incurred in the acquisition of property have been held to be capital expenditures. n177.10 Even a taxpayer's overhead, management, and other seemingly deductible miscellaneous costs must be capitalized as part of the cost of real estate if those costs are directly related to the acquisition of that real estate. n177.11 The cost of a taxpayer's own labor, however, cannot be included in a property's adjusted basis. n177.11.1

Various rulings and court decisions have clarified that certain items are capital expenditures in specified property

acquisitions. The following items have been required to be capitalized:

- property evaluation expenditures; n177.12
- brokers' and real estate commissions; n177.13
- option payments;
- title charges and recording fees; n177.14
- architect fees; n177.15
- costs of acquiring outstanding leases;
- costs of defending or perfecting title to property; n177.16
- attorney fees for drafting documents; n177.17
- attorney and consulting fees incurred in a lawsuit against the seller of real estate related to misrepresentations about the property; n177.18
- survey fees; n177.19
- up-front condominium fees paid for membership in a corporation managing the condominium; n177.20
- costs of grading and paving a road in connection with the development of a subdivision of rental property; n177.21
- expenditures made to challenge zoning ordinances if the benefits resulting from the zoning change are indefinite and undeterminable in nature n177.22
- attorney and appraisal fees in connection with condemnation proceedings; n177.23
- attorney fees connected with the disposition of property; n177.24
- the value of property dedicated to public use as a condition for being permitted to develop other land; n177.25 and
- settlement costs, legal fees, and costs to acquire water rights and discharge units related to those rights. n177.26

[3] Treatment of Costs Incurred in Unsuccessful Acquisition

Costs incurred in connection with an unsuccessful acquisition may generally be deducted as a loss in the tax year the decision is made not to acquire the property or in the year a building project is abandoned, provided the expenses were directly related to a transaction entered into for profit. This rule has been applied to property evaluation expenditures n177.27 and architect's fees, n177.28 and would apply equally to other expenditures that would have to be capitalized if the acquisition were successful or the project completed.

[4] Equipment Used to Construct Capital Improvements

A taxpayer may not depreciate under usual MACRS rules the cost of equipment that it owns and uses in the construction of its own capital facilities. The cost of the equipment must be capitalized in the same manner as the capital facilities to which the cost corresponds. n177.29

FOOTNOTES:

(n1)Footnote 177.1. *Woodward v Commr*, 397 US 572 (1970) .

(n2)Footnote 177.2. *Treas Reg* §§ 1.263(a)-1(a), 1.1016-2(a).

(n3)Footnote 177.3. See *IRC* §§ 167, 168; see Chapter 5 for a discussion of depreciation.

(n4)Footnote 177.4. *IRC* § 1001(a).

(n5)Footnote 177.5. *IRC* § 163; see Chapter 4.

(n6)Footnote 177.6. *IRC* § 164; see Chapter 4.

(n7)Footnote 177.7. *US v Hilton Hotels, Corp*, 397 US 580 (1970) ; *Am Stores Co & Subs v Commr*, 114 TC 458 (2000) ; *Winter v Commr*, TC Memo 2002-173 (legal and consulting fees incurred in a lawsuit against the seller of real estate related to misrepresentations about the property cannot be deducted, but must be capitalized as part of the property's basis).

(n8)Footnote 177.8. *Ltr Rul* 200229014 ; *Red Star Yeast and Products Co v Commr*, 25 TC 321 (1955) ; see *Rev Rul* 60-386, 1960-2 CB 107 (costs of seawalls, bulkheads, and drainage systems on taxpayer's own property had to be capitalized).

(n9)Footnote 177.9. *Treas Reg* § 1.263(a)-2(a).

(n10)Footnote 177.10. *Woodward v Commr*, 397 US 572 (1970) .

(n11)Footnote 177.11. *FRBC Investment, LLC v Commr*, TC Memo 2002-276 .

(n12)Footnote 177.11.1. *Maguire/Thomas Ptnrs Fifth & Grand v Commr*, TC Memo 2005-34 ; *Cox v Commissioner*, TC Memo 1982-667 ; *Bayly v Commissioner*, TC Memo 1981-549 .

(n13)Footnote 177.12. *Rev Rul* 74-104, 1974-1 CB 70 .

(n14)Footnote 177.13. *Meiers v Commr*, TC Memo 1982-51 ; *Godfrey v Commr*, 335 F2d 82 (6th Cir 1964) ; *Burman v Commr*, 23 BTA 639 (1931) .

(n15)Footnote 177.14. *Frank v Commr*, TC Memo 1996-177 .

(n16)Footnote 177.15. *Treas Reg* § 1.263(a)-2(d); *Haspel v Commr*, 62 TC 59 (1974) .

(n17)Footnote 177.16. *Treas Reg* § 1.263(a)-2(c).

(n18)Footnote 177.17. *Meiers v Commr*, TC Memo 1982-51 ; *Godfrey v Commr*, 335 F2d 82 (6th Cir 1964) ; *Burman v Commr*, 23 BTA 639 (1931) .

(n19)Footnote 177.18. *Winter v Commr*, TC Memo 2002-173 .

(n20)Footnote 177.19. *Meiers v Commr*, TC Memo 1982-51 ; *Godfrey v Commr*, 335 F.2d 82 (6th Cir 1964) ;

Burman v Commr (1931) 23 BTA 639 .

(n21)Footnote 177.20. *Meiers v Commr*, TC Memo 1982-51 .

(n22)Footnote 177.21. *Rev Rul 73-377*, 1973-2 CB 84 .

(n23)Footnote 177.22. *Maguire/Thomas Ptnrs Fifth & Grand v Commr*, TC Memo 2005-34 ; *Hustead v Commr*, TC Memo 1997-205 ; *Godfrey v Commr*, 335 F2d 82 (6th Cir 1964) ; *Soelling v Commr*, 70 TC 1052 (1978) ; *Galt v Commr*, 19 TC 892 (1953) , *affd in part and modified on other issues* 216 F2d 41 (7th Cir 1954) .

(n24)Footnote 177.23. *Soelling v Commr*, 70 TC 1052 (1978) ; *Baylin v US*, 43 F3d 1451 (Fed Cir 1995) .

(n25)Footnote 177.24. *Baylin v US*, 43 F3d 1451 (Fed Cir 1995) .

(n26)Footnote 177.25. *Eggert v Commr*, TC Memo 1977-265 .

(n27)Footnote 177.26. *FSA 200228005* ; see *Niagara Mohawk Power Corp v US*, 525 F2d 1380 (Ct Cl 1975) (holding that water rights, like land, are a nondepreciable capital asset with an indeterminate useful life); *Rev Rul 73-341*, 1973-2 CB 306 (ruling that the sale of subsurface water rights qualifies for capital gain treatment under *IRC* § 1231).

(n28)Footnote 177.27. *Rev Rul 74-104*, 1974-1 CB 70 .

(n29)Footnote 177.28. See *Haspel v Commr*, 62 TC 59 (1974) (no abandonment loss allowed because original architect's plans were later used by another architect).

(n30)Footnote 177.29. *Commr v Idaho Power Co*, 418 US 1 (1974) .

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Federal Taxes Affecting Real Estate

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CHAPTER 2 Acquisition of Real Estate *

1-2 Federal Taxes Affecting Real Estate § 2.04

§ 2.04 Allocation of Basis

Whenever improved real estate is acquired, it generally is necessary for the acquirer to allocate the total purchase price between the land and the improvements. This will be required, for example, because the various improvements are depreciable, while land itself is not. An allocation of basis will also be required among two or more separate parcels of real property where they are purchased for one price at one time and later sold separately. n178 Allocation must also be made when a portion of the property acquired is used for trade or business purposes, and the remaining part is not. A somewhat similar problem of allocation of basis arises when a transferor of property transfers a life estate to one individual and the remainder interest in the property is transferred to another. The allocation must be made in accordance with the relative fair market values of the properties acquired. n179

[1] Substantiation for Allocations

An allocation between depreciable and nondepreciable property must be made using a ratio comprised of the respective fair market values of the properties at the time of acquisition. The determination of the fair market values of the respective portions of a bulk purchase of realty is a question of fact. n180 Various factors will be considered by the courts and the Service, some of which are:

- (1) appraisals by qualified individuals or firms;
- (2) the assessed valuations placed upon the various properties by the local tax assessor; n181 and
- (3) in certain cases, the values set forth in the contract of sale itself, if the contract is between an arm's-length buyer and seller for adequate consideration. n182

As a practical matter, in allocating purchase price among several pieces of property, the evidence most acceptable to the Service is the value determined by independent sources, such as appraisers. Artificial values, which may result in unrealistic tax benefits for the buyer or the seller, or both, may be challenged, even though the dollar amounts are clearly identified in the sales contract.

The allocation will be important to the purchaser of improved real estate since a deduction for depreciation will be based upon this allocation, although in view of the cost recovery periods that were lengthened in the mid-1980s, this is

not as significant a factor as in the past. The allocation also will be important to the seller since the amount of depreciation recapture (subject to tax at ordinary income tax rates, or not eligible for the lowest capital gains tax rates) is dependent upon the allocation of sales price to buildings or other improvements. Therefore, specifying fair market values in the contract of sale of improved real estate is important because of the generally opposing interests of the buyer and seller.

The allocation of basis also may be important to both the buyer and seller in the sale of a going business. n183 Many items sold (such as inventory, depreciable assets subject to recapture, and accounts receivable) may produce ordinary income for the seller and deductions against ordinary income for the buyer. In addition, allocation to so-called "Section 197 intangibles" allows a buyer to amortize basis over a 15-year period, which is more rapid than the periods applicable to most real property improvements. n184 Section 197 intangibles include the following: n185

- (1) franchises;
- (2) trademarks;
- (3) trade names;
- (4) goodwill;
- (5) going concern value;
- (6) intangibles relating to workforce, information base, know-how, customers and suppliers;
- (7) licenses;
- (8) covenants not to compete;
- (9) government permits; etc.

These rules have had a dramatic impact upon the allocation of basis among various assets when a business is purchased that owns real estate.

Planning Tip:

Where possible, it may be advantageous to a buyer to allocate purchase price to *IRC Section 197* items, such as goodwill and going concern value, rather than to depreciable real estate since the rate of recovery from amortization of intangibles is almost twice as fast as the rate of cost recovery for residential property (15 vs. 27.5 years) and two and a half times the rate for non-residential property (15 vs. 39 years). n186 Conversely, it may be advantageous to a non-corporate seller to allocate consideration to such Section 197 assets if the seller is a dealer in real property, since the seller may be entitled to long term capital gain treatment on the sale of goodwill but will be subject to ordinary income treatment on the sale of property held for sale to customers.

[2] Allocations for Multiple Interests

For certain purposes, an allocation of basis is required where multiple interests in one property (e.g., a life estate and a remainder interest) are created. There is little problem where the respective interests are acquired by purchase. In such cases, basis to the life tenant and to the remainderman are obviously determined by the respective purchase prices of the interests.

Where a life estate is sold, or a remainder interest is sold before the termination of the life estate, it is necessary to utilize actuarial factors to determine the portion of the total basis applicable to the interest sold. These factors are set out in tables in regulations. n187 When life estates (or other term interests) originally acquired by gift or inheritance are subsequently disposed of, a basis of zero is utilized *for purposes of determining gain or loss on the transaction*. n188 This means that the entire amount received in the sale or other taxable transaction is taxed. This zero-basis rule does not apply, however, if the life tenant and the remainderman together, and in the same transaction, make a transfer to third person(s) of the entire interest in the property. n189

When there are multiple interests in property, the basis of the respective interests must be adjusted to take into account items of a capital nature affecting the property during the time it was held by the life tenant. This would include such items as deductions for depreciation, additions of permanent improvements, etc. For example, if A gifted to B a life estate in property having a basis of \$10,000, and A had held the property for five years, during which time she claimed \$1,000 of depreciation deductions, the basis of the property to B, the remainderman, would be \$9,000 (the basis of \$10,000 less the \$1,000 of depreciation claimed by A).

FOOTNOTES:

(n1)Footnote 178. *Avery v Commr*, 11 BTA 958 (1928) , acq VII-2 CB 3; *Rev Rul 72-255*, 1972-1 CB 221 .

(n2)Footnote 179. *Sleiman, Jr et al v Commr*, TC Memo 1997-530 , *affd* 187 F3d 1352 (11th Cir 1999) .

(n3)Footnote 180. *Sleiman, Jr et al v Commr*, TC Memo 1997-530 , *affd* 187 F3d 1352 (11th Cir 1999) .

(n4)Footnote 181. *Williams v Commr*, TC Memo 1960-19 .

(n5)Footnote 182. See *Treas Reg § 1.751-1(a)(2)*; *Commr v Gazette Telegraph Co*, 19 TC 692 (1952) , acq 1954-2 CB 4 (1954) , *affd* 209 F2d 926 (10th Cir 1954) .

(n6)Footnote 183. *IRC § 1060* provides rules for allocating basis and consideration in connection with the acquisition of a going business.

(n7)Footnote 184. *IRC § 197*.

(n8)Footnote 185. *IRC § 197(d)*.

(n9)Footnote 186. See *IRC §§ 168(c)(1); 197(a)*.

(n10)Footnote 187. See *Treas Reg §§ 20.2031-7(d)*, 25.2512-5(d); *IRC § 7520*; *Treas Reg § 1.7520-1(a)(1)*, 1.7520-1.

(n11)Footnote 188. *IRC § 1001(e)(i)*.

(n12)Footnote 189. *Rev Rul 71-122*, 1971-1 CB 224 .

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Federal Taxes Affecting Real Estate

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CHAPTER 2 Acquisition of Real Estate *

1-2 Federal Taxes Affecting Real Estate § 2.05

§ 2.05 Holding Period

The holding period of investment assets (such as raw land) and certain depreciable business assets that are treated as capital assets is important because it is one of the criteria that will determine whether the more advantageous tax rates applicable to long-term capital gains of non-corporate taxpayers will apply. The minimum holding period for long term capital gains treatment is more than one year. n190

The holding period is computed in months rather than in days. In determining the holding period, the date of purchase is excluded and the date of sale is included. n191 For example, if property is acquired on March 22, it will qualify for long-term capital gain treatment beginning on March 23 of the following year.

[1] Property Acquired by Purchase

In a purchase, the most common situation, the holding period commences at the time the buyer assumes the benefits and burdens of ownership. While this is normally the closing date (the day title passes), the rule is not inviolate. For example, if, pursuant to an unconditional contract of sale, possession--as well as the burdens and benefits of ownership--is acquired prior to the transfer of title, the holding period will commence at that earlier date. This rule normally follows state law. n192

[2] Property Acquired by Gift

In the case of property transferred by gift, if the basis of the donor carries over to the donee, the holding period of the donor will be included, that is, the donee's holding period will be "tacked onto" the donor's. However, if, under the rules regarding losses discussed earlier in this chapter, the basis is equal to the fair market value of the property at the date of the gift, the holding period will commence with the date of the gift. n193

[3] Property Acquired from a Decedent

In the case of a person acquiring property from a decedent, if the basis of the property in the hands of such person is "stepped up" to fair market value, and the property is sold or otherwise disposed of by that person within one year after the decedent's death, then the person is treated as having held the property for more than one year. n194

[4] Property Acquired in an Exchange

The holding period of replacement property acquired in a like-kind exchange includes the holding period of the relinquished property. n195 In other words, the holding period of the relinquished property is tacked onto the holding period of the replacement property. This rule applies only to property that is of a like-kind to that exchanged, and not to "boot" (see *section 2.02[7]*, above).

[5] Property Acquired under Option

When property is acquired through the exercise of an option, the holding period of the option itself is disregarded. The holding period commences when the option is exercised and the property is acquired. n196 The option is considered exercised when title passes or when there is delivery of possession, together with the assumption of the benefits and burdens of ownership by the purchaser. n197 In short, the option has a holding period of its own until it is exercised.

Planning Tip:

When property that can be acquired under an option is to be sold quickly, it may be better to sell the *option* than to acquire and sell the property, if the holding period of the option will allow long-term capital gain treatment on the profit realized from the sale.

[6] Property Acquired through Involuntary Conversion

For purposes of determining the holding period, property acquired as a result of an involuntary conversion is treated as property acquired in a tax-deferred exchange, as explained in *section 2.04[4]*, above. n198

[7] Improvements

The holding period of improvements made after the acquisition of real estate is computed separately from the holding period of the land itself. n199 While land may have a sufficient holding period to qualify for long-term capital gain or loss treatment, a building subsequently constructed on the land may have a different holding period which would not result in long-term status.

The "brick-by-brick" rule applies to the amount of construction completed on a building; that is, gain or loss must be allocated between the amount of construction completed more than one year before disposition of a building and the amount of construction completed less than one year before disposition of a building. n200

FOOTNOTES:

(n1)Footnote 190. *IRC § 1222(3)*.

(n2)Footnote 191. *Weir v Commr*, 10 TC 996 (1948) , *affd per curiam* 173 F2d 222 (3d Cir 1949) .

(n3)Footnote 192. *Rev Rul 54-607*, 1954-2 CB 177 .

(n4)Footnote 193. *IRC § 1223(2)*.

(n5)Footnote 194. *IRC § 1223(10)*.

(n6)Footnote 195. *IRC § 1223(1)*.

(n7)Footnote 196. *Helvering v San Joaquin Fruit & Inv Co*, 297 US 496 (1936) .

(n8)Footnote 197. *Rev Rul 54-607*, 1954-2 CB 177 .

(n9)Footnote 198. *IRC § 1223(1)*.

(n10)Footnote 199. *Dunigan v Burnet*, 66 F2d 201 (DC Cir 1933) .

(n11)Footnote 200. *Paul v Commr*, 206 F2d 763 (3d Cir 1953) (at the time of this decision, the requisite holding period for long-term capital gains and losses was six months; the court's decision thus spoke of six months as being the decisive time period).

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CHAPTER 2 Acquisition of Real Estate *

1-2 Federal Taxes Affecting Real Estate § 2.06

§ 2.06 Apportionment of Real Estate Taxes

[1] Between Buyers and Sellers

When real property is sold, real estate taxes for the year of sale must be apportioned between the buyer and the seller. n201 The apportionment is made on a daily basis over the period that the taxes cover. n202 The seller is entitled to a deduction for taxes covering the period from the first day of the tax year of the assessing authority to the day before the sale. The balance is deductible by the purchaser. This statutory apportionment rule applies whether or not the purchaser and seller apportion the tax. n202.1 This rule also applies regardless of whether the taxpayer uses the cash method of accounting for property taxes or has made the election under *IRC Section 461(c)* to accrue the taxes. Allocations specified in the sales contract do not govern the allocation of the deduction, although they may affect the economics of the transaction. n203 A purchaser who pays real property taxes that are allocated to the seller cannot deduct them, n203.1 but must capitalize them and add them to the basis of the acquired property. n203.2 It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is any way intended to reflect, real estate taxes allocable to the seller. n203.3 Proration of property taxes has also been applied when there is an involuntary seizure of property (as opposed to a voluntary purchase and sale), with allocation of items to periods before or after the date of seizure. n204

The period covered by a specific real estate tax levy varies with state law. n205 For example, a state's real property taxes may be assessed on a calendar-year basis; another state's, on the other hand, may cover the period from July 1 to June 30.

When property is purchased subject to delinquent real property taxes, the taxes may not be deducted by the purchaser and are, therefore, treated by the purchaser as an additional cost of the property to the purchaser that must be capitalized. n206

[2] On Non-Sale Transfers

The treatment of real estate tax allocations described above is limited to sales transactions. n207 Thus, the apportionment of real estate taxes in transactions such as contributions of real estate to a corporation or partnership and distribution of real estate in dissolution of such entities may not be covered by the rules of *IRC Section 164(d)*. In such situations, the availability and amount of any deduction will depend upon the method of accounting adopted by the taxpayer and other Code provisions governing allocations of tax items.

In transactions other than sales, it must be determined if the transferor and transferee are cash-basis taxpayers and are related entities within the meaning of the Code. If such a relationship exists, the taxpayer who holds the property when the real estate taxes accrue (i.e., the date on which the taxes become a lien against the property) will be entitled to the deduction in full. The Service, however, may attempt to cause an apportionment of the real estate taxes in order to reflect more clearly the income of the related parties. n208

In a non-sale transaction, if both the transferor and transferee have elected to accrue real estate taxes, each party will be entitled to a deduction for real estate taxes under the general rule. If, however, the transferor is a cash-basis taxpayer and the lien date for the taxes relating to the year of transfer does not fall within his period of ownership, the transferee will be entitled to the entire real estate tax deduction for the year of transfer. n209

FOOTNOTES:

(n1)Footnote 201. *IRC § 164(d)*.

(n2)Footnote 202. *Treas Reg § 1.164-6(b)(1)*.

(n3)Footnote 202.1. See *Treas Reg § 1.164-6(b)(1)(i)*.

(n4)Footnote 203. *Treas Reg § 1.164-6(c)*.

(n5)Footnote 203.1. *Treas Reg §§ 1.248*.

(n6)Footnote 203.2. *Treas Reg § 1.1012-1(b)*.

(n7)Footnote 203.3. *Treas Reg § 1.1012-1(b)*.

(n8)Footnote 204. *Correra v Commr, TC Memo 1997-356*.

(n9)Footnote 205. *Id.*

(n10)Footnote 206. *Treas Reg §§ 1.248*.

(n11)Footnote 207. *Rev Rul 62-45, 1962-1 CB 27*.

(n12)Footnote 208. See, eg, *Tenn Life Ins Co v Phinney, 280 F2d 38 (5th Cir 1960)*, cert denied 364 US 914; *Rev Rul 62-45, 1962-1 CB 27*.

(n13)Footnote 209. *Doric Co v Commr, 341 F2d 967 (9th Cir 1965)*.

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CHAPTER 3 Development of Real Estate

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CHAPTER 3 Development of Real Estate

1-3 Federal Taxes Affecting Real Estate Scope

Scope

The tax treatments of organizational expenditures, start-up expenditures, and construction period interest and taxes and other capitalizable costs incurred in connection with a real estate project are governed by *Internal Revenue Code Sections 248 and 709, 195 and 263A*, respectively. Every newly formed corporation or partnership incurs organizational expenditures in connection with the formation of the entity. Newly formed business entities or existing business entities incur start-up expenditures when creating or acquiring a new business. All costs incurred during the development stage of a real estate project, including interest, are subject to a comprehensive set of capitalization rules. This chapter reviews the tax treatment of these expenditures.



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CHAPTER 3 Development of Real Estate

1-3 Federal Taxes Affecting Real Estate § 3.01

§ 3.01 Organizational and Start-Up Expenditures

[1] Organizational Expenditures

[a] Definition

Organizational expenditures are defined as the costs incident to the creation of a corporation or a partnership that are chargeable to a capital account and are of a character that, if the corporation or partnership had a limited life, would normally be amortizable over that limited life. n1 Organizational expenditures include fees for legal services incident to the organization of the corporation or partnership, such as fees for drafting the corporate charter, by-laws, minutes of organizational meetings, or the partnership agreement and certificates. These costs also include fees for necessary accounting services and fees paid to the state of incorporation or organization. n2

Only organizational costs of the corporation or partnership are subject to *IRC Section 248* or *IRC Section 709*. Expenses incurred by individual shareholders or partners are not. n3 The following items do not qualify as organizational expenses: n4

- (1) expenditures connected with issuing or selling shares of stock or other securities or partnership interests (syndication and issuance expenses);
- (2) expenses connected with the reorganization of a corporation, unless directly incident to the creation of a corporation (these costs generally must be capitalized and cannot be amortized);
- (3) expenses connected with the admission or removal of partners other than at the time the partnership is first organized (the costs of *admission* may be treated as syndication expenses; the tax treatment of the costs of *removal* of partners may depend on the reason for the removal);
- (4) expenses connected with transferring assets to a corporation or partnership, or expenses of acquiring assets for a partnership (these expenses may be capitalized as part of the cost of acquiring the asset); or
- (5) expenses connected with a contract relating to the operation of a partnership trade or business, even if the contract is between the partnership and one of its members (these expenses may be currently deductible).

[b] Election to Deduct Organizational Expenditures

Corporations and partnerships (including LLCs treated as partnerships for tax purposes) may elect to deduct up to \$5,000 of organizational expenditures in the taxable year in which the trade or business begins. However, the \$5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of organizational expenditures exceeds \$50,000. n5

If the election is made, organizational expenditures that are not deductible in the year in which the trade or business begins are amortized over a 15-year period beginning with the month in which the corporation or partnership begins an active trade or business. n6 If a partnership making the election is liquidated before the end of the 15-year amortization period, any deferred expenses attributable to the partnership that were not allowed as a deduction may be deducted as a loss. n7

For organizational expenditures incurred before October 23, 2004, a corporation or partnership could elect to amortize those expenditures over a period of not less than 60 months, beginning with the month in which the entity began an active trade or business. n8

For both the current election to deduct and the prior election to amortize, a determination of when business begins must be made for the commencement of amortization. n8.1 A corporation or partnership that does not make an election under Treas Reg §§ 1.248 must capitalize its organizational costs. The costs will therefore provide no tax benefit until the entity is dissolved. n8.2

[c] Syndication and Issuance Expenses

Expenditures connected with issuing or selling shares of stock or partnership interests and related costs such as commissions, professional fees, and printing costs must be capitalized and do not qualify as organization fees or start-up expenditures. n9 The restrictions in deducting syndication expenses cannot be avoided by paying those expenses indirectly, rather than directly. The courts have upheld the Service's position that a management fee paid to a general partner to reimburse him for organization and syndication costs paid on behalf of the partnership should not have been claimed as a deduction. n10 It might be logical to expect that the nondeductible partnership syndication costs are deductible by the partnership in the final year of the partnership. However, there is no authority for this position, and, indeed, the regulations and a ruling by the Service provide to the contrary. n11 Although the capitalized syndication expenses cannot be deducted, if there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses can be deducted by the partnership in its final taxable year as a loss, to the extent provided under *IRC Section 165*. n11.1 However, since these costs are included in the partner's basis, the partner should receive a tax benefit (a capital loss) upon liquidation of the partnership. n12

[d] How to Elect to Deduct Organizational Expenses

The election to expense and amortize organizational expenditures must be made for a year by the due date of the return for that year, including extensions. The amortization period elected must be adhered to in computing the taxable income of the corporation for the year of election and for all later tax years. n12.1

No special election or statement must be filed in order to "elect" to deduct or amortize organizational expenditures under *IRC Section 248*. A corporation is deemed to have made an election to do so for the taxable year in which the corporation begins business. A corporation may choose to forgo the deemed election by clearly electing to capitalize its organizational expenditures on a timely filed federal income tax return (including extensions) for the taxable year in which the corporation begins business. The election either to amortize organizational expenditures or to capitalize them is irrevocable and applies to all organizational expenditures of the corporation. n13

Similarly, no special election or statement must be filed by a partnership in order to "elect" to deduct or amortize organizational expenditures under *IRC Section 709(b)*. A partnership is deemed to have made an election under *IRC Section 709(b)* to amortize organizational expenses for the taxable year in which it begins business. A partnership may choose to forgo the deemed election by clearly electing to capitalize its organizational expenses on a timely filed federal income tax return (including extensions) for the taxable year in which the partnership begins business. The election either to amortize or capitalize organizational expenses is irrevocable and applies to all organizational expenses of the partnership. n14

NOTE:

A change in the characterization of an item as an organizational expenditure is a change in method of accounting if the corporation or partnership treated the item consistently for two or more taxable years. A change in the determination of the taxable year in which the corporation or partnership begins business also is treated as a change in method of accounting if the entity amortized organizational expenditures for two or more taxable years. As a change in method of accounting, IRS permission must be obtained in order to make the change, and various statutory adjustments may be required. n15-18

Planning Note (1):

A corporation or partnership may be in a position of having to file a tax return for its first year before all organizational expenses have been identified or calculated. This can occur, for example, when invoices for organizational expenses are not received or paid before the return is due. The known, but unpaid, expenses may be included in the initial election. Later identified organizational expenses may be included on an amended return or statement for the entity's first tax year, or they may be added to the amortization computation for the next tax year. n19

Planning Note (2):

A C corporation should generally elect to deduct organizational costs to the extent possible, and amortize the remainder over 15 years. Doing so will reduce taxable income to the maximum extent during the corporation's early years, and any unused deductions can be carried forward as a net operating loss and reduce taxable income in future years. n20 Partnerships and S corporations should also make the election, because if it is not made, passed-through losses will not be deductible until the entity terminates. Even if the basis of the partners or shareholders is insufficient to deduct the passed-through deductions in the early years, it is likely there will be sufficient basis to take deductions during the 15-year amortization period. n21

[2] Start-Up Expenditures

[a] Definition

Start-up expenditures (also referred to as pre-opening expenditures) are amounts paid or incurred in connection with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of the activity becoming an active trade or business. n22

Note

The third item in the above list does not prevent the deduction of ordinary and necessary expenses incurred in a profit-making activity under *IRC Section 212*, regardless of whether that activity is later transformed into a trade or business. Provided that a taxpayer is in fact engaged in a profit-making

activity, *IRC Section 195* does not require expenses incurred in that activity to be treated as start-up expenditures. n22.1

An expenditure qualifies as a start-up expenditure only if it would have been currently deductible had it been paid or incurred in connection with the operation of an existing active trade or business. n23

Start-up expenditures include costs incurred for such items as advertising, employee training, lining up distributors, suppliers, or potential customers, professional services in setting up books and records, feasibility or marketing studies, and other noncapital expenses incurred before actual business operations. Management and certain advisory fees incurred while in the process of investigating or acquiring a trade or business are also considered start-up expenditures. n24 Expenses incurred with respect to rental real estate before the rental activity becomes an active trade or business are also start-up expenditures. This includes costs of renovating rental property to prepare it for rental. n24.1 Thus, virtually every newly formed entity has some type of start-up expenditures.

Amounts paid for the following items are specifically excluded from the definition of start-up expenditures: n25

- (1) interest on indebtedness; n26
- (2) taxes; n27 and
- (3) research and experimental expenditures. n28

Planning Note:

Start-up expenditures include only those expenditures that would be deductible by an existing business. n29 Capital expenditures n30 and items that would have to be capitalized under the uniform capitalization rules n31 do not qualify as start-up expenditures. A start-up "type" of expenditure that is incurred *after* the active trade or business begins is, by definition, currently deductible, n32 and is not a start-up expenditure. n33 Only expenditures that relate to a trade or business can qualify as start-up expenditures under *IRC Section 195*. In contrast, expenditures can qualify as organizational expenses under *IRC Section 248* once an entity has begun the business activities for which it was formed, whether or not they relate to an "active" trade or business. n34

The IRS has issued a revenue ruling that provides guidance on the types of expenditures that will qualify as investigatory costs eligible as start-up expenditures under *IRC Section 195*. The ruling states that expenditures incurred in a general search for, or an investigation of, an active trade or business--i.e., expenditures made in order to determine whether to enter a new business and, if so, which new business to enter--are investigatory costs that qualify as start-up expenditures under *IRC Section 195*, unless they are costs to acquire capital assets that are used in the search or investigation. In contrast, costs incurred in the attempt to acquire a specific business are capital in nature and, thus, are not start-up expenditures. The nature of any particular cost must be analyzed, based on all facts and circumstances of the transaction, to determine whether it is an investigatory cost incurred to facilitate the "whether" and "which" decisions, or an acquisition cost incurred to facilitate consummation of the acquisition. The label that the parties use to describe a cost and the point in time at which the cost is incurred do not necessarily determine the nature of that cost. n34.1

NOTE:

A change in the characterization of an item as a start-up expenditure is a change in method of accounting to which *IRC Sections 446* and *481(a)* apply if the taxpayer treated the item consistently for two or more taxable years. n34.2 For example, assume that Corporation X, a calendar year taxpayer, incurs \$41,000 of start-up expenditures that relate to an active trade or business that begins on July 1 of Year 1. It is

deemed to have elected to deduct start-up expenditures under *IRC Section 195(b)* in Year 1. Therefore, Corporation X deducts \$5,000 and the portion of the remaining \$36,000 that is amortizable in July through December of Year 1 ($\$36,000/180 \times 6 = \$1,200$) in Year 1 Corporation X determines in Year 3 that it incurred \$10,000 for an additional start-up expenditure erroneously deducted in Year 1 under *IRC Section 162* as a business expense. Corporation X is deemed to have elected to amortize start-up expenditures under *IRC Section 195(b)* in Year 1, including the additional \$10,000 of start-up expenditures. Corporation X is using an impermissible method of accounting for the additional \$10,000 of start-up expenditures and must change its method under regulations and general administrative procedures in effect in Year 3. n34.3

[b] Election to Deduct Start-Up Expenditures

Taxpayers may elect to deduct up to \$5,000 of start-up expenditures in the taxable year in which the trade or business begins. n35 However, the \$5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds \$50,000. n35.1 Start-up expenditures that are not deductible in the year in which the trade or business begins are amortized over a 15-year period beginning with the month in which the active trade or business begins. n35.2 For start-up expenditures incurred before October 23, 2004, taxpayers may elect to amortize those expenditures over a period of not less than 60 months, beginning with the month in which the active trade or business begins. n35.3

If the election is not made, no current deduction is allowed for the start-up expenditures. n36 Instead, they must be capitalized and recovered, if ever, on the disposition or cessation of the business. n37

[c] How to Elect to Deduct Start-Up Expenditures

No special election or statement must be filed in order to "elect" to deduct or amortize start-up expenditures. A taxpayer is deemed to make an election to deduct them for the taxable year in which the active trade or business to which the expenditures relates begins. n38 A taxpayer may choose to forgo the deemed election by clearly electing to capitalize its start-up expenditures on a timely filed federal income tax return (including extensions) for the taxable year in which the active trade or business begins. The election to capitalize start-up expenditures is made in accordance with the forms and instructions used by the taxpayer to file its Federal income tax return. An election either to deduct start-up expenditures under *IRC Section 195(b)* or to capitalize them is irrevocable and applies to all start-up expenditures of the taxpayer that are related to the active trade or business. n39-44

[3] When Active Trade or Business Begins

[a] The Determination Date

The date when an active trade or business begins is important in determining whether organizational or start-up expenditures are currently deductible, or, if they are not currently deductible, when amortization may begin. n45 For purposes of deducting or amortizing organizational expenditures, ascertaining when business has begun is a question of fact subject to interpretation and challenge. The words "begins business," however, do not have the same meaning as "in existence." Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business. n46-51

For start-up expenditures, an acquired trade or business is treated as beginning when the taxpayer acquires it. n52 Neither the statute nor the regulations specify when a newly created trade or business begins for purposes of *IRC*

Section 195. However, the legislative history of *IRC Section 195* anticipated that the definition of when a business begins for purposes of that section is to be made with reference to *IRC Sections 195* and *248*,ⁿ⁵³ with the focus being on whether the entity is conducting the business operations for which it was organized.ⁿ⁵⁴ In analyzing whether business has begun for purposes of *IRC Section 195*, however, the IRS applies the "going concern" standard used under *IRC Section 162*.ⁿ⁵⁵ The IRS rationalizes using this stricter standard on differences in statutory language. *IRC Section 195* refers to an "active trade or business." *IRC Sections 248* and *709*, in contrast, refer merely to the date the entity "begins business."ⁿ⁵⁶

The Service generally takes the position that mere commencement of construction is not sufficient to constitute the commencement of an active trade or business, and that until the business has begun to function as a going concern and perform the activities for which it was organized, it is still in the start-up phase. The courts, in several pre-*IRC Section 195* cases, have generally upheld the Service's position that commencement of construction, per se, is not the commencement of a trade or business.ⁿ⁵⁷ In one case, however, a district court permitted the deduction of normal operating expenses incurred before, but in the same taxable year as, completion of construction and commencement of use of the real estate.ⁿ⁵⁸ In a typical real estate venture, start-up expenses are usually incurred over more than one taxable year, and therefore this case does not appear to provide strong support for most start-up situations. The Court of Claims, has in *dicta* provided a significant pro-taxpayer analysis of this issue in a pre-*IRC Section 195* case. The court indicated that an entity formed for the specific purpose of constructing a real estate project was engaged in endeavors serving business and profit motives during the construction period, and the trade or business requirement was no barrier to the deductibility of normal operating expenses.ⁿ⁵⁹ The Service has stated in a private letter ruling that this case was wrongly decided, and in any event was legislatively overruled by Public Law No 98-369, the Deficit Reduction Act of 1984, and should not be followed.ⁿ⁶⁰

A real estate investment and rental business cannot begin until a taxpayer actually buys, remodels or rents property. Expenses incurred before that time, such as costs of looking for property, attending workshops on real estate investment, or buying a computer or software cannot be deducted under *IRC Section 162* as trade or business expenses. At best, they might be treated as start-up expenditures.^{n60.1}

[b] Expansion of Existing Business

An entity that has established its trade or business in the real estate industry through prior construction activities might appear relatively safe from a challenge by the Service that start-up types of expenditures incurred in expanding the business or starting a new project cannot be currently deducted.ⁿ⁶¹ Because the entity is already involved in an active trade or business, the expenses would be incurred in connection with the expansion of an existing trade or business. However, the Service could take the position that a new project must be segregated from the taxpayer's existing trade or business, and that a new "beginning of trade or business" determination must be made with respect to the new project, or that the costs relating to the new project provided significant long-term benefits and must be capitalized for that reason. Under this analysis, the Service might challenge deductions claimed by established businesses that construct a project that is significantly different from those previously constructed, or a project that is of such magnitude that it could be construed to be a separate trade or business.ⁿ⁶² Under pre-*Section 195* law, taxpayers appeared to have a great deal of latitude in this area, and the definition of an existing business was broadly defined,ⁿ⁶³ although the developments in the law relating to when expense capitalization is required may eventually restrict this definition.

[c] Entity Established for a Project

The determination of whether a real estate project is an expansion of an existing active trade or business or constitutes a new trade or business will be affected by whether the project is established within an existing entity or in a new, separate entity. If an entity is formed for the construction of a specific project, whether as a subsidiary of an established corporation engaged in a real estate trade or business, or as a partnership consisting of one or more partners with established real estate business activities, it is likely to come under Service challenge.ⁿ⁶⁴ Since most real estate

developments are formed as separate entities, either a partnership between established developers, or a partnership between an established developer and investors, or as a subsidiary of a corporate developer, careful analysis must be given to the status of start-up expenditures.

Planning Note:

In order to establish the earliest possible "beginning of an active trade or business" date for a new entity established to construct a new project, a taxpayer should take all steps possible to reflect an intent to commence business immediately. Intent can be proved by including in the partnership agreement or corporate charter the construction of the project as a specific purpose of the entity. n65 It would also be prudent from a tax perspective, as well as from an economic perspective, for taxpayers to accelerate the revenue cycle to the earliest possible date, through intensive leasing and marketing efforts, the actual procurement of leases, and the securing of forfeitable deposits. n66

[d] Change in Determination Date is Change in Method of Accounting

A change in the determination of the taxable year in which a taxpayer's active trade or business begins is treated as a change in method of accounting if the taxpayer amortized start-up expenditures for two or more taxable years. n66.1

Example:

Corporation X, a calendar year taxpayer, incurs \$41,000 of start-up expenditures that relate to an active trade or business that begins on July 1 of Year 1. The corporation is deemed to have elected to deduct start-up expenditures under section 195(b) in Year 1. It therefore deducts \$5,000 and the portion of the remaining \$36,000 that is amortizable in July through December of Year 1 ($\$36,000/180 \times 6 = \$1,200$) in Year 1. In Year 2, Corporation X deducts the start-up expenditures allocable to that year ($\$36,000/180 \times 12 = \$2,400$). In Year 3, it is determined that Corporation X actually began business in Year 2. Corporation X is deemed to have elected to deduct start-up expenditures under *IRC § 195(b)* in Year 2. Corporation X impermissibly deducted start-up expenditures in Year 1, and incorrectly determined the amount of start-up expenditures deducted in Year 2. Therefore, Corporation X is using an impermissible method of accounting for the start-up expenditures and must change its method under the regulations and general administrative procedures in effect in Year 2. n66.2

FOOTNOTES:

(n1)Footnote 1. *IRC §§ 248(b), 709(b)*.

(n2)Footnote 2. *Treas Reg § 1.709-1(b)(2), 1.709-2(a)*.

(n3)Footnote 3. *IRC §§ 248(a), 709(b)(2)*.

(n4)Footnote 4. *Treas Reg §§ 1.248-1(b)(3), 1.709-2(a)*.

(n5)Footnote 5. *IRC §§ 248(a)(1), 709(b)(1)(A)*, effective for organizational expenditures incurred after Oct 22, 2004. All organizational expenditures related to a particular trade or business, whether incurred before or after October 22, 2004, are considered in determining whether the cumulative cost of the organizational expenditures exceeds \$50,000.

(n6)Footnote 6. *IRC §§ 248(a)(2), 709(b)(1)(B)*.

(n7)Footnote 7. *IRC § 709(b)(2)*; see *IRC § 165*.

(n8)Footnote 8. *IRC §§ 248(a), 709(b)(1)*, before amendment by Pub L No 108-357.

(n9)Footnote 8.1. *McManus III v Commr*, TC Memo 1987-457 (1987) , *affd without published opinion* 865 F2d 255 (4th Cir 1988) ; *Treas Reg* § 1.709-2(c). See § 3.01 [3], *infra*, for a discussion of when a business begins.

(n10)Footnote 8.2. See *Warner Mountains Lumber Co v Commr*, 9 TC 1171 (1947) .

(n11)Footnote 9. *Treas Reg* §§ 1.248-1(b)(3), 1.709-2(b); *Rev Rul* 85-32, 1985-1 CB 186 .

(n12)Footnote 10. *Egolf v Commr*, 87 TC 34 (1986) .

(n13)Footnote 11. *Temp Treas Reg* § 1.709-1T(b)(3); *Rev Rul* 87-111, 1987-2 CB 160 .

(n14)Footnote 11.1. *Temp Treas Reg* § 1.709-1T(b)(3).

(n15)Footnote 12. *Rev Rul* 87-111, 1987-2 CB 160 .

(n16)Footnote 12.1. *IRC* § 248(c).

(n17)Footnote 13. *Temp Treas Reg* § 1.248-1T(c), effective for organizational expenditures paid or incurred after Sept 8, 2008. Taxpayers, however, may apply this rule to expenditures paid or incurred after Oct 22, 2004, provided the period of limitations on assessment of tax has not expired for the year the election is deemed made [*Temp Treas Reg* § 1.248-1T(f)]. For prior expenditures, a statement containing specified information had to be filed with the return [*Treas Reg* § 1.248-1, *before removal by TD 9411*].

(n18)Footnote 14. *Temp Treas Reg* § 1.709-1T(b)(2), effective for organizational expenditures paid or incurred after Sept 8, 2008. Taxpayers, however, may apply this rule to expenditures paid or incurred after Oct 22, 2004, provided the period of limitations on assessment of tax has not expired for the year the election is deemed made [*Temp Treas Reg* § 1.709-1T(b)(5)]. For prior expenditures, a statement containing specified information had to be filed with the return [*Treas Reg* § 1.709-1(c), *before removal by TD 9411*].

(n19)Footnote 15-18. *Temp Treas Reg* §§ 1.248-1T(c), 1.709-1T(b)(2). *IRC* §§ 446, 481(a).

(n20)Footnote 19. See *IRC* §§ 248, 709.

(n21)Footnote 20. *IRC* §§ 172, 248.

(n22)Footnote 21. See *IRC* §§ 704(d); 1366(d).

(n23)Footnote 22. *IRC* § 195(c)(1)(A); see *McKelvey v Commr*, TC Memo 2002-63 , *affd* 76 Fed. Appx. 806 (9th Cir 2003) (preliminary tree planting and other expenditures were start-up expenses because the taxpayer had not commenced a tree farming business).

(n24)Footnote 22.1. *Toth v Commr*, 128 TC 1 (2007) .

(n25)Footnote 23. *IRC* § 195(c)(1)(B).

(n26)Footnote 24. See HR Rep No 96-1278, 96th Cong 2d Sess (1980) relating to Pub L No 96-605.

(n27)Footnote 24.1. *Charlton v Commr*, 114 TC 333 (2000) .

(n28)Footnote 25. *IRC* § 195(c)(1).

(n29)Footnote 26. See *IRC* § 163(a).

(n30)Footnote 27. See *IRC* § 164.

(n31)Footnote 28. See *IRC § 174*.

(n32)Footnote 29. *IRC § 195(c)(1)(B)*.

(n33)Footnote 30. See *IRC § 263*.

(n34)Footnote 31. See *IRC § 263A*; see § 3.02, *infra*, for a discussion.

(n35)Footnote 32. *IRC § 162*.

(n36)Footnote 33. *IRC § 195(c)(1)*.

(n37)Footnote 34. *Active Lipid Dev Partners Ltd v Commr, TC Memo 1991-522*.

(n38)Footnote 34.1. *Rev Rul 99-23, 1999-2 CB 998*.

(n39)Footnote 34.2. *Temp Treas Reg § 1.195-1T(a)*.

(n40)Footnote 34.3. *Temp Treas Reg § 1.195-1T(c)*, Example 3; see *Reg § 1.446-1(e)*.

(n41)Footnote 35. See § 3.01[3], below, for a discussion of when a business begins.

(n42)Footnote 35.1. *IRC § 195(b)(1)(A)*, effective for start-up expenditures incurred after Oct 22, 2004. All start-up expenditures related to a particular trade or business, whether incurred before or after October 22, 2004, are considered in determining whether the cumulative cost of start-up expenditures exceeds \$50,000 [*Temp Treas Reg § 1.195-1T(a)*].

(n43)Footnote 35.2. *IRC § 195(b)(1)(B)*.

(n44)Footnote 35.3. *IRC § 195(b)*, before amendment by Pub L No 108-357.

(n45)Footnote 36. *IRC § 195(a)*.

(n46)Footnote 37. See *Fishman v Commr, 837 F2d 309 (7th Cir 1988)* (analyzing pre-section 195 law).

(n47)Footnote 38. *Temp Reg § 1.195-1T(b)*, effective for start-up expenditures paid or incurred after Sept 8, 2008. Taxpayers, however, may apply this rule to expenditures paid or incurred after Oct 22, 2004, provided the period of limitations on assessment of tax has not expired for the year the election is deemed made [*Temp Treas Reg § 1.195-1T(d)*]. For prior expenditures, a statement containing specified information had to be filed with the return [*Reg § 1.195-1, before removal by TD 9411*].

(n48)Footnote 39-44. *Temp Treas Reg § 1.195-1T(b)*.

(n49)Footnote 45. *IRC §§ 195, 248, 709*.

(n50)Footnote 46-51. *Temp Treas Reg § 1.248-1T(d)*.

(n51)Footnote 52. *IRC § 195(c)(2)(B)*.

(n52)Footnote 53. S Rep No 1936, 96th Cong, 2d Sess 14 (1980).

(n53)Footnote 54. See *Treas Reg § 1.709-2(c)*. See *Temp Treas Reg § 1.248-1T(d)*, and former *Treas Reg § 1.248-1(a)(3)*, before removal by TD 9411.

(n54)Footnote 55. See *Richmond Television Corp v US*, 345 F2d 901 (4th Cir 1965) , vacated and remanded per curiam on other grounds 382 US 68 (1965) , original holding on this issue reaff'd 354 F2d 410 (4th Cir 1965) , overruled on other grounds *NCNB Corp v US*, 684 F2d 285 (4th Cir 1982) .

(n55)Footnote 56. See *Active Lipid Dev Partners, Ltd v Commr*, TC Memo 1991-522 ; TAM 9027002 ; Ltr Rul 9331001 .

(n56)Footnote 57. *Jonnsen v Commr*, 794 F2d 1157 (6th Cir 1986) ; *Madison Gas and Elec Co v Commr*, 72 TC 521 (1979) , aff'd 633 F2d 512, 46 AFTR2d 80-5955 (7th Cir 1980) ; *Goodwin v Commr*, 75 TC 424 (1980) , aff'd 691 F2d 490 (3d Cir 1982) ; *Francis v Commr*, TC Memo 1977-170 .

(n57)Footnote 58. *US v Manor Care*, 490 F Supp 355, 46 AFTR2d 80-5331 (DC Md 1980) .

(n58)Footnote 59. *Blitzer v US*, 684 F2d 874, 50 AFTR2d 82-5293 (Ct Cl 1982) .

(n59)Footnote 60. Ltr Rul 9027002 .

(n60)Footnote 60.1. *Woody v Commr*, TC Memo 2009-93 ; *Charlton v Commr*, 114 TC 333 (2000) (mere purchase of property did not constitute an active trade or business because property was not rented out until a future year).

(n61)Footnote 61. See *IRC § 162*.

(n62)Footnote 62. See Ltr Rul 9331001 (the first retail boutique built and opened by manufacturer of cosmetics/importer and distributor of clothing found by IRS to be a new trade or business; additional boutiques ruled to be expansion of existing trade or business, although the expenditures might not be deductible if they provided significant long-term benefits); *FMR Corp v Commr*, 110 TC 402 (1998) .

(n63)Footnote 63. *Malmstedt v Commr*, 578 F2d 520, 42 AFTR2d 78-5290 (4th Cir 1978) ; *York v Commr*, 261 F2d 421 (4th Cir 1958) .

(n64)Footnote 64. *Madison Gas and Elec Co v Commr*, 72 TC 521 (1979) , aff'd 633 F2d 512, 46 AFTR2d 80-5955 (7th Cir 1980) ; *Goodwin v Commr*, 75 TC 424 (1980) , aff'd 691 F2d 490 (3d Cir 1982) .

(n65)Footnote 65. See *Treas Reg § 1.709-2(c)*, *Temp Treas Reg § 1.248-1T(d)*, and former *Treas Reg § 1.248-1(a)(3)*, before removal by TD 9411 .

(n66)Footnote 66. Cf *Fishman v Commr*, 837 F2d 309 (7th Cir 1988) .

(n67)Footnote 66.1. *Temp Treas Reg § 1.195-1(b)*.

(n68)Footnote 66.2. *Temp Treas Reg § 1.195T-1(c)*, Example 4; *Treas Reg § 1.446-1(e)*.



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Federal Taxes Affecting Real Estate

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CHAPTER 3 Development of Real Estate

1-3 Federal Taxes Affecting Real Estate § 3.02

§ 3.02 Uniform Capitalization Rules

The uniform capitalization rules set forth in *IRC Section 263A* require the capitalization of certain costs relating to the production of property or the acquisition of property for resale. The uniform capitalization rules apply to all taxpayers and to all types of activities. n67

[1] Property to Which Uniform Capitalization Rules Apply

IRC Section 263A applies to real or tangible personal property produced by the taxpayer and real and certain tangible personal property acquired by the taxpayer for resale. Thus, it applies to real property produced by a taxpayer for use in its own trade or business or for sale to its customers. This chapter will generally discuss only the real property aspects of *IRC Section 263A*. It also applies to property produced for a taxpayer under a contract with another party. n68 The statute contains certain exceptions for the farming industry, but nevertheless applies to certain types of farming businesses and to certain products produced in farming businesses. n69

The uniform capitalization rules apply to all tangible property that the taxpayer produces or constructs, whether the property is used by the taxpayer or is held for sale to customers. n70 This includes property--such as real estate--that is held for sale in the ordinary course of business, but is not considered to be inventory. n71

The uniform capitalization rules also apply to real and personal (tangible and intangible) property that is acquired for resale (as distinguished from property produced or constructed by the taxpayer). n72

The uniform capitalization rules do not apply to property produced by a taxpayer for use by the taxpayer in other than a trade or business or an activity conducted for profit, such as personal use property. n73 They also do not apply to property that is produced by a taxpayer under a long-term contract. n74 The capitalization rules relating to long-term contracts are contained in *IRC Section 460*.

For purposes of the uniform capitalization rules, the word "produce" includes construct, build, install, manufacture, develop or improve. n75 Taxpayers are treated as producing any property produced for them under contract, except that only costs paid or incurred by the taxpayer (whether under such a contract or not) must be taken into account in applying the uniform capitalization rules. n76

1-3 Federal Taxes Affecting Real Estate § 3.02

Courts have broadly interpreted the word "produce" to encompass nearly all activities that are steps in the development of property, even ancillary activities that occur before any physical changes are made to the land and costs, such as real estate taxes, relating to property intended to be developed, even if no development activity ever takes place. n77 Therefore, real estate developers must capitalize under *IRC Section 263A* the costs of meeting with government officials, obtaining building permits and zoning variances, negotiating permit fees, performing engineering and feasibility studies and drafting architectural plans, as well as property taxes. The costs must be capitalized even for amounts that are paid to third-party independent contractors, who actually perform the services. The rationale for requiring capitalization is that all of the above activities fall within the definition of "produce" because they represent the first steps in the development of the property. n78

The IRS takes the position that impact fees incurred by a taxpayer in connection with the construction of a new building are capitalized costs allocable to the building under *IRC Section 263* and *IRC Section 263A*, and are subject to the uniform capitalization rules. Its rationale is that the fees result in permanent improvement or betterment to the taxpayer's development project n79 Impact fees are one-time charges that are imposed by state or local governments against new development or expansion of existing developments to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. In general, impact fees are refundable (in full or in part) if the new or expanded development ultimately is not constructed as planned. n79.1

Note:

Any change in a taxpayer's treatment of impact fees incurred in connection with the new construction or expansion of a building to conform to *Revenue Ruling 2002-9* is a change in accounting method to which *IRC Sections 446* and *481* apply. A taxpayer wanting to change the method of accounting for impact fees to conform with *Revenue Ruling 2002-9* must follow the automatic change in method of accounting provisions in *Revenue Procedure 2002-9* [see *2002-1 CB 327* (or its successor), as modified and clarified by *Announcement 2002-17 (2002-1 CB 562)*], subject to two modifications:

- If a taxpayer changes its method of accounting for impact fees to conform to *Revenue Ruling 2002-9* for the first tax year ending on or after December 31, 2001, the scope limits in Section 4.02 of *Rev Proc 2002-9* do not apply; and

- *Rev Proc 2002-9*, Section 6.02(4)(a) is modified to require that a Form 3115 filed under *Revenue Ruling 2002-9* include the statement "Automatic Change Filed Under *Rev. Rul. 2002-9*". The statement should be legibly printed or typed on the appropriate line on the Form 3115.

If a taxpayer changes its method of accounting for impact fees to conform with *Revenue Ruling 2002-9*, the IRS will not raise the treatment of impact fees as an issue in any tax year before the year of change. If the change in method of accounting is made for the taxpayer's first tax year ending on or after December 31, 2001, and the treatment of impact fees has already been raised as an issue in a tax year before the taxpayer's first tax year ending on or after December 31, 2001, the IRS will not further pursue the treatment of impact fees. The IRS added that if the building is subject to depreciation, the taxpayer must depreciate the impact fees as residential rental property or nonresidential real property, as appropriate, beginning when the newly constructed building or expansion of the building is placed in service by the taxpayer. n79.2

[2] Costs that Must Be Capitalized

The statute itself provides no detail as to what costs are to be capitalized. It requires only that all direct costs, plus a "proper share" of indirect costs (including taxes) allocable to the property, be capitalized. n80 However, any cost that could not otherwise be taken into account in computing taxable income for any tax year (for example, the portion of a business meal deduction limited by *IRC Section 274(n)*) cannot be treated as an allocable cost under the uniform

capitalization rules. n81

Regulations provide that for producers, direct costs include materials that are consumed or become a part of property and labor that can be associated with the property. n82 For resellers, direct costs include acquisition costs of property acquired for resale. n83 Indirect costs include costs that directly benefit the asset or that are incurred because of the production or resale activity. n84 Taxpayers with indirect costs allocable to more than one activity must make a reasonable allocation of those costs between production, resale and other activities. n85

Regulations detail the following as examples of indirect costs that must be capitalized, to the extent they are properly allocable to property produced by the taxpayer or acquired for resale: n86

- (1) indirect labor costs;
- (2) officers' compensation
- (3) pension and related costs;
- (4) employee benefits;
- (5) indirect material costs;
- (6) purchasing, handling and storage costs;
- (7) depreciation, amortization and cost recovery allowances on equipment and facilities;
- (8) depletion;
- (9) rent;
- (10) taxes attributable to labor, materials, supplies, equipment, land or facilities used in production or resale activities;
- (11) insurance;
- (12) utilities;
- (13) repairs and maintenance;
- (14) engineering and design costs;
- (15) spoilage, including costs of rework labor, scrap and spoilage;
- (16) tools and equipment;
- (17) quality control costs;
- (18) bidding costs incurred in soliciting contracts that are ultimately awarded to the taxpayer, including contracts pertaining to property acquired for resale; (**Note:** bidding costs on contracts *not* awarded to the taxpayer are deductible in the year the contract is awarded to another party, the year the taxpayer is notified in writing that no contract will be awarded, or the year the taxpayer abandons its bid or proposal.

A taxpayer who is awarded only part of a bid may deduct costs related to the unsuccessful bid if the product for the unsuccessful bid is different from that of the successful bid. However, in the case of a multi-unit contract involving similar products, all bidding costs incurred on all the contracts must be capitalized and allocated to the subject matter of any contract that is awarded to the taxpayer.)

(19) licensing and franchise costs;

(20) interest; n87 and

(21) capitalizable service costs attributable to general and administrative support or service departments, such as accounting, data processing, legal and personal security departments. n88

[3] Costs Not Subject to Uniform Capitalization Rules

The following costs are not subject to the uniform capitalization rules:

(1) research and experimental expenses; n89

(2) development and other costs of oil and gas wells and other mineral property; n90

(3) costs incurred in producing property under long-term contracts; n91

(4) costs incurred in connection with the production of timber and certain ornamental trees; n92

(5) costs incurred by certain cash-basis taxpayers in a farming business to produce animals, or to produce any plant with a preproductive period of two years or less; n93 and

(6) qualified creative expenses incurred by freelance authors, photographers and writers. n94

Regulations also list a variety of additional indirect costs that are not required to be capitalized under the uniform capitalization rules: n95

(1) selling (including marketing and advertising) and distribution costs;

(2) otherwise depreciable costs for which an *IRC Section 179* election is made;

(3) losses deductible under *IRC Section 165*;

(4) cost recovery allowances on temporarily idle equipment;

(5) state, local and foreign income taxes and franchise taxes that are assessed on the basis of income;

(6) certain strike expenses;

(7) warranty and product liability costs;

(8) on-site storage or warehousing costs incurred at an on-site storage facility with respect to property produced or property acquired for resale;

(9) unsuccessful bidding expenses; and

(10) deductible service costs and mixed service costs. n96

[4] Application of Uniform Capitalization Rules to Farming Businesses

As in many other areas of the Code, special capitalization rules apply to farming businesses. The uniform capitalization rules do not apply to the production of animals or to the production of plants with a preproductive period of two years or less. n97 Nursery growers also qualify for this farming exception. n98 This exception does not apply, however, to any farming corporation, partnership or tax shelter that is required to use an accrual method of accounting under *IRC Section 447* or *448(a)(3)*. n99 The uniform capitalization rules also do not apply to replanting costs for plants that are destroyed as a result of frost, disease or other casualty. n100

Certain taxpayers who would otherwise be subject to uniform capitalization rules may elect not to have those rules apply to any plant produced in their farming business. n101 The election may be made only for the first taxable year during which the taxpayer engages in a farming business, and may be revoked only with the consent of the Secretary. n102

Taxpayers who must use an accrual method of accounting under *IRC Section 447* or *448(a)(3)* cannot make the election. n103 The election cannot apply to any item attributable to a citrus or almond grove which is incurred before the close of the fourth taxable year beginning with the year the trees were planted. n104

A plant for which otherwise capitalizable amounts are expensed by virtue of this election is treated as *IRC Section 1245* property, and the amount deductible by virtue of the election is treated as an amount that is subject to the recapture rules when the property is disposed of. n105 If the taxpayer or a related person makes the election, the alternative depreciation system n106 must be used with respect to all property of the taxpayer that is used predominantly in the farming business and is placed in service in any tax year during which the election is in effect. n107

[5] Interest Capitalization

[a] Property to Which Interest Capitalization Rules Apply

Interest is a cost that is subject to the uniform capitalization rules. In general, capitalization is required only for interest that is paid or incurred during the production period of certain designated property. n108 Designated property includes all real property produced by the taxpayer. n109

Designated property also includes tangible personal property that meets any of the following criteria: n110

- (1) property with a class life of at least 20 years that is not inventory in the hands of the taxpayer or a related person;
- (2) property with an estimated production period of over two years; n111 or
- (3) property with an estimated production period exceeding one year and an estimated cost of production exceeding \$1 million.

The various thresholds in items (1) through (3) above are determined for each "unit of property." n112

Designated property does not include the following: n113

- (1) timber or Christmas trees; or

(2) personal use property--property produced by the taxpayer for use by the taxpayer, other than in a trade or business or an activity conducted for profit.

A *de minimis* rule also applies. Any property with a production period of not more than 90 days and a total cost of production that does not exceed \$1 million, divided by the number of days in the production period, will not constitute designated property. n114

Example:

T owns a \$200,000 rental property and intends to take it out of service to make \$15,000 worth of repairs involving a kitchen remodel and plumbing improvements. The repair project is expected to take 60 days. Under the *de minimis* rule, if the project is completed within that time, the property improvements do not constitute designated property and the interest capitalization rules will not apply during the production period. This is because \$15,000, the cost of the project, is less than \$16,666 [$\$1 \text{ million} / 60 \text{ days}$ of the project]. If the project takes 70 days to complete, the improvements do qualify as designated property and the interest capitalization rules do apply during the production period. This is because \$15,000 is greater than \$14,285 [$\$1 \text{ million} / 70 \text{ days}$ of the project]. n114.1

[b] Real Property Defined

The uniform capitalization rules require capitalization of interest paid or incurred during the production period of real property produced by a taxpayer. n115 For this purpose, "real property" is broadly defined to include land, buildings and inherently permanent structures and unsevered natural products of land. Any interest in this type of property is included, whether it is a fee ownership, co-ownership, leasehold, option, or similar interest. Real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar items. Tenant improvements to a building that are inherently permanent are also real property. Property that is produced for sale and is not real property in the hands of the taxpayer or a related person, but may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer (e.g., bricks, nails, paint and windowpanes), n116 although that property will nevertheless be subject to the uniform capitalization rules on the basis that it is tangible personal property produced by the taxpayer.

Inherently permanent structures include property that is affixed (whether by weight alone or other means) to real property and that will ordinarily remain affixed for an indefinite period of time. This includes items such as swimming pools, roads, bridges, tunnels, paved parking areas, and other pavements, special foundations, wharves and docks, fences, certain advertising displays, outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. n117 Property may be an inherently permanent structure even though it is not classified as a building for purposes of the former investment tax credit. n118

Machinery is not ordinarily an inherently permanent structure, and it is not real property, unless a building or inherently permanent structure includes property in the nature of machinery as a structural component. n119 It should be noted in this regard that a structure may be an inherently permanent structure and not in the nature of machinery, even if the structure is necessary to operate or use machinery, or if it supports or is otherwise associated with machinery. n120

Unsevered natural products include growing crops and plants, mines, wells and other natural deposits. Growing crops and plants, however, are real property only if their preproductive period exceeds two years. n121

[c] Avoided Cost Method

The amount of interest required to be capitalized must be determined using the avoided cost method. n122 Interest is an avoided cost if the taxpayer theoretically would have avoided the interest charge if it had used funds spent on production costs to, instead, pay down debt. Under the avoided cost method, interest on any indebtedness directly attributable to production expenditures for designated property (traced debt) is capitalized first. This requires the traced debt amount to be determined. n123 If production expenditures for designated property exceed the amount of traced debt, interest on any other debt must be capitalized to the extent the interest could have been reduced if production expenditures had not been incurred. n124 This is referred to as the excess expenditure amount. n125

The application of the avoided cost method does not depend on whether the taxpayer actually would have used the amounts expended for production to repay or reduce debt. Rather, the avoided cost method assumes that the debt would have been paid or reduced without regard to the taxpayer's subjective intent or any other restrictions (such as legal, regulatory or contractual restrictions) against repayment or use of the debt proceeds. n126

Planning Note:

In adopting the avoided cost method in final regulations, the Service rejected suggestions that taxpayers should simply be able to use "Statement of Financial Accounting Standards No 34" (SFAS 34) to capitalize interest. SFAS 34 establishes standards for capitalizing interest for financial statement purposes. Thus, taxpayers will have to keep separate records in this area for accounting and tax purposes.

The traced debt and excess expenditure amounts generally must be determined for each tax year or shorter production period for each unit of designated property. n127 A taxpayer must adopt a computation period and measurement dates (at least quarterly) to determine the amount of traced debt and excess expenditure amounts. n128 A taxpayer may, however, make an election not to trace debt to specific units of designated property. n129

[d] Traced Debt Amount

The interest attributable to the traced debt amount with respect to a unit of designated property must be capitalized. The interest on any debt traced to the accumulated production expenditures for a unit of designated property includes the interest on the traced debt for the entire measurement period for any measurement period in which production occurs. n130 The traced debt amount is determined by reference to outstanding eligible debt. n131 The eligible debt taken into account for a given unit of designated property is all outstanding debt except debt that the regulations specifically exclude. n132 Traced debt includes debt that is allocated under temporary regulations to accumulated production expenditures with respect to a unit of property. n133 Traced debt also includes unpaid interest that has been capitalized with respect to that unit and that is included in accumulated production expenditures on the measurement date. n134

Example:

Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of real property during the year. X adopts a taxable year computation period and quarterly measurement dates. Production begins on January 14 and ends on June 16. On March 31 and June 30 of the year (the quarterly measurement dates), X has outstanding a \$1 million loan that is allocated to production expenditures with respect to the unit. During the period January 1 through June 30, X incurs \$50,000 of interest related to the loan. The interest must be capitalized as traced debt. n135

[e] Excess Expenditure Amount

If accumulated production expenditures exceed traced debt on a unit of designated property on a measurement date, a taxpayer must, for the computation period that includes the measurement date, capitalize the excess expenditure amount with respect to that unit of property. This rule, however, serves to allocate capitalizable interest away from other properties; it does not increase the amount of capitalizable interest. Accordingly, if the excess expenditure amount for all units of designated property exceeds the total interest required to be capitalized, only a pro-rata amount of that

interest must be capitalized with respect to each unit. n136

For each unit of designated property, the excess expenditure amount for a computation period equals the following: n137

- (1) the average excess expenditure for the unit of designated property for that period; and
- (2) the weighted average interest rate for that period.

In computing the excess expenditure amount, interest from the following sources must be capitalized, and in the following sequence: n138

- (1) interest incurred on nontraced debt; n138.1
- (2) interest incurred on certain borrowings from related persons; and
- (3) in the case of a partnership, guaranteed payments for the use of capital that would be deductible by the partnership but for the interest capitalization rule. n139

The amount of interest required to be capitalized, however, cannot exceed the excess expenditure amount for all units of designated property. n140 Special rules apply when interest is subject to a deferral provision. n141

The average excess expenditures for a unit of designated property for a computation period are computed by:

- (1) determining the amount (if any) by which accumulated production expenditures exceed traced debt each measurement date during the computation period; and
- (2) dividing the sum of those amounts by the number of measurement dates during the computation period. n142

The weighted average interest rate for a computation period is determined by dividing interest incurred on nontraced debt during the period by average nontraced debt for the period. n143

[f] Eligible Debt

The amount of interest required to be capitalized is made by reference to outstanding eligible debt. n144 Eligible debt generally includes all debt of the taxpayer on which interest is deductible in computing taxable income. n145 Accordingly, eligible debt does not include any of the following:

- (1) accounts payable and other non-interest bearing debt, unless it is traced debt;
- (2) debt bearing interest that is disallowed because it is (a) on an obligation not in registered form; n146 (b) incurred to purchase or carry a single premium life insurance, endowment or annuity contract; n147 (c) incurred to purchase life insurance or any endowment or annuity contract owned by the taxpayer in excess of \$50,000 on an individual; n148 (d) incurred to purchase or carry obligations on which interest is tax-exempt; n149 (e) incurred by a corporation to acquire stock or assets of another corporation; n150 and (f) disallowed under special rules for insurance companies; n151
- (3) debt borrowed from persons related to the taxpayer that bears a rate of interest lower than the applicable federal rate in effect on the date of issuance; n152

- (4) debt bearing personal or qualified residence interest; n153
- (5) certain debt incurred by tax-exempt entities;
- (6) reserves, deferred tax liabilities, and similar items that are not treated as debt for federal tax purposes; and
- (7) Federal, state, and local income tax liabilities, deferred tax liabilities, n154 and hypothetical tax liabilities under the look-back method n155 or similar method.

[g] Election Not to Trace Debt

A taxpayer may elect not to trace debt. n156 If the election is made, then the average excess expenditures and weighted average interest rate n157 are determined by treating all eligible debt as nontraced debt. For this purpose, accounts payable and other accrued non-interest bearing items may be included in eligible debt, provided that it would otherwise be treated as traced debt but for the election. n158

An election not to trace debt applies to all designated property of the taxpayer. The making or revocation of the election is considered a change in method of accounting, requiring the consent of the Commissioner. n159

[h] Unit of Property Defined

A unit of real property for purposes of the interest capitalization rules includes all functionally interdependent components of the property. n160 Thus, a unit of real property includes any components of the real property owned by the taxpayer or a related person that are functionally interdependent. It also includes an allocable share of any common feature owned by the taxpayer or a related person that is real property, even though the common feature does not meet the functional interdependence test. n161 The portion of land included in a unit of real property includes land on which real property (including a common feature) included in the unit is situated, land subject to setback restrictions with respect to the property, and any other contiguous portion of the tract of land, other than the land that the taxpayer holds for a purpose unrelated to the unit being produced. n162

Planning Note:

When the production period begins with respect to any functionally interdependent component or any common feature of the unit of real property, the production period generally is treated as having begun for the entire unit of real property. n163

Two special common feature rules apply. The first gives taxpayers an option with respect to land attributable to benefitted property. Land costs of benefitted property may be treated as not included in the accumulated production expenditures for the unit until a direct production activity begins on the benefitted property. n164 Thus, if no direct production activities have been undertaken on planned houses, such as clearing and grading activities on the land underlying the houses, the cost of that land may be treated as not included in the accumulated production expenditures for the unit. n164.1

The second is a suspension period rule that applies when clearing and grading have begun. If, after clearing and grading has been undertaken with respect to the land attributable to the benefitted property, there is no direct production activity taken with respect to that property for a period of at least 120 consecutive days, then the accumulated production expenditures attributable to that property are treated as not included in the accumulated production expenditures of the unit from the first measurement period after the beginning of the 120-day period until the measurement period in which

direct production activity resumes with respect to that property. n165

When benefitted property is sold or placed in service prior to the completion of a common feature allocable to a unit, the costs of the benefitted property and allocable common features no longer attract interest capitalization. n166

Planning Note:

Revenue Procedure 92-29 n167 allows a developer to include in the basis of properties sold their allocable share of the estimated cost of common improvements without regard to whether economic performance with respect to the costs has occurred despite the fact that the Code would otherwise generally require economic performance before costs are taken into account for tax purposes. n168 At the end of the tax year, however, the total amount of common improvement costs included in the basis of the properties cannot exceed the amount of common improvement costs that have been incurred under *IRC Section 461(h)* (the "alternative cost limitation"). Final regulations clarify that *Revenue Procedure 92-29* does not affect the determination of accumulated production expenditures of unsold units even if the costs of common improvements for those unsold units have been used to determine the alternative cost limitation for purposes of including common improvement costs in the basis of sold units. n169

[i] Accumulated Production Expenditures Defined

Accumulated production expenditures include the cumulative amount of direct and indirect costs n170 that must be capitalized with respect to a unit of property. Included in these expenditures are interest capitalized in prior computation periods and the adjusted bases of any assets used to produce the unit of property during the period of their use. Accumulated production expenditures may also include the basis of any property received by the taxpayer in a non-taxable transaction. n171

In general, costs are first taken into account in computing accumulated adjusted expenditures at the time they would otherwise be taken into account under the taxpayer's method of accounting. n172 Costs incurred and capitalized with respect to a unit of property before the beginning of the production period are taken into account as accumulated production expenditures beginning on the date on which the production period of the property begins. n173 Costs of raw materials are included in accumulated production expenditures when they are incurred and dedicated to production of a unit of property. n174 Special rules determine when costs are taken into account when a unit of property produced under a contract is designated property with respect to a customer or contractor. n175

Special rules apply for determining the accumulated production expenditures for an improvement to existing real property. n176 First, accumulated production expenditures for an improvement include all direct and indirect costs required to be capitalized with respect to the improvement, plus an allocable portion of the cost of associated land. Thus, land costs are included in the accumulated production expenditures for property during its production period, even if they are incurred before the production period. n177 In addition, the adjusted bases of an existing structure or common features that either are not already placed in service or must be taken out of service in order to complete the improvement and directly benefit or are incurred by reason of the improvement are included in the accumulated production expenditures. n178

Second, a *de minimis* rule applies for property taken out of service. n179 Under that rule, the aggregate costs of all property or common features taken out of service to complete an improvement ("associated property costs") are excluded from the accumulated production expenditures for the improvement unit during its production period if, on the date the production period of the unit begins, the taxpayer reasonably expects that on no date during the production period of the unit will the accumulated production expenditures for the unit, determined without regard to associated property costs, exceed 5 percent of the associated property costs. n180

[j] Production Period

A separate production period must be determined for each unit of property. The production period begins on the date that production of the unit of property begins. n181 A production period for a unit of real property generally begins on the first date that any physical production activity is performed with respect to that unit. n182 The production period does not end until all production activities reasonably expected to be undertaken by the taxpayer (or a related party) with respect to the unit are completed. n183

Planning Note:

In adopting final regulations, the Service rejected a suggestion that the production period should end when only *de minimis* customizing activities remain to be performed. The final regulations, however, do contain a rule that may provide relief when there are long periods of delay in the performance of customizing activities. When production activities related to the production of a unit of designated property cease for a period of at least 120 days, taxpayers may retroactively suspend interest capitalization as of the first measurement period following the measurement period in which production activities ceased. n184 Alternatively, if the cessation period spans more than one tax year, and a taxpayer does not want to file an amended return for the prior year, the taxpayer may suspend the capitalization of interest with respect to its units of designated property beginning with the first measurement period of the tax year in which the 120-day period is satisfied. n185

In connection with the shorter 120-day cessation period, several criteria are used for determining whether production activities are considered to have ceased. They are not considered to have ceased if they cease because of delays inherent in the asset production process, such as normal bad weather, scheduled plant shutdowns, delays due to design or construction flaws, obtaining of permits or licenses, or the settlement of groundfill to construct property. n186

[k] Oil and Gas Well Provisions

Special rules apply with respect to the capitalization of interest in developing oil and gas wells. n187 The rules require the inclusion of *IRC Section 614* costs in accumulated production expenditures, establish the beginning and ending of the production period for oil or gas wells, and provide for the allocation of capitalized interest to depreciable or depletable unit components. A special "definite plan" rule allows taxpayers to partition *IRC Section 614* costs among the number of wells to be drilled on the property if they can devise a "definite plan" up-front that identifies the number and location of the wells to be drilled. n188

FOOTNOTES:

(n1)Footnote 67. For comprehensive coverage of the uniform capitalization rules, see L Schneider, *Federal Income Taxation of Inventories* (Matthew Bender 1999).

(n2)Footnote 68. *Treas Reg § 1.263A-2(a)*.

(n3)Footnote 69. *IRC § 263A(d)*; see § 3.02[4], *infra*, for a discussion.

(n4)Footnote 70. *IRC § 263A(b)(1)*.

(n5)Footnote 71. *Carpenter v Commr, TC Memo 1994-289*.

(n6)Footnote 72. *IRC § 263A(b)(2)*.

(n7)Footnote 73. *IRC § 263A(c)(1)*.

(n8)Footnote 74. *IRC § 263A(c)(4)*.

(n9)Footnote 75. *IRC § 263A(g)(1)*.

(n10)Footnote 76. *IRC § 263A(g)(2)*.

(n11)Footnote 77. *Reichel v Commr, 112 TC 14 (1999)* .

(n12)Footnote 78. *Von-Lusk, et al v Commr, 104 TC 207 (1995)* .

(n13)Footnote 79. *Rev Rul 2002-9, 2002-1 CB 614* .

(n14)Footnote 79.1. *Id.*

(n15)Footnote 79.2. *Id.*

(n16)Footnote 80. *IRC § 263A(a)(2)*.

(n17)Footnote 81. *IRC § 263A(a); Treas Reg § 1.263A-1(c)(2)(i)*.

(n18)Footnote 82. *Treas Reg § 1.263A-1(e)(2)*.

(n19)Footnote 83. *Treas Reg § 1.263A-1(e)(2)(ii)*.

(n20)Footnote 84. *Treas Reg § 1.263A-1(e)(3)*.

(n21)Footnote 85. *Treas Reg § 1.263A-1(e)(3)(i)*.

(n22)Footnote 86. *Treas Reg § 1.263A-1(e)(3)(ii)*.

(n23)Footnote 87. See § 3.02[5], *infra*, for a discussion of capitalization of interest.

(n24)Footnote 88. See *Treas Reg § 1.263A-1(e)(4)*.

(n25)Footnote 89. *IRC § 263A(c)(2); see IRC § 174*.

(n26)Footnote 90. *IRC § 263A(c)(3); see IRC §§ 167(h)* (amortization of geological and geophysical expenditures), 179B (small business refiner deduction for capital costs incurred in complying with Environmental Protection Agency sulfur regulations), 263(c), (i), 291(b)(2) (intangible drilling and development costs), 616 (mining development costs), 617 (mining exploration expenditures).

(n27)Footnote 91. *IRC § 263A(c)(4); see IRC § 460*.

(n28)Footnote 92. *IRC § 263A(c)(5)*.

(n29)Footnote 93. *IRC § 263A(d); see § 3.02[4], infra*, for a discussion of the application of uniform capitalization rules to farming businesses.

(n30)Footnote 94. *IRC § 263A(h)*.

(n31)Footnote 95. *Treas Reg § 1.263A-1(e)(3)(iii)*.

(n32)Footnote 96. See *Treas Reg § 1.263A-1(e)(4)*.

(n33)Footnote 97. *IRC § 263A(d)(1)(A)*.

(n34)Footnote 98. Ann 97-120, 1997-50 IRB 61 .

(n35)Footnote 99. IRC § 263A(d)(1)(B). The accrual method of accounting rules generally do not apply to S corporations or corporations with gross receipts below a specified threshold.

(n36)Footnote 100. IRC § 263A(d)(2).

(n37)Footnote 101. IRC § 263A(d)(3)(A).

(n38)Footnote 102. IRC § 263A(d)(3)(D).

(n39)Footnote 103. IRC § 263A(d)(3)(B).

(n40)Footnote 104. IRC § 263A(d)(3)(C).

(n41)Footnote 105. IRC § 263A(e)(1).

(n42)Footnote 106. See IRC § 168(g)(2).

(n43)Footnote 107. IRC § 263A(e)(2).

(n44)Footnote 108. IRC § 263A(f)(1); Treas Reg § 1.263A-8(b); see § 3.02[5][j], *infra*, for discussion of the production period.

(n45)Footnote 109. Treas Reg § 1.263A-8(b)(1)(I); see § 3.02[5][b], *infra*, for a definition of real property.

(n46)Footnote 110. Treas Reg § 1.263A-8(b)(1)(ii).

(n47)Footnote 111. See Treas Reg § 1.263A-12.

(n48)Footnote 112. Treas Reg § 1.263A-8(b)(2)(i); see § 3.02[5][h], *infra*, for a definition of "unit of property".

(n49)Footnote 113. Treas Reg § 1.263A-8(b)(3).

(n50)Footnote 114. Treas Reg § 1.263A-8(b)(4).

(n51)Footnote 114.1. Treas Reg § 1.263A-8(b)(4).

(n52)Footnote 115. IRC § 263A(b)(1), (f)(1).

(n53)Footnote 116. Treas Reg § 1.263A-8(c)(1).

(n54)Footnote 117. Treas Reg § 1.263A-8(c)(3).

(n55)Footnote 118. Treas Reg § 1.263A-8(c)(3); see former IRC § 48(a)(1)(B), *before amendment* by Pub L No 101-508, former Treas Reg § 1.48-1.

(n56)Footnote 119. Treas Reg § 1.263A-8(c)(4)(i).

(n57)Footnote 120. Treas Reg § 1.263A-8(c)(4)(i).

(n58)Footnote 121. Treas Reg § 1.263A-8(c)(2).

(n59)Footnote 122. Treas Reg § 1.263A-9(a)(1).

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- (n60)Footnote 123. See *Treas Reg* § 1.263A-9(b); see § 3.02[5][d], *infra*, for a discussion.
- (n61)Footnote 124. *Treas Reg* § 1.263A-9(a)(2).
- (n62)Footnote 125. *Treas Reg* § 1.263A-9(a)(2)(B), (c); see § 3.02[5][e], *infra*, for a discussion of the excess expenditure amount.
- (n63)Footnote 126. *Treas Reg* § 1.263A-9(a)(1).
- (n64)Footnote 127. *Treas Reg* § 1.263A-9(a)(2)(ii); see § 3.02[5][h], *infra*, for a definition of unit of designated property.
- (n65)Footnote 128. See *Treas Reg* § 1.263A-9(f).
- (n66)Footnote 129. *Treas Reg* § 1.263A-9(d); see § 3.02[5][g], *infra*, for a discussion of the election not to trace debt.
- (n67)Footnote 130. *Treas Reg* § 1.263A-9(a)(2)(i)(A), (b)(1).
- (n68)Footnote 131. See § 3.02[5][f], *infra*, for a definition of eligible debt.
- (n69)Footnote 132. *Treas Reg* § 1.263A-9(a)(4).
- (n70)Footnote 133. *Treas Reg* § 1.263A-9(b)(2); *Temp Treas Reg* § 1.163-8T.
- (n71)Footnote 134. *Treas Reg* § 1.263A-9(b)(1).
- (n72)Footnote 135. *Treas Reg* § 1.263A-9(b)(3).
- (n73)Footnote 136. *Treas Reg* § 1.263A-9(c)(1).
- (n74)Footnote 137. *Treas Reg* § 1.263A-9(c)(2).
- (n75)Footnote 138. *Treas Reg* § 1.263A-9(c)(2).
- (n76)Footnote 138.1. See TAM 200009004 (a bank making construction payments from customer deposits on which it paid interest must include the amounts in the customer accounts in its nontraced debt).
- (n77)Footnote 139. See *IRC* § 263A(f).
- (n78)Footnote 140. *Treas Reg* § 1.263A-9(c)(2).
- (n79)Footnote 141. *Treas Reg* § 1.263A-9(c)(4).
- (n80)Footnote 142. *Treas Reg* § 1.263A-9(c)(5)(ii)(A).
- (n81)Footnote 143. *Treas Reg* § 1.263A-9(c)(5)(iii)(A).
- (n82)Footnote 144. *Treas Reg* § 1.263A-9(b)(2).
- (n83)Footnote 145. *Treas Reg* § 1.263A-9(a)(4).
- (n84)Footnote 146. See *IRC* § 163(f)(2).
- (n85)Footnote 147. See *IRC* § 264(a)(2); *Rev Rul* 95-53, 1995-2 CB 30 (interest paid on mortgage loan not

deductible to the extent the loan is collateralized by single premium annuity contract).

(n86)Footnote 148. See *IRC* § 264(a)(4), (e).

(n87)Footnote 149. See *IRC* § 265(a)(2); see also *IRC* §§ 265(b)(2), 291(e)(1)(B)(ii) (disallowed interest expense for financial institutions).

(n88)Footnote 150. See *IRC* § 279(a).

(n89)Footnote 151. See *IRC* §§ 805(b)(1), 834(c)(5).

(n90)Footnote 152. See *IRC* § 1274(d).

(n91)Footnote 153. See *IRC* § 163(h)(2), (3).

(n92)Footnote 154. See *IRC* § 453A.

(n93)Footnote 155. See *IRC* § 460(b).

(n94)Footnote 156. *Treas Reg* § 1.263A-9(d)(1).

(n95)Footnote 157. See § 3.02[5][e], *supra*, for a discussion.

(n96)Footnote 158. *Treas Reg* § 1.263A-9(d)(1).

(n97)Footnote 159. *Treas Reg* § 1.263A-9(d)(1).

(n98)Footnote 160. *Treas Reg* § 1.263A-10(b). See CCA 200913011 (hotel and casino complex treated as single unit of property under regulation).

(n99)Footnote 161. *Treas Reg* § 1.263A-10(b).

(n100)Footnote 162. *Treas Reg* § 1.263A-10(b).

(n101)Footnote 163. *Treas Reg* § 1.263A-10(b)(5); see § 3.02[5][j], *infra*, for a detailed discussion of production periods.

(n102)Footnote 164. *Treas Reg* § 1.263A-10(b)(5)(ii)(A).

(n103)Footnote 164.1. *Treas Reg* § 1.263A-10(b)(5)(ii)(A)(1).

(n104)Footnote 165. *Treas Reg* § 1.263A-10(b)(5)(ii)(B).

(n105)Footnote 166. *Treas Reg* § 1.263A-10(b)(5)(iii), (iv), (v).

(n106)Footnote 167. *Rev Proc* 92-29, 1992-1 CB 748 .

(n107)Footnote 168. See *IRC* § 461(h).

(n108)Footnote 169. *Treas Reg* § 1.263A-10(b)(6), Example 5.

(n109)Footnote 170. See *IRC* § 263A(a); *Treas Reg* § 1.263A-11(a).

(n110)Footnote 171. *Treas Reg* § 1.263A-11(a).

(n111)Footnote 172. *Treas Reg § 1.263A-11(b)(1)*.

(n112)Footnote 173. *Treas Reg § 1.263A-11(b)(1)*.

(n113)Footnote 174. *Treas Reg § 1.263A-11(b)(2)*.

(n114)Footnote 175. *Treas Reg § 1.263A-11(c)*.

(n115)Footnote 176. *Treas Reg § 1.263A-11(e)*.

(n116)Footnote 177. *Treas Reg § 1.263A-11(e)(1)(ii)(A)*.

(n117)Footnote 178. *Treas Reg § 1.263A-11(e)(1)*.

(n118)Footnote 179. *Treas Reg § 1.263A-11(e)(2)*.

(n119)Footnote 180. *Treas Reg § 1.263A-11(e)(2)*.

(n120)Footnote 181. *Treas Reg § 1.263A-12(c)(1)*.

(n121)Footnote 182. *Treas Reg § 1.263A-12(c)(2)*.

(n122)Footnote 183. *Treas Reg § 1.263A-12(d)*.

(n123)Footnote 184. *Treas Reg § 1.263A-12(g)(1)*.

(n124)Footnote 185. *Treas Reg § 1.263A-12(g)(2)*.

(n125)Footnote 186. *Treas Reg § 1.263A-12(g)(1)*.

(n126)Footnote 187. *Treas Reg § 1.263A-13*.

(n127)Footnote 188. *Treas Reg § 1.263A-13*.



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Federal Taxes Affecting Real Estate

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CHAPTER 3 Development of Real Estate

1-3 Federal Taxes Affecting Real Estate § 3.03

§ 3.03 Voluntary Capitalization of Interest, Taxes, and Other Carrying Charges

Section 3.02, above, discusses the mandatory capitalization rules of *IRC Section 263A*. This section discusses the voluntary election to capitalize interest, taxes, and other carrying charges under *IRC Section 266*. The mandatory capitalization rules of *IRC Section 263A* apply only to property produced by the taxpayer and property acquired for resale; vacant land held for investment is not covered. Additionally, even as to projects subject to capitalization under *Section 263A*, interest expense before the start of construction and certain other costs may not need to be capitalized. n189 Under *IRC Section 266*, taxpayers may elect to capitalize many of the costs not required to be capitalized in those situations in which a current deduction would be less advantageous. Because the rules of the two sections are different, some taxpayers will prefer the treatment of one over the other, and no general rules will apply to all taxpayers.

The *Section 266* election could be beneficial if a taxpayer has more tax deductions than can be used to offset taxable income currently or during a net operating loss carryover period, if a noncorporate taxpayer has only long-term capital gains during the year, or if the taxpayer expects to be in significantly higher tax brackets in future years. In addition, a taxpayer may not have taxable income in the state where a particular real property is located, or the state where the property is located may not allow carryover or carryback of tax losses. In such situations, it may be advantageous to capitalize interest, tax costs, and other carrying charges for state income tax purposes only, if permissible; or for both federal and state purposes, if beneficial. Also, it appears that items that are capitalized to the basis of the property, rather than expensed, will qualify for the low-income housing credit, rehabilitation credit, and the investment tax credit (when still available under the *IRC* transitional rules).

IRC Section 266 establishes two different sets of rules relating to the types of expenses that may be capitalized and the operating rules relating to the election to capitalize. One set of rules applies to unimproved, unproductive property; the other applies to property in the process of construction or development.

[1] Unimproved, Unproductive Property

The expenses subject to capitalization with respect to unimproved and unproductive property are interest on a mortgage incurred to acquire the property, annual property taxes, and any other direct carrying charges, but not including items such as advertising expense, professional fees, and similar investment or operating expenses.

Separate elections are available for each property and for each type of expense with respect to each property. n190 An

election to capitalize annual taxes, mortgage interest and other carrying charges with respect to unimproved and unproductive real property in one year is not binding for any subsequent year. n191 Thus, for a property for which interest expense and property taxes are incurred: in the current year, either or both of them could be expensed or either or both of them could be capitalized, and in the succeeding year either or both of them also could be capitalized or deducted.

The regulations provide that an election under *IRC Section 266* is to be made by attaching a statement to the original tax return for which the election is made, indicating the items that the taxpayer elects to capitalize. n192 A corporation that had not made a valid election under *IRC Section 266* because it had failed to file a statement with the tax return identifying the items being capitalized, attempted to correct the method of accounting by filing amended returns within the time period prescribed by law. The regulations provide that the election must be made on the original return, and the Service has ruled that the taxpayer could not retroactively change an erroneous method of accounting to a permissible method merely by filing amended returns. n193 *Revenue Ruling 90-38* revoked or modified earlier rulings in which the Service permitted taxpayers to correct erroneous accounting methods by filing amended returns within the statute of limitations. In general, a method of accounting is adopted when an item of income or deduction is treated consistently for two years. n194 The two-year rule is waived for certain changes in depreciation or amortization. n194.1 An erroneous method of accounting can be changed, only on a prospective basis, by filing a Form 3115, "Application for Change in Accounting Method," and obtaining the consent of the Commissioner.

[2] Property Under Construction or Development

Property under construction or development includes property that was unimproved, improved, productive, or unproductive before the commencement of the construction or development.

Expenses subject to capitalization under *IRC Section 266* would be those expenses not required to be capitalized under *IRC Section 263A*, such as interest expense incurred before beginning construction, interest on debt to carry the underlying land (if it is determined that expense is not covered by Section 263A), and those other costs not required to be capitalized under Section 263A. The point in time at which property becomes subject to the rules applicable to property under construction or development may have been advanced by the *Reichel* case. n195

A separate election is available for each project under construction and for each type of expense within a project. n196 Thus, interest could be capitalized under *IRC Section 266* on one project, while all other types of expenses of that project and all expenses, including interest, of all other projects could be deducted (subject to the capitalization rules of Section 263A). However, once the election to capitalize is made under Section 266 for a type of expense for a project, the election is binding for that type of expense of that project for all subsequent years until that project is completed. n197 For example, when interest is capitalized under Section 266 on one project in the current year, interest must be capitalized on that project for all subsequent years until completion of construction.

The election to capitalize under Section 266 is first available when improvement of the property begins, or it can be made in any subsequent year during the period of improvement.

The regulations offer little assistance in the definition of what constitutes a project. IRS agents have generally been flexible and practical on this question. However, when a long-term development covering a number of phases is involved, caution should be exercised before making a capitalization election for an item of significant expense. If it were held that the entire development was one project, the binding nature of the capitalization election would eliminate future flexibility. In such a situation, zoning, construction licenses and permits, engineering plans, financial arrangements, and sales plans should be carefully analyzed to determine the relative degree of assurance that each phase could be sustained as a separate project.

[3] Election

When the taxpayer decides to capitalize expenses, it must file a statement with its original tax return indicating the item or items to be capitalized. n198 When the taxpayer is making an election for property under construction or development, care should be taken to specifically identify the project for which the election is applicable. In addition, the taxpayer should take care to include a specific statement in the return—not merely a schedule showing the capitalized expenses. If a specific statement is not made, the Service may hold that a valid election has not been made. Taxpayers may seek an extension of time for making an election to capitalize interest and taxes under *IRC Section 266* by filing a request for a private letter ruling. n199

FOOTNOTES:

(n1)Footnote 189. But see *Reichel v Commr*, 112 TC 14 (1999) .

(n2)Footnote 190. *Treas Reg* § 1.266-1(c)(1).

(n3)Footnote 191. *Treas Reg* § 1.266-1(c)(2)(i).

(n4)Footnote 192. *Treas Reg* § 1.266-1(c)(3).

(n5)Footnote 193. *Rev Rul* 90-38, 1990-1 CB 57 .

(n6)Footnote 194. See *Treas Reg* § 1.446-1(e)(2)(ii)(a); *Rev Rul* 90-38, 1990-1 CB 57 .

(n7)Footnote 194.1. *Rev Proc* 2007-16, 2007-4 IRB 358 .

(n8)Footnote 195. 112 TC 14 (1999) .

(n9)Footnote 196. *Treas Reg* § 1.266-1(c)(1).

(n10)Footnote 197. *Treas Reg* § 1.266-1(c)(2)(ii)(a) .

(n11)Footnote 198. *Treas Reg* § 1.266-1(c)(3).

(n12)Footnote 199. See *Ltr Rul* 199932056 .



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Federal Taxes Affecting Real Estate

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CHAPTER 3 Development of Real Estate

1-3 Federal Taxes Affecting Real Estate § 3.04

§ 3.04 Deduction Relating to Income Attributable to U.S. Production Activities

[1] In General

Effective for taxable years beginning after December 31, 2004. n200 a deduction is allowed based on a percentage of income from domestic production activities. n201 Extensive regulations provide guidance regarding the deduction. n201.1 The deduction was crafted primarily to benefit U.S. manufacturers who face significant competition from foreign countries that provide subsidies for their manufacturers and exports through their indirect tax systems. Nevertheless, the deduction affects real estate activities significantly. This is because the deduction can be applied as a percentage of gross receipts from the following: n202

- for taxpayers engaged in the active conduct of a construction trade or business, the construction of real property performed in the United States by the taxpayer in the ordinary course of that trade or business; or
- for taxpayers engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services performed in the United States by the taxpayer in the ordinary course of that trade or business with respect to the construction of real property in the United States.

NOTE:

A key limitation regarding the deduction as it relates to real estate is that gross receipts from the lease, rental, license, sale, exchange, or other disposition of land are excluded in computing the deduction. n202.1

The discussion following focuses on the deduction only as it pertains to those activities and not to non-real estate aspects of the deduction.

The deduction is phased in over several years and is based on a percentage of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, n203 or (2) taxable income (determined without regard to this deduction) for the taxable year. n204 In the case of an individual, the deduction is based on a percentage of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) adjusted gross income. n205

"Adjusted gross income" for this purpose is determined after taking into account taxable Social Security benefits, the exclusions for interest on U.S. savings bonds used to pay higher education costs and adoption assistance, taking into account deductions for IRA contributions, interest on education loans, and qualified tuition and related expenses, and after application of the passive activity loss and credit limitations. n206 Adjusted gross income is determined without regard to the deduction under *IRC Section 199* based on the taxpayer's qualified production activities. n207

The deduction percentages are as follows: n208

Taxable years beginning in 2005 and 2006	3 percent
Taxable years beginning in 2007, 2008, and 2009	6 percent
Taxable years beginning after 2009	9 percent

However, the deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in that taxable year. n209 Only W-2 wages that are properly allocable to domestic production gross receipts can be taken into account in applying this 50-percent wage limitation. n209.1 (See § 3.04[8], *below*, for a discussion of methods of allocating wages to domestic production gross receipts) W-2 wages do not include any amount that is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for that return. n209.2

The deduction is also limited for taxpayers with oil related qualified production activities income. n209.3 Under the limitation, if a taxpayer has oil-related qualified production activities income in a tax year, the amount otherwise deductible under *IRC Section 199* is reduced by 3 percent of the least of the following: (1) the oil related qualified production activities income of the taxpayer for the taxable year; (2) the qualified production activities income of the taxpayer for the taxable year, or (3) taxable income (or adjusted gross income, in the case of individuals), without regard to the deduction under *IRC Section 199*. n209.4 Oil related qualified production activities income is qualified production activities income that is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof during a taxable year. n209.5

In the case of corporate taxpayers that are members of certain affiliated groups, the deduction is determined by treating all members of the group as a single taxpayer and the deduction is allocated among the members in proportion to each member's respective amount (if any) of qualified production activities income. n210

[2] Qualified Production Activities Income

In general, "qualified production activities income" is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; (2) other deductions, expenses, or losses (other than the deduction allowed *IRC Section 199*), that are properly allocable to those receipts. n211 Extensive regulations have been issued providing guidance on various aspects of the *IRC Section 199* deduction, n211.1 including allocation of various items in computing qualified production activities income. n211.2

[3] Domestic Production Gross Receipts

[a] In General

"Domestic production gross receipts" consists primarily of items that are unrelated to real estate. n214 Included, however, are two items relating to real estate: (1) gross receipts of a taxpayer that are derived from construction activities performed in the United States, and (2) engineering or architectural services performed in the United States for construction projects located in the United States. n215 Gross receipts from the lease, rental, license, sale, exchange, or other disposition of land are excluded in computing the deduction. n215.1

In addition, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed, or rented by the taxpayer for use by any related person. n216 Related persons for this purpose include a variety of corporate and other entities which, by virtue of 50-percent common ownership n217 or membership in an affiliated service group, n218 are treated as a single employer. n219

Regulations detail at great length the definition of construction performed in the United States, n219.1 and what services qualify as engineering and architectural services for purposes of the *IRC Section 199* deduction. n219.2

[b] "Construction" for Purposes of *IRC Section 199*

Regulations detail at great length the definition of construction performed in the United States, n220 and provide numerous examples of what does and does not constitute construction activity. n220.1 The term generally means activities and services relating to the construction or erection of real property in the US that is constructed by a taxpayer that, at the time of the construction, is engaged in the trade or business of construction on a regular and ongoing basis. The business must be considered construction by the North American Industry Classification System (NAICS), as described in the regulations. n220.2 Tangible personal property (for example, appliances, furniture, and fixtures) that is sold as part of a construction project is not considered real property for purposes of the deduction. In determining whether property is real property, the fact that property is or is not real property under local law is not controlling. n220.3

A taxpayer is considered to be engaged in a construction trade or business on a regular and ongoing basis if the taxpayer derives gross receipts from an unrelated person by selling or exchanging the constructed real property within 60 months of the date on which construction is complete (for example, on the date a certificate of occupancy is issued for the property). n221 For a newly-formed trade or business or a taxpayer in its first taxable year, the taxpayer is considered to be engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis. n221.1

A de minimis exception applies. If less than 5 percent of the total gross receipts derived by a taxpayer from a construction project are derived from activities other than the construction of real property in the United States (for example, from non-construction activities or the sale of tangible personal property or land), then the total gross receipts derived by the taxpayer from the project may be treated as domestic product gross receipts (DPGR) from construction. n222 If a taxpayer applies the land safe harbor for a construction project (as described below), n222.1 then the gross receipts excluded under the land safe harbor are excluded in determining total gross receipts under this paragraph. If a taxpayer does not apply the land safe harbor and uses any reasonable method (for example, an appraisal of the land) to allocate gross receipts attributable to the land to non-DPGR, then a taxpayer may exclude those gross receipts derived from the sale, exchange, or other disposition of the land from total gross receipts under this de minimis exception. n222.2

In the case of gross receipts derived from construction that are received over a period of time (for example, an installment sale), the de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from construction. For this purpose, a taxpayer who treats gross receipts as DPGR under this de minimis exception must treat the gross receipts recognized in each taxable year consistently as DPGR. n223

A similar de minimis exception applies for non-DPGR receipts. If less than 5 percent of the total gross receipts derived by a taxpayer from a construction project qualify as DPGR, then the total gross receipts derived by the taxpayer from the construction project may be treated as non-DPGR. In the case of gross receipts derived from construction that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from construction. For this purpose, a taxpayer who treats gross receipts as non-DPGR under this de minimis exception must treat the gross receipts

recognized in each taxable year consistently as non-DPGR. n224

Activities constituting "construction" are those performed in connection with a project to erect or substantially renovate real property, including activities performed by a general contractor or that constitute activities typically performed by a general contractor. These include activities relating to management and oversight of the construction process such as approvals, periodic inspection of the progress of the construction project, and required job modifications. n225 Construction activities do not include tangential services such as hauling trash and debris, and delivering materials, even if those services are essential for construction. However, if the taxpayer performing construction also, in connection with the construction project, provides tangential services such as delivering materials to the construction site and removing its construction debris, then the gross receipts derived from those tangential services are DPGR. n225.1

Improvements to land that are not capitalizable to the land (for example, landscaping) and painting are activities constituting construction only if they are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property and provided the taxpayer meets the other requirements that apply to construction. Services such as grading, demolition (including demolition of structures under *IRC § 280B*), clearing, excavating, and any other activities that physically transform the land are activities constituting construction only if they are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property and provided the taxpayer meets the other requirements under that apply to construction. A taxpayer engaged in these activities must make a reasonable inquiry or a reasonable determination as to whether the activity relates to the erection or substantial renovation of real property in the United States. Construction activities also include activities relating to drilling an oil or gas well and mining and include any activities the cost of which are intangible drilling and development costs n226 or development expenditures for a mine or natural deposit. n226.1

If the taxpayer performing construction activities also provides, in connection with the construction project, administrative support services (for example, billing and secretarial services) incidental and necessary to that construction project, then these administrative support services are considered construction activities. n227

Construction activity does not include the lease, license, or rental of equipment, for example, bulldozers, generators, or computers, for use in the construction of real property. It also does not include any activity that qualifies as engineering and architectural services. n227.1

For purposes of defining construction, the term "real property" means buildings (including structural components), inherently permanent structures (and their structural components) other than machinery, n227.2 inherently permanent land improvements, oil and gas wells, and infrastructure. An entire utility plant including both the shell and the interior is treated as an inherently permanent structure. Property produced by a taxpayer that is not real property in the hands of that taxpayer, but that may be incorporated into real property by another taxpayer, is not treated as real property by the producing taxpayer (for example, bricks, nails, paint, and windowpanes). Structural components of buildings and inherently permanent structures include property such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. n227.3

The term "infrastructure" includes roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring. The term also includes inherently permanent oil and gas platforms. n228 The term "substantial renovation" means the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs its useful life, or adapts it to a new or different use. n228.1

Assuming all the above requirements are met, DPGR derived from the construction of real property performed in the US includes the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the US (whether or not the property is sold immediately after construction is completed and whether or not the

construction project is completed). DPGR derived from the construction of real property includes compensation for the performance of construction services by the taxpayer in the US. DPGR derived from the construction of real property includes gross receipts derived from materials and supplies consumed in the construction project or that become part of the constructed real property, assuming all other requirements regarding construction are met. n228.2

DPGR derived from the construction of real property includes gross receipts from any qualified construction warranty, that is, a warranty that is provided in connection with the constructed real property if, in the normal course of the taxpayer's business, both of the following are met: n229

- the price for the construction warranty is not separately stated from the amount charged for the constructed real property; and
- the construction warranty is neither separately offered by the taxpayer nor separately bargained for with customers (that is, the customer cannot purchase the constructed real property without the construction warranty).

DPGR derived from the construction of real property performed in the United States does not include gross receipts derived from the sale, exchange, or other disposition of real property acquired by the taxpayer even if the taxpayer originally constructed the property. In addition, DPGR derived from the construction of real property does not include gross receipts from the lease or rental of real property constructed by the taxpayer or, except as provided in the de minimis exception, n229.1 gross receipts derived from the sale or other disposition of land (including zoning, planning, entitlement costs, and other costs capitalized to the land). n229.2

For purposes of determining the DPGR derived from the construction of real property performed in the US, a land safe harbor applies. Under it, a taxpayer may allocate gross receipts between the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer and land by reducing its costs related to DPGR under the DPGR cost allocation regulations n229.3 by the cost of land and other costs capitalized to the land (land costs) and reducing its DPGR by those land costs plus a specified percentage. n229.4 A taxpayer that uses the land safe harbor to allocate gross receipts between real property constructed by the taxpayer and land does not take into account under the small business simplified overall method n229.5 the costs that have already been taken into account for purposes of *IRC Section 199* pursuant to the land safe harbor. n229.6

[c] Engineering and Architectural Services under *IRC Section 199*

Domestic production gross receipts includes gross receipts from engineering or architectural services performed in the U.S. for construction projects in the U.S. n230 Regulations detail at some length what services qualify as engineering and architectural services for purposes of the *IRC Section 199* deduction. n230.1 In general DPGR include gross receipts derived from engineering or architectural services performed in the United States for a construction project, provided that at the time the taxpayer performs those services, the taxpayer is engaged in engineering or architectural services on a regular and ongoing basis. The business must be considered engineering or architectural services by the North American Industry Classification System (NAICS), as described in the regulations. n230.2 In the case of a newly-formed trade or business or a taxpayer in its first taxable year, a taxpayer is considered to be engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis. DPGR include gross receipts derived from engineering or architectural services, including feasibility studies for a construction project in the US, even if the planned construction project is not undertaken or is not completed. n230.3

Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services such as consultation, investigation, evaluation, planning, design,

or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project. n231

Architectural services in connection with any construction project include the offering or furnishing of any professional services such as consultation, planning, aesthetic and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project. n231.1

Incidental and necessary administrative support services (such as billing and secretarial services) to engineering or architectural services provided by the same taxpayer are also included. n232

Engineering or architectural services do not include post-construction services such as annual audits and inspections. n232.1

A de minimis exception applies. If less than 5 percent of the total gross receipts derived by a taxpayer from engineering or architectural services performed in the United States for a construction project are derived from services not relating to a construction project (for example, the services are performed outside the US or in connection with property other than real property), then the total gross receipts derived by the taxpayer may be treated as DPGR from engineering or architectural services performed in the US for the construction project. In the case of gross receipts derived from engineering or architectural services that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from engineering or architectural services. For this purpose, a taxpayer who treats gross receipts as DPGR under this de minimis exception must treat the gross receipts recognized in each taxable year consistently as DPGR. n233

A similar de minimis exception applies for non-DPGR receipts. If less than 5 percent of the total gross receipts derived by a taxpayer from engineering or architectural services performed in the US for a construction project qualify as DPGR, then the total gross receipts derived by the taxpayer from engineering or architectural services performed in the US for the construction project may be treated as non-DPGR. In the case of gross receipts derived from engineering or architectural services that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from engineering or architectural services. For this purpose, a taxpayer who treats gross receipts as non-DPGR under this de minimis exception must treat the gross receipts recognized in each taxable year consistently as non-DPGR. n234

Example:

X is engaged in the trade or business of providing engineering services on a regular and ongoing basis. Y buys unimproved land and hires X to provide engineering services for roads, sewers, sidewalks, and power and water lines to be constructed on Y's land. These items qualify as infrastructure. X's gross receipts from engineering services for the infrastructure are DPGR. X's gross receipts from other engineering services relating to land do not qualify as DPGR because they are not derived from engineering services for a construction project. n235

[d] Puerto Rico Activities That Qualify for the *IRC Section 199* Deduction

For purposes of *IRC Section 199*, the United States generally does not include Puerto Rico or other US possessions. n235.1 nor are wages paid to bona fide residents of Puerto Rico generally included in the wage limitation amount. n235.2 For the first four taxable years of a taxpayer beginning after December 31, 2005, and before January 1, 2010, however, n235.3 Puerto Rico is included within the definition of the United States for purposes of determining the domestic production gross receipts of eligible taxpayers. A taxpayer may treat Puerto Rico as part of the United States

for purposes of *IRC Section 199* (and therefore take into account its Puerto Rico business activity for purposes of calculating its domestic production gross receipts and qualified production activities income) only if all of the taxpayer's gross receipts from sources within Puerto Rico are currently taxable for US Federal income tax purposes. n235.4 Consequently, a controlled foreign corporation cannot take advantage of the deduction made available by the provision. Any taxpayer eligible for the Puerto Rico-based deduction may take into account wages paid to bona fide residents of Puerto Rico for purposes of calculating the 50-percent wage limitation. n235.5

[4] Rules for Passthrough Entities (Other than Cooperatives)

For partnerships and S corporations, the deduction under *IRC Section 199* is applied at the partner or shareholder level, and each partner or shareholder must take into account his or her allocable share of each item used to determine the entity's qualified production activities income. n236 In addition, for purposes of applying the wage limitation, n237 a shareholder, partner, or similar person who is allocated components of qualified production activities income from a passthrough entity is treated as having been allocated wages from the entity in an amount that is equal to that person's allocable share of wages as determined under regulations prescribed by the Secretary. n238

A special rule applies for partnerships that are owned by expanded affiliated groups. If all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group at all times during the taxable year of the partnership, the partnership and all members of the expanded affiliated group are treated as a single taxpayer during that period. n239

For trusts and estates, each item used to determine the entity's qualified production activities income n240 and W-2 wages of the trust or estate for the taxable year must be apportioned between the beneficiaries and the fiduciary (and among the beneficiaries) under regulations prescribed by the Secretary. n241 The adjusted gross income of the trust to which the applicable percentage is applied to determine the deduction is determined in accordance with *IRC Section 67(e)*. n242

The IRS has issued a revenue procedure that specifies the conditions under which certain partnerships and S corporations may choose to calculate qualified production activities income W-2 wages at the entity level, as well as the manner for allocating and reporting those items to partners or shareholders, for purposes of determining the deduction under *IRC § 199*. n242.1

[5] Alternative Minimum Tax

The deduction under *IRC Section 199* is allowed for purposes of determining alternative minimum taxable income under the AMT. n243 Two modifications apply, however. First, in determining alternative minimum taxable income, a taxpayer's "qualified production activities income" n244 is determined without regard to any AMT adjustments under *IRC Sections 56 through 59*. n245

The second modification applies only to corporations. A corporation's alternative minimum taxable income, n246 rather than its taxable income, is used in computing the deduction. n247

[6] Qualified Production Activities Income of Agricultural and Horticultural Cooperatives

A person who receives a qualified payment n248 from a member-owned agricultural or horticultural cooperative n249 may deduct in the year the payment is received an amount equal to the portion of the deduction under *IRC Section 199* that is allowed with respect to the portion of the qualified production activities income to which the payment is attributable. The deduction is allowed only if it is identified by the cooperative in a written notice mailed to the patron during the payment period. n250 The cooperative is denied a deduction for the portion of the qualified payment to the extent of the deduction that may be claimed by the patron. n251 For purposes of computing the *IRC Section 199*

deduction allowed to the cooperative, no deduction is allowed for certain patronage dividends, per-unit retain allocations, and non-patronage distributions. n252

[7] Net Earnings From Self-Employment

The deduction under *IRC Section 199* is not permitted in determining an individual's net earnings from self-employment. n253

[8] Methods of Allocating Wages to Domestic Production Gross Receipts

[a] In General

Only wages described in regulations n254 (referred to as "paragraph (e)(1) wages") that are properly allocable to domestic production gross receipts (DPGR) may be taken into account in determining the deduction under *IRC Section 199*. n255 Regulations provide that a taxpayer may determine the amount of those wages that is properly allocable to DPGR using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. n256

The regulations provide safe harbors for determining the amount of paragraph (e)(1) wages that is properly allocable to DPGR. The safe harbor that applies depends on the cost allocation method used by the taxpayer. Under the wage expense safe harbor for taxpayers using either the *IRC Section 861* method of cost allocation n257 or the simplified deduction method n258 a taxpayer may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR by multiplying the amount of those wages by the ratio of the taxpayer's wage expense included in calculating qualified production activities income (QPAI) for the taxable year to the taxpayer's total wage expense used in calculating the taxpayer's taxable income (or AGI, if applicable) for the taxable year. n259 For purposes of determining the amount of wage expense in cost of goods sold (CGS) under this safe harbor, a taxpayer may determine its wage expense included in CGS using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. For example, a reasonable method would include a taxpayer using direct labor included in CGS as wage expense included in CGS. Additionally, a reasonable method would include a taxpayer using the *IRC Section 263A* labor costs used by the taxpayer in its simplified service cost method with labor-based allocation ratio regulations n260 as wage expense included in CGS. n261

A taxpayer that uses the small business simplified overall method of cost allocation n262 may use the small business simplified overall method safe harbor for determining the amount of wages that is properly allocable to DPGR. Under that safe harbor, the amount of paragraph (e)(1) wages that is properly allocable to DPGR is equal to the same proportion of wages that the amount of DPGR bears to the taxpayer's total gross receipts. n263

Detailed examples of computations are provided in the temporary regulations. n264

[b] Expanded Affiliated Groups

The *IRC Section 199* deduction for members of an expanded affiliated group (EAG) may be reduced if one member of an EAG uses employees of another member of the EAG to perform activities attributable to DPGR and does not have paragraph (e)(1) wages. As noted above, to qualify as W-2 wages n265 paragraph (e)(1) wages must be properly allocable to DPGR. n266 Because each member of an EAG separately calculates its own items before they are aggregated by the EAG, the member having the paragraph (e)(1) wages must itself have DPGR to which the wages are properly allocable in order to qualify those wages as W-2 wages. Paragraph (e)(1) wages that are not properly allocable to DPGR of the member having the paragraph (e)(1) wages do not qualify as W-2 wages, even if the paragraph (e)(1) wages were paid in connection with another member's DPGR activities. However, the result may differ if members of the EAG join in the filing of a consolidated Federal income tax return. In that case, the separate entity attributes of the members' intercompany items or corresponding items be redetermined to the extent necessary to produce the effect as if

they were divisions of a single corporation. Thus, wages incurred by one member may be treated as if incurred by another. n267 The regulations under *IRC Section 199* provide examples showing computations under various scenarios. n268

A special rule applies regarding net operating losses (NOLs) of an EAG. To the extent that an NOL was used in the year it was sustained in determining any EAG's taxable income for purposes of the taxable income limitation. n269 it is not treated as an NOL carryover or NOL carryback to any taxable year in determining the taxable income limitation. n270 This rule was adopted in order to prevent the same loss being used twice in determining the taxable income limitation under *IRC Section 199(a)(1)(B)*. Detailed examples illustrate the rule. n271

[c] Pass-Thru Entities

In general, a partnership or S corporation must allocate its paragraph (e)(1) wages (including any such wages from a lower-tier partnership of which the partnership or S corporation is a partner) among its partners or shareholders in the same manner that wage expense is allocated among those partners or shareholders. n272 The partner or shareholder must then add its share of the paragraph (e)(1) wages from the partnership or S corporation to the partner's or shareholder's paragraph (e)(1) wages from other sources, if any. The partner (other than a partner that itself is a partnership or S corporation) or shareholder then must calculate its W-2 wages n273 by determining the amount of its paragraph (e)(1) wages properly allocable to DPGR. n274 Examples showing allocations are provided in the temporary regulations. n275

[d] Trusts and Estates

A non-grantor trust or estate must calculate each beneficiary's share (as well as the trust's or estate's share, if any) of QPAI and W-2 wages from the trust or estate at the trust or estate level. n276 The QPAI of a trust or estate and W-2 wages of the trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI) n277 for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. n278 An example showing allocations is provided in the regulations. n279

FOOTNOTES:

(n1)Footnote 200. Pub L No 108-357, § 102(e)(1); items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before 1/1/05 are not be taken into account for purposes of computing the deduction [Pub Law No 109-135, § 403(a)(19)].

(n2)Footnote 201. *IRC* § 199.

(n3)Footnote 201.1. See *Treas Reg* §§ 1.199-1 through 1.199-9, effective generally for tax years beginning on or after June 1, 2006 [*Reg* §§ 1.199-8(i), 1.199-9(k)].

(n4)Footnote 202. *IRC* § 199(c)(4)(A)(ii),(iii).

(n5)Footnote 202.1. *IRC* § 199(c)(4)(B)(iii).

(n6)Footnote 203. See [2], below, for a discussion.

(n7)Footnote 204. *IRC* § 199(a)(1).

(n8)Footnote 205. *IRC* § 199(d)(2).

(n9)Footnote 206. *IRC* § 199(d)(2)(A); see *IRC* §§ 86, 135, 137, 219, 221, 222, 469.

(n10)Footnote 207. *IRC § 199(d)(2)(B)*.

(n11)Footnote 208. *IRC § 199(a)(1), (2)*.

(n12)Footnote 209. *IRC § 199(b)(1)*.

(n13)Footnote 209.1. *IRC § 199(b)(2)(B)*.

(n14)Footnote 209.2. *IRC § 199(b)(2)(C)*.

(n15)Footnote 209.3. *IRC § 199(d)(9)(A)*, effective for tax years beginning after 2009.

(n16)Footnote 209.4. *IRC § 199(d)(9)(A)*.

(n17)Footnote 209.5. *IRC § 199(d)(9)(B)*.

(n18)Footnote 210. *IRC § 199(d)(4)*.

(n19)Footnote 211. *IRC § 199(c)(1)*.

(n20)Footnote 211.1. See *Treas Reg §§ 1.199-1* through *1.199-9*, effective generally for tax years beginning on or after June 1, 2006 [*Treas Reg §§ 1.199-8(i), 1.199-9(k)*].

(n21)Footnote 211.2. See *IRC §§ 1.199-1(c), (d), 1.199-3(i)(4)*.

(n22)Footnote 214. *IRC § 199(c)(4)*.

(n23)Footnote 215. *IRC § 199(c)(4)(A)(ii), (iii)*.

(n24)Footnote 215.1. *IRC § 199(c)(4)(B)(iii)*.

(n25)Footnote 216. *IRC § 199(c)(7)*.

(n26)Footnote 217. See *IRC § 52(a), (b)*.

(n27)Footnote 218. See *IRC § 414(m), (o)*.

(n28)Footnote 219. *IRC § 199(c)(7)(B), 414(m), (o)*.

(n29)Footnote 219.1. *Treas Reg § 1.199-3(m)*; see [b], below.

(n30)Footnote 219.2. *Treas Reg § 1.199-3(n)*; see [c], below, for a discussion.

(n31)Footnote 220. *Treas Reg § 1.199-3(m)*. The regulations supersede earlier guidance provided in *Notice 2005-14, 2005-1 CB 498*.

(n32)Footnote 220.1. *Treas Reg § 1.199-3(m)(6)(v)*.

(n33)Footnote 220.2. *Treas Reg § 1.199-3(m)(1)(i)*.

(n34)Footnote 220.3. *Treas Reg § 1.199-3(m)(1)(i)*.

(n35)Footnote 221. *Treas Reg § 1.199-3(m)(1)(ii)(A)*.

(n36)Footnote 221.1. *Treas Reg § 1.199-3(m)(1)(ii)(B)*.

(n37)Footnote 222. *Treas Reg § 1.199-3(m)(1)(iii)(A)*.

(n38)Footnote 222.1. See *Treas Reg § 1.199-3(m)(6)(iv)*.

(n39)Footnote 222.2. *Treas Reg § 1.199-3(m)(1)(iii)(A)*.

(n40)Footnote 223. *Treas Reg § 1.199-3(m)(1)(iii)(A)*.

(n41)Footnote 224. *Treas Reg § 1.199-3(m)(1)(iii)(B)*.

(n42)Footnote 225. *Treas Reg § 1.199-3(m)(2)(i)*.

(n43)Footnote 225.1. *Treas Reg § 1.199-3(m)(2)(ii)*.

(n44)Footnote 226. See *Treas Reg § 1.612-4*.

(n45)Footnote 226.1. *Treas Reg § 1.199-3(m)(2)(iii)*; see *IRC § 616*.

(n46)Footnote 227. *Treas Reg § 1.199-3(m)(2)(iv)*.

(n47)Footnote 227.1. *Treas Reg § 1.199-3(m)(2)(v)*; see *Treas Reg § 1.199-3(n)*, discussed in [c], below, for a discussion of engineering and architectural services.

(n48)Footnote 227.2. See *Treas Reg § 1.263A-8(c)(3), (4)*.

(n49)Footnote 227.3. *Treas Reg § 1.199-3(m)(3)*.

(n50)Footnote 228. *Treas Reg § 1.199-3(m)(4)*.

(n51)Footnote 228.1. *Treas Reg § 1.199-3(m)(5)*.

(n52)Footnote 228.2. *Treas Reg § 1.199-3(m)(6)(i)*.

(n53)Footnote 229. *Treas Reg § 1.199-3(m)(6)(ii)*.

(n54)Footnote 229.1. See *Treas Reg § 1.199-3(m)(2)(iii)*.

(n55)Footnote 229.2. *Treas Reg § 1.199-3(m)(6)(iii)*.

(n56)Footnote 229.3. See *Treas Reg § 1.199-4*.

(n57)Footnote 229.4. *Treas Reg § 1.199-3(m)(6)(iv)(A)*.

(n58)Footnote 229.5. See *Treas Reg § 1.199-4(f)*.

(n59)Footnote 229.6. 1381-1388.

(n60)Footnote 230. *IRC § 199(c)(4)(A)(iii)*.

(n61)Footnote 230.1. *Treas Reg § 1.199-3(n)*. The regulations supersede earlier guidance provided in *Notice 2005-14, 2005-1 CB 498*.

(n62)Footnote 230.2. *Treas Reg § 1.199-3(n)(1)*.

(n63)Footnote 230.3. *Treas Reg § 1.199-3(n)(1)*.

(n64)Footnote 231. *Treas Reg* § 1.199-3(n)(2).

(n65)Footnote 231.1. *Treas Reg* § 1.199-3(n)(3).

(n66)Footnote 232. *Treas Reg* § 1.199-3(n)(4).

(n67)Footnote 232.1. *Treas Reg* § 1.199-3(n)(5).

(n68)Footnote 233. *Treas Reg* § 1.199-3(n)(6)(i).

(n69)Footnote 234. *Treas Reg* § 1.199-3(n)(6)(ii).

(n70)Footnote 235. *Treas Reg* § 1.199-3(n)(7).

(n71)Footnote 235.1. *IRC* § 7701(a)(9).

(n72)Footnote 235.2. *IRC* § 3401(a)(8)(C).

(n73)Footnote 235.3. *Treas Reg* § 1.263-1(h)(4)(ii).

(n74)Footnote 235.4. *IRC* § 199(d)(8)(A).

(n75)Footnote 235.5. *IRC* § 199(d)(8)(B).

(n76)Footnote 236. *IRC* § 199(d)(1)(A)(i), (ii); see *IRC* § 199(c)(1)(A), (B).

(n77)Footnote 237. See *IRC* § 199(b).

(n78)Footnote 238. *IRC* § 199(d)(1)(A)(iii), effective for tax years beginning after May 17, 2006 [Pub Law 109-222, § 514(c)]. Regulations [*Treas Reg* §§ 1.199-5(b)(3), (c)(3)] provide guidance for allocating a partner's or shareholder's share of wages of the partnership or S corporation, as discussed in § 3.04[8][c], below. For prior periods, a specified amount of W-2 wages was treated as allocated to partners or shareholders of passthrough entities [*IRC* § 199(d)(1)(A)(iii), before amendment by Pub Law 109-222].

(n79)Footnote 239. *IRC* § 199(c)(4)(D); see *IRC* § 199(d)(4)(B) (definition of expanded affiliated group).

(n80)Footnote 240. *IRC* § 199(d)(1)(A)(ii); see *IRC* § 199(c)(1)(A), (B).

(n81)Footnote 241. *IRC* § 199(d)(1)(B)(i).

(n82)Footnote 242. *IRC* § 199(d)(1)(B)(ii); see *IRC* § 199(d)(1)(B), (d)(2).

(n83)Footnote 242.1. *Rev Proc* 2007-34, 2007-23 *IRB* 1345 .

(n84)Footnote 243. *IRC* § 199(d)(6); see *IRC* § 55.

(n85)Footnote 244. See *IRC* § 199(c)(1).

(n86)Footnote 245. *IRC* § 199(d)(6)(A).

(n87)Footnote 246. See *IRC* § 55(b)(2).

(n88)Footnote 247. *IRC* § 199(d)(6)(B); see *IRC* § 199(a)(1)(B).

(n89)Footnote 248. See *IRC* §§ 199(d)(3)(E), 1385(a)(1), (3) (definition of "qualified payment.").

(n90)Footnote 249. See *IRC* §§ 199(d)(3)(F), 1381-1388.

(n91)Footnote 250. *IRC* § 199(d)(3)(A); see *IRC* § 1382(d) (payment period).

(n92)Footnote 251. *IRC* § 199(d)(3)(B).

(n93)Footnote 252. *IRC* § 199(d)(3)(C); see *IRC* § 1382(b),(c).

(n94)Footnote 253. *IRC* § 1402(a)(16).

(n95)Footnote 254. *Treas Reg* § 1.199-2(e)(1).

(n96)Footnote 255. *IRC* § 199(b)(2)(B).

(n97)Footnote 256. *Treas Reg* § 1.199-2(e)(2)(i).

(n98)Footnote 257. See *Treas Reg* § 1.199-4(d).

(n99)Footnote 258. See *Treas Reg* § 1.199-4(e).

(n100)Footnote 259. *Treas Reg* § 1.199-2(e)(2)(ii)(A).

(n101)Footnote 260. See *Treas Reg* § 1.263-1(h)(4)(ii).

(n102)Footnote 261. *Treas Reg* § 1.199-2(e)(2)(ii)(B).

(n103)Footnote 262. See *Treas Reg* § 1.199-4(f).

(n104)Footnote 263. *Treas Reg* § 1.199-2(e)(2)(iii).

(n105)Footnote 264. *Treas Reg* § 1.199-2(e)(2)(iv), Examples 1 through 6.

(n106)Footnote 265. See *Treas Reg* § 1.199-2(e)(2).

(n107)Footnote 266. *IRC* § 199(b)(2)(B)

(n108)Footnote 267. *Treas Reg* § 1.1502-13(c)(1)(i), (c)(4).

(n109)Footnote 268. *Treas Reg* § 1.199-2(e)(2)(iv), Examples 2, 5, 6.

(n110)Footnote 269. See *IRC* § 199(a)(1)(B).

(n111)Footnote 270. *Treas Reg* § 1.199-7(b)(4); see *IRC* § 199(a)(1)(B).

(n112)Footnote 271. *Treas Reg* § 1.199-7(b)(4)(ii).

(n113)Footnote 272. *Treas Reg* § 1.199-5(b)(3), (c)(3).

(n114)Footnote 273. See *Treas Reg* § 1.199-2(e)(2).

(n115)Footnote 274. *Treas Reg* § 1.199-5(b)(3), (c)(3). A transition rule applies for the situation in which a partner (or shareholder) and a partnership (or S corporation) have different taxable years, only one of which begins on or before 5/16/06 [see *Treas Reg* § 1.199-5(b)(4), (c)(4)].

(n116)Footnote 275. *Treas Reg* § 1.199-5(b)(6).

(n117)Footnote 276. *Treas Reg* § 1.199-5(e)(1).

(n118)Footnote 277. See *IRC* § 643(a).

(n119)Footnote 278. *Treas Reg* § 1.199-5(e)(2)(i).

(n120)Footnote 279. *Treas Reg* § 1.199-5(e)(4).



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CHAPTER 4 Operating and Leasing Real Estate

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CHAPTER 4 Operating and Leasing Real Estate

1-4 Federal Taxes Affecting Real Estate Scope

Scope

To state the obvious, the net cash flow of a real estate project can be materially affected by income taxes. This chapter discusses ways to select accounting methods and periods, maximize available deductions, and defer recognition of income to minimize the adverse impact of taxes on the net cash flow of a real estate project. In addition, while recognizing that the economic terms of a lease are generally the primary focus of lease negotiations (and the primary factors affecting net cash flows under a lease), this chapter discusses the ways in which the provisions of a lease can affect the timing of the taxes that will be paid by the lessor and the lessee, enabling the parties to draft lease terms that document the intended results.



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CHAPTER 4 Operating and Leasing Real Estate

1-4 Federal Taxes Affecting Real Estate § 4.01

§ 4.01 Selecting and Using Accounting Methods and Periods

The method of accounting adopted by a taxpayer determines when items of income and expense are reportable for federal income tax purposes. n1 Consequently, choosing the proper accounting method is an important decision, and one that must be made at the outset of the project. A taxpayer may use different accounting methods for different businesses. n2 In many cases the net cash flows expected from a real estate transaction are premised on the adoption of a certain method of accounting. Sometimes it may be tempting to adopt a particular accounting method for a real estate project to accomplish a short-range objective in the current year; however, since the adoption of a method is generally binding on subsequent years, n3 long-range tax planning must be considered.

The two most commonly used overall methods of accounting employed are the cash receipts and disbursements method (referred to as the "cash method") and the accrual method. The choice of the method to suit the taxpayer's needs depends on the form in which the business is conducted, the other business activities of the taxpayer, and the objectives and estimated profitability of the particular investment. Generally, a taxpayer using either the cash or accrual method of accounting may report certain sales under the installment method (see Chapter 7).

[1] The Cash Method

[a] In General

Under the cash method of accounting, gross income is reported in the year in which the cash or property is actually or constructively received, and deductions generally are allowed in the year paid. n4 "Constructive receipt" refers to income that taxpayers have a present right to receive, and that is available to them without qualification or restriction. n5 For example, if a landlord using the cash method of accounting refuses to accept rent that is due from a tenant when the rent is tendered, or fails to deposit a rent check received, in order to defer payment of the related income tax, the landlord is deemed to have "constructively received" the rent, and is required to recognize the income for tax purposes when it was available to him. n6

Although expenses are generally deductible when paid under the cash method of accounting, amounts that are paid for an asset with a useful life extending substantially beyond the close of the tax year are not necessarily deductible in full in the year paid. Instead they may be recoverable only through depreciation or amortization deductions. n7 However, in some cases a prepayment covering a relatively short period (less than one year) is deductible. n8 Amounts prepaid for periods longer than one year, however, cannot be deducted. n9

Furthermore, the delivery of a promissory note in payment of an expense does not entitle a cash-basis taxpayer to a deduction until the taxpayer pays the note. n9.1 Similarly, a cash-basis taxpayer is not entitled to an increase in basis for expenditures chargeable to capital account if payment is made by issuing a secured promissory note. Basis cannot be increased until the note is actually paid. n9.2

[b] Who May Use the Cash Method of Accounting

All taxpayers may use the cash method of accounting, unless either they are precluded from doing so by an express statutory limitation, or the cash method does not clearly reflect their income. n10

In addition, under a special small business exception set forth in *Revenue Procedure 2002-28*, the IRS allows certain taxpayers with average annual gross receipts of \$10 million or less to use the cash method of accounting. n10.1 This relatively liberal stance is intended to reduce the administrative and tax compliance burdens on small businesses who are otherwise required to use the accrual method of accounting to account for inventories under *IRC Section 471*. n10.2 The revenue procedure specifies the manner in which qualifying taxpayers may obtain automatic consent to change to the cash method and/or a method of accounting for inventoriable items as non-incidental materials and supplies. n10.3 *Revenue Procedure 2002-28* is effective for tax years ending on or after December 31, 2001, but the IRS will not challenge a taxpayer's use of the cash method or its failure to account for inventories under *IRC Section 471* for earlier years if the taxpayer would have otherwise qualified to use the cash method under *Revenue Procedure 2002-28* had it been applicable to that year. n10.4

To be eligible to use the cash method under *Revenue Procedure 2002-28*, the taxpayer must have average annual gross receipts of \$10 million or less. n10.5 This requirement is met if, for each prior taxable year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the three taxable-year period ending with the applicable prior taxable year do not exceed \$10 million. A taxpayer who has not been in existence for three prior taxable years must determine its average annual gross receipts for the number of years (including short taxable years) that it has been in existence. n10.6

A taxpayer meeting the above requirement may use the cash method for all of its trades and businesses if it satisfies any one of the following three tests and did not previously change (and was not previously required to have changed) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method under *Revenue Procedure 2002-28*: n10.7

- The taxpayer reasonably determines that its principal business activity is in an eligible North American Industry Classification System (NAICS) code. n10.8
- Notwithstanding that a taxpayer's principal business activity is described in one of the ineligible NAICS Codes, the taxpayer reasonably determines that its principal business activity is the provision of services, including the provision of property incident to those services.
- Notwithstanding that a taxpayer's principal business activity is described in one of the ineligible NAICS Codes, the taxpayer reasonably determines that its principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications. For purposes of this rule, this requirement is not met if a customer merely chooses among pre-selected options offered by the taxpayer or if the taxpayer must make only minor modifications to its basic design to meet the customer's specifications. In addition, a taxpayer that manufactures an item in quantities for a customer is not treated as fabricating or modifying tangible personal property in accordance with customer design or specifications.

1-4 Federal Taxes Affecting Real Estate § 4.01

A taxpayer with multiple trades or businesses may use the cash method with respect to any separate and distinct trade or business by applying the above tests to that separate and distinct trade or business. n10.9 The revenue procedure clarifies the definition of business activity, principal business activities, and gross receipts. n10.10

A taxpayer who satisfies one of the above tests and chooses not to use an overall accrual method with inventories being accounted for under *IRC Section 471* has the following three options for an eligible trade or business: n10.11

- (1) the taxpayer can use the overall cash method and account for inventories under *IRC Section 471*;
- (2) the taxpayer can use an overall accrual method and account for inventoriable items in the same manner as materials and supplies that are not incidental under regulations; n10.12 or
- (3) the taxpayer can use the overall cash method and account for inventoriable items in the same manner as materials and supplies that are not incidental under regulations. n10.13

Taxpayers that are permitted to use the cash method under *Revenue Procedure 2002-28* , and that do not want to account for inventories under *IRC Section 471* must treat all inventoriable items in the trade or business in the same manner as materials and supplies that are not incidental under regulations. n10.14 This means that these taxpayers need not apply the uniform capitalization rules of *IRC Section 263A* to inventoriable items that are treated as materials and supplies that are not incidental. Items that would be accounted for as incidental materials and supplies under regulations n10.15 may still be accounted for in that matter. Whether an item is purchased for resale or use (and thus accounted for as a non-incidental material and supply) or is purchased to provide to customers incident to services (and thus may be accounted for as either an incidental or a non-incidental material and supply depending on the facts and circumstances) must be determined under general tax principles. n10.16

Under regulations, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer's business. n10.17 For purposes of *Revenue Procedure 2002-28* , inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year the qualifying small business taxpayer provides the items to a customer. Thus, the cost of those items is deductible only in that year, or in the year in which the taxpayer actually pays for the goods, whichever is later. n10.18 A qualifying small business taxpayer may determine the amount of the allowable deduction for non-incidental materials and supplies by using either a specific identification method, a FIFO method, or an average cost method, provided that method is used consistently. A taxpayer may not use the LIFO method to determine the amount of the allowable deduction for non-incidental materials or supplies. n10.19 The revenue procedure provides numerous examples to illustrate its application. n11

Apart from the \$10 million small business exception in *Revenue Procedure 2002-28* , the following taxpayers generally are prohibited by statute from using the cash method: n12

- (1) C corporations;
- (2) partnerships (including limited liability companies) that have a C corporation as a partner (or member); and
- (3) tax shelters within the meaning of *IRC Section 461(i)(3)*.

The prohibition against C corporations and partnerships with C corporation partners (items (1) and (2), above) has three statutory exceptions, in addition to the administrative exception in *Revenue Procedure 2002-28* . First, except as is provided in *IRC Section 447*, dealing with farming corporations, such entities engaged in the farming or timber business n13 may use the cash method, notwithstanding *IRC Section 448*. n14

Second, qualified personal service corporations may use the cash method. n15 A qualified personal service corporation is a corporation substantially all activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and in which substantially all (95 percent) of the stock is held directly or indirectly by employees performing those services, retired employees, estates of former employees or retired employees or (for a two-year period) anyone who acquired stock by reason of the death of such a person). n16

Third, corporations and partnerships with average annual gross receipts for the three preceding tax years or less than \$5 million may use the cash method. n17 It should be noted that this statutory exception will ordinarily be subsumed within the \$10 million small business exception in *Revenue Procedure 2002-28* . n17.1

Planning Note:

Even if a taxpayer meets the \$5 million gross receipts test, the Service may still claim that the cash method does not clearly reflect income, and that the taxpayer must therefore use some other method of accounting. To contest this claim, a taxpayer must be able to show that the Service has abused its discretion. Key factors that can weigh heavily in a taxpayer's favor are that the taxpayer: (1) has never maintained an inventory; (2) has consistently used the cash method since its inception; and (3) has never made an attempt to unreasonably pre-pay expenses or defer recognition of income. n18

Certain taxpayers engaged in farming may also not use the cash method. Corporations (other than S corporations) and partnerships with a partner that is a corporation ordinarily must use an accrual method of accounting to compute taxable income from farming. This prohibition does not apply, however, to nursery operations, sod farms, or the raising or harvesting of trees other than fruit and nut trees. These taxpayers may therefore use the cash method. n19

There is also a small taxpayer exception to the cash method prohibition for farming corporations. Notwithstanding the general prohibition, the cash method may be used by the following:

- (1) corporations that, for each tax year beginning after 1975, have not had gross receipts exceeding \$1 million; n20 and
- (2) family corporations that, for each tax year beginning after 1985, have not had gross receipts exceeding \$25 million. n21

Family corporations include corporations in which members of the same family n22 own at least 50 percent of the voting stock and at least 50 percent of all other classes of stock of the corporation. n23 Family corporations also include certain closely-held farming corporations that have met specified ownership requirements at all times since October 4, 1976. n24

Finally, the cash method of accounting cannot be used by any taxpayer to compute taxable income from long-term contracts. Instead, the percentage of completion method must be used. n25 Further, whether the taxpayer is using the cash method or the accrual method, construction costs on houses that are incomplete or unsold at the end of the taxable year cannot be deducted currently, but instead must be capitalized. n26 Generally, the cash method cannot be used for any business in which inventories are a material factor, but real estate assets are not inventory for this purpose. Therefore, the cash method should be available for real estate activities, even if real properties are held for sale to customers in the ordinary course of business. n27

[2] The Accrual Method

Under the accrual method of accounting, income is recognized in the year during which all the events occur to fix the right to receive the income and, correspondingly, deductions are allowed in the year during which all the events occur to fix a liability for the expense. In accruing either income or expense, the amount must be determinable with reasonable accuracy, and economic performance has occurred with respect to the liability. n28

For example, under the accrual method, rental income is recognized in the period to which it relates, even if the tenant has not actually paid the rent. Similarly, the accrual-basis taxpayer must deduct expenses in the year incurred even though they are not paid until a subsequent year. Assume, for example, that a plumber performs services and sends a bill in December. Although the invoice may not be payable until the subsequent year, under the accrual method, the expense is deducted in December.

Prepaid expenses for services or goods not yet provided are not deductible by the accrual-basis taxpayer. Prepaid rent or insurance is amortized over the period to which it relates. However, income actually received by an accrual-basis taxpayer before it is earned, such as prepaid rent, must generally be reported as income in the year received. n29 This differs from the accounting treatment of such amounts.

Tax deductions are not allowed for estimated future liabilities such as general warranty reserves or potential maintenance and repairs. n30 However, tax deductions have been allowed for a reserve for worker's compensation liability when the "all-events test" was met, and the determination of the amount of the reserve was reasonably accurate. In *Kaiser Steel Corporation v. United States*, n31 Kaiser deducted sums reserved for future payments of its worker's compensation liability on uncontested claims for injuries suffered during the tax year. The Court held that all events had occurred, thereby establishing the fact of liability, because the injury had occurred and Kaiser did not contest liability for the injury. Furthermore, the amount of liability becoming payable in future years was determined with reasonable accuracy, through application of Kaiser's medical and accounting practices. In *United States v. General Dynamics Corp.*, however, the Supreme Court restricted the deductibility of reserves for self-insurance. n32 Also, see § 4.03[6], below.

Generally, the accrual method is required when inventories are a material income-producing factor. n33 However, it is the position of the Service that real estate assets are not inventory. n34 This position was upheld in *W.C. & A.N. Miller Development Company v. Commissioner*. n35

Courts have also ruled that land developers cannot use the lower-of-cost-or-market method or other inventory method to claim deductions for the decrease in the fair market value of parcels of land held for development. n36 Subject to the restriction on using inventory accounting methods, and the required consistency with the basis on which books are kept, taxpayers engaging in real estate activities may use any method of accounting that clearly reflects income. n37

[3] Hybrid Accounting Method

Many businesses do not use a complete accrual method of accounting, but report some items on the cash method. However, adoption of such "hybrid" methods is at the discretion of the Commissioner. n38 If the hybrid method results in a distortion of taxable income, the taxpayer can be required to use another method of accounting. Taxpayers have been allowed to use the accrual method for reporting purchases and sales, and the cash method for reporting other items. However, as a general rule, if the cash method is used for reporting income, it must be used to report expenses, and if the accrual method is used to report expenses, it must be used to report income. n39

[4] Percentage of Completion Method

IRC Section 460 requires taxpayers to account for long-term contracts under the percentage-of-completion method. n40 Extensive regulations describe how income from a long-term contract must be accounted for under *IRC Section 460*. n40.1 A long-term contract is a contract for the manufacture, building, installation or construction of property that is not

completed within the taxable year in which the contract was executed. n41

There are several exceptions under *IRC Section 460*. The percentage of completion method need not be used in the following circumstances: n42

(1) in any home construction contract (generally a construction contract with respect to dwelling units in a building with four or fewer dwelling units, in which 80 percent of the costs incurred are construction costs);

(2) in any other construction contract expected to be completed within two years if the taxpayer's average annual gross receipts for the three taxable years before the year the contract is entered into do not exceed \$10 million.

Contracts that would otherwise fall within the home construction contract exception (item 1 above), but involve a building containing more than four units (e.g., large condominium buildings) may be accounted for by using a 70 percent percentage-of-completion/30 percent completed-contract method instead of the percentage-of-completion method. n43 The application of *IRC Section 460* and the percentage-of-completion method to residential homebuilders who do not meet the home-construction-contract exception may have a devastating effect on the homebuilders' cash flow. These homebuilders would be forced to pay tax on income that may not be received until the following taxable year, when the sale of the home is completed. n44

Under the percentage of completion method, a taxpayer estimates the total contract costs allocated to a contract, and at the close of each taxable year, determines the percentage of the contract that is completed and must include in income that percentage of the income from the contract. Upon completion of the contract, the taxpayer must pay (or is entitled to receive) interest computed under the look-back method. n45 The interest is paid or received on the amount of tax liability that is deferred or accelerated as a result of overestimating or underestimating the total contract price or contract costs. n46 Any amount of interest required to be paid is treated as an increase in the tax for the taxable year in which the contract is completed. n47 Any income under the contract that has not previously been included in gross income must be included in gross income for the taxable year following the taxable year in which the contract was completed. n48

Under the look-back method, interest is computed as follows: n49

(1) Income under the contract must be allocated among tax years before the year in which the contract is completed on the basis of the actual contract price and costs instead of the estimated contract price and costs.

(2) The overpayment or underpayment of tax that would result from the application of step (1) must be determined for each tax year before the year in which the contract is completed.

(3) The adjusted overpayment rate is applied to the overpayment or underpayment as determined under step (2). The adjusted overpayment rate for an interest accrual period is the overpayment rate in effect under *IRC Section 6621* for the calendar quarter in which the interest accrual period begins. n50

A simplified look-back method is used to make computations for pass-thru entities that are not closely held, pursuant to which the look-back rules are applied at the entity level. n51 Special rules are used for computations to reflect amounts properly taken into account after completion of the contract. n52 Costs are allocated to long-term contracts according to statutory provisions n53 and detailed regulations. n54

In determining taxable income from a long-term contract under the percentage-of-completion method, a taxpayer can

elect not to recognize any income or expenses from the contract for a tax year if less than 10 percent of the estimated costs of the contract have been incurred as of the end of the tax year. The election applies to all contracts entered into during the year of the election as well as to any later tax years. The election is not available if the taxpayer uses the simplified method of allocating contract costs. n55

A taxpayer may elect not to apply the look-back method with respect to a long-term contract if, for each prior contract year, the cumulative taxable income (or loss) under the contract--as determined using the estimated contract price and costs--is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs. n56 In addition, a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the above *de minimis* exception). n57 The election is made by attaching a statement containing specified information to the taxpayer's timely-filed federal income tax return (including extensions) for the tax year for which the election is effective. The statement must have the legend "NOTIFICATION OF ELECTION UNDER SECTION 460(b)(6)." The election, once made, applies to all long-term contracts completed during and after the year of election, unless the Commissioner consents to the revocation of the election. n58

[5] Comparison of Methods

The accrual method tends to avoid distortion of taxable income, because income items are more evenly matched with related expenses. However, the accrual method is more complicated than the cash method, and requires more sophisticated accounting techniques and may require taxpayers to pay tax on amounts that they have not yet received in cash.

Under the cash method the taxpayer has more flexibility in controlling the payment of expenses and the receipt of income.

In summary, the taxpayer should carefully consider the adoption of an accounting method. Because real estate taxation is complex, it may be prudent for a taxpayer to seek professional tax guidance on the most advantageous method of accounting.

[6] Establishment of Method

The establishment of a method of accounting is made with the first tax return for each trade or business. Generally, the Internal Revenue Code requires that taxable income be computed under the method of accounting that a taxpayer regularly uses to compute income in keeping its books. n59 This requirement of conformity, however, conflicts with the requirement of consistency n60 (i.e., the taxpayer must report its taxable income on a consistent basis from year to year) when the taxpayer changes the accounting method it uses in keeping its books. Some taxpayers have changed to the accrual method of accounting on their books of account or financial statements for management or regulatory reporting purposes, but have continued on the cash method for tax reporting. Whether this leaves the taxpayer's tax accounting method subject to challenge by the Service depends on the supporting records that the taxpayer keeps for converting its accrual-method book figures to cash-method figures for the tax return reporting. If these records are the equivalent of "books," the taxpayer has met the requirement of conformity, which should permit the continued filing of tax returns using the cash method. n61 In one case, a court held that a clear set of reconciling work papers was sufficient to meet the conformity requirement. n62 In a subsequent ruling, however, the Service took the position that the conformity requirement is met only if the adjustments from the accrual to the cash method must be readily verifiable from the taxpayer's permanent books and records. n63

Once a method of tax accounting is adopted, it generally cannot be changed without the consent of the Service. n64 (A

limited number of circumstances exist where Service consent is not required or is deemed to have been received, including changes from the cash to the accrual method of accounting.) n65 Furthermore, a taxpayer may not change its accounting method or its treatment of a particular item without IRS consent, even if its current method or treatment of the item is legally improper. n65.1 Permission is required to change not only the overall method of accounting but also the method of accounting for a single item. Permission must generally be requested within the first 180 days of the taxable year. n66 The IRS issued *Revenue Ruling 90-38* n67 in which it clarified its position with respect to when a taxpayer is deemed to have established an accounting method. The ruling also holds that a taxpayer may not change an accounting method by amending a return.

The Service, however, may require a change if an inappropriate method has been used or if the method used does not clearly reflect income. n68 The rules relating to the adjustments required as a result of changes in accounting methods are set forth in *IRC Section 481*. Different rules apply to changes initiated by the taxpayer than apply to changes initiated by the Service. If a taxpayer has to change from the cash to accrual method by reason of *IRC Section 448*, the change is deemed to be initiated by the taxpayer with the consent of the Service. n69

Regulations clarify when particular changes in treating various items constitute a change in the method of accounting. n69.1 They also clarify when changes in depreciation or amortization are and are not a change in method of accounting. n69.2

A taxpayer may use different methods of accounting for different business activities that are distinct and separate in character. n70 Therefore, real estate investments may be separated from other activities as long as complete and separate books are maintained for each business, and the separate accounting methods have not resulted in a distortion of the taxpayer's income. n71

[7] The Accounting Period

[a] In General

In certain circumstances, selection of an accounting period can also create tax planning alternatives. However, a taxable entity can only have one accounting period. n72 Thus, an individual directly holding real estate must account for it on his taxable period (usually, the calendar year). n73 A newly created trust, estate, or corporation (not filing a consolidated return) is generally free to adopt the end of any month as its fiscal year-end, but this initial period cannot exceed 12 months. n74 Trusts must generally adopt a calendar year. n75 Finally, there are restrictions on the year-end that can be elected by a partnership, personal service corporation, or S corporation.

Personal service corporations and S corporations must use a calendar year as their tax year unless they establish a business purpose for another accounting period. n76 A personal service corporation is defined as a corporation whose principal activity is the performance of personal services, and whose services are substantially performed by employee/owners. n77 An employee/owner is defined as any employee of the corporation who owns, directly or by attribution, on any day during the tax year, any of the outstanding stock of the corporation. n78

A partnership must generally have the same tax year as the tax year of the partners owning a majority interest in the partnership. If there is no such "majority interest taxable year" (as when multiple partners owning a majority do not have the same taxable year), the partnership must adopt the same tax year as all of its principal partners (partners owning 5 percent or more of partnership capital or profits). If there is no majority of partners having the same tax year and the principal partners do not have the same year, the partnership may adopt the calendar year without securing approval of the Commissioner. In every other case (unless an *IRC Section 444* election is made), a partnership must obtain approval from the Commissioner before adopting a taxable year. n79

A partnership, S corporation, or personal service corporation may adopt a fiscal tax year if it can convince the Service

that a business purpose exists for that year. n80 The intent of an entity to make its tax year coincide with its natural business cycle constitutes a valid business purpose. n81 If a business has a nonpeak and peak period, the natural business year usually ends at, or soon after, the close of the peak period. The IRS has issued a revenue procedure which provides the manner for establishing a business purpose and obtaining the approval of the Commissioner to adopted, change or retain an annual accounting period. n81.1

[b] IRC Section 444 Election

Partnerships, S corporations and personal service corporations generally may elect under *IRC Section 444* to have a taxable year different from their otherwise required taxable year. n82 Entities that are electing their first taxable year may elect any taxable year, but the deferral period provided by the taxable year that is elected cannot be longer than three months. n83 For entities that are changing their taxable year, the election cannot create a deferral period that is longer than the shorter of the following: n84

- (1) three months; or
- (2) the deferral period of the taxable year that is being changed.

For any taxable year of an entity, the deferral period refers to the months between the beginning of that taxable year and the close of the first required taxable year ending within that year. n85 For example, an entity with a required tax year ending December 31 that elected a tax year beginning on December 1 would have a one-month deferral period; if the elected year began November 1, the deferral period would be two months, etc.

An *IRC Section 444* election remains in effect until the entity changes its taxable year or otherwise terminates the election. An entity may change to its otherwise required taxable year without the consent of the Commissioner. n86 If an *IRC Section 444* election is terminated, no other *IRC Section 444* election may be made. n87

A partnership or S corporation that makes an *IRC Section 444* election must make annual payments to the Service under *IRC Section 7519* that are intended to compensate for the benefit of the tax deferral. n88 A personal service corporation that makes an *IRC Section 444* election is subject to statutory deduction limitations with respect to certain amounts paid to employee-owners. n89

Some general conclusions that can be reached about the cost/benefit of making a Section 444 election are:

- The greater the portion of annual income earned in the deferral period, the greater the tax benefit of retaining a fiscal year. Entities with seasonal losses in the deferral period may be better off changing to a calendar year.
- Because the computation of the "required payment" uses the prior fiscal year's income, a growing company will continue to have a deferral benefit.
- In many states the election of a tax year under *IRC § 444* for federal tax purposes also results in a state tax deferral, without having to make any compensating required payments to the state. Each situation must be considered individually, but the benefits of retaining a fiscal year, even with the required-payment provisions, in many cases, will justify a retention of a fiscal year. Other business considerations include the natural business cycle, the industry standard, and contracts with government agencies.

FOOTNOTES:

(n1)Footnote 1. *IRC §§ 446(a), 451(a), 461(a).*

(n2)Footnote 2. *IRC § 446(d)*.

(n3)Footnote 3. *Treas Reg §§ 1.460; Treas Reg § 1.446-1(c)*.

(n4)Footnote 4. *Treas Reg § 1.446-1(c)(1)(i)*.

(n5)Footnote 5. *Treas Reg § 1.451-2(a)*.

(n6)Footnote 6. See *Treas Reg § 1.451-2(a)*; see § 4.02[8] for a detailed discussion of constructive receipt of rental income.

(n7)Footnote 7. *Treas Reg § 1.461-1(a)(1)*.

(n8)Footnote 8. *Zaninovich v Commr, 616 F2d 429 (9th Cir 1980) , revg 69 TC 605 (1978) .*

(n9)Footnote 9. *Moore v Commr, TC Memo 1994-503* (loan discount fee for 15-year loan not currently deductible). A different rule applies to loan discount points paid with respect to a principal residence. (See Ch 9.)

(n10)Footnote 9.1. *Owen v US, 34 F Supp 2d 1071 (WD Tenn 1998) ; see Helvering v Price, 309 US 409 (1940) ; Patmon, Young & Kirk Professional Corp v Commr, 536 F2d 142 (6th Cir 1976) .*

(n11)Footnote 9.2. *Owen v US, 34 F Supp 2d 1071 (WD Tenn 1998) ; Jenkins v Bitgood, 101 F2d 17 (2d Cir 1939)*

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(n12)Footnote 10. *IRC § 446(b), (c)*.

(n13)Footnote 10.1. *Rev Proc 2002-28, 2002-1 CB 815* ; farming businesses and tax shelters may not use *Rev Proc 2002-28* .

(n14)Footnote 10.2. See *Treas Reg § 1.446-1(c)(2)(i)*.

(n15)Footnote 10.3. *Rev Proc 2002-28 , § 7, 2002-1 CB 815 .*

(n16)Footnote 10.4. *Rev Proc 2002-28 , § 9, 2002-1 CB 815 .*

(n17)Footnote 10.5. *Rev Proc 2002-28 , § 5.01, 2002-1 CB 815 .*

(n18)Footnote 10.6. *Rev Proc 2002-28 , § 5.02, 2002-1 CB 815 .*

(n19)Footnote 10.7. *Rev Proc 2002-28 , § 4.01, 2002-1 CB 815 .*

(n20)Footnote 10.8. See www.census.gov for information regarding the codes. The ineligible codes cover certain mining activities (NAICS Codes 211 and 212), manufacturing activities (NAICS Codes 31-33), wholesale trade (NAICS Code 42), retail trade (NAICS Codes 44 and 45), and information industries (NAICS Codes 5111 and 5122).

(n21)Footnote 10.9. *Rev Proc 2002-28 , § 4.01, 2002-1 CB 815 .*

(n22)Footnote 10.10. *Rev Proc 2002-28 , §§ 5.03-5.06, 2002-1 CB 815 .*

(n23)Footnote 10.11. *Rev Proc 2002-28 , § 4.02, 2002-1 CB 815 .*

(n24)Footnote 10.12. See *Treas Reg § 1.162-3*.

(n25)Footnote 10.13. See *Treas Reg § 1.162-3*.

- (n26)Footnote 10.14. See *Treas Reg* § 1.162-3.
- (n27)Footnote 10.15. See *Treas Reg* § 1.162-3.
- (n28)Footnote 10.16. *Rev Proc* 2002-28 , § 4.04, 2002-1 CB 815 .
- (n29)Footnote 10.17. *Treas Reg* § 1.162-3.
- (n30)Footnote 10.18. *Rev Proc* 2002-28 , § 4.05, 2002-1 CB 815 .
- (n31)Footnote 10.19. *Rev Proc* 2002-28 , § 4.06, 2002-1 CB 815 .
- (n32)Footnote 11. *Rev Proc* 2002-28 , § 6, 2002-1 CB 815 .
- (n33)Footnote 12. *IRC* § 448(a).
- (n34)Footnote 13. See *IRC* § 448(d)(1).
- (n35)Footnote 14. *IRC* § 448(b)(1), (d)(1).
- (n36)Footnote 15. *IRC* § 448(b)(2), (d)(2).
- (n37)Footnote 16. *IRC* § 448(d)(2); *Temp Treas Reg* § 1.448-1T(e).
- (n38)Footnote 17. *IRC* § 448(b)(3), (c).
- (n39)Footnote 17.1. See *IRC* § 448(b)(3), (c); *Rev Proc* 2002-28 , § 6, 2002-1 CB 815 .
- (n40)Footnote 18. *Ansley-Sheppard-Burgess Co v Commr*, 104 TC 367 (1995) .
- (n41)Footnote 19. *IRC* § 447(a), (c)(1).
- (n42)Footnote 20. *IRC* § 447(d)(1).
- (n43)Footnote 21. *IRC* § 447(d)(2).
- (n44)Footnote 22. See *IRC* § 447(e).
- (n45)Footnote 23. *IRC* § 447(d)(2)(C)(i).
- (n46)Footnote 24. *IRC* § 447(d)(2)(C)(ii), (h).
- (n47)Footnote 25. *IRC* § 460(a).
- (n48)Footnote 26. *IRC* § 263A; *Carpenter v Commr*, TC Memo 1994-289 .
- (n49)Footnote 27. *WC & AN Miller Development Co v Commr*, 81 TC 619 (1983) ; *Atlantic Coast Realty Co v Commr*, 11 BTA 416 (1928) ; *Pierce v Commr*, TC Memo 1997-411 (lower of cost or market method cannot be used to value real estate); see *Carpenter v Commr*, TC Memo 1994-289 .
- (n50)Footnote 28. *Treas Reg* §§ 1.451-1(a), 1.461-1(a)(2).
- (n51)Footnote 29. *Treas Reg* § 1.61-8(b).
- (n52)Footnote 30. *Brown v Helvering*, 291 US 193, 13 AFTR 851 (1934) .

(n53)Footnote 31. *717 F2d 1304 (9th Cir 1983)* .

(n54)Footnote 32. *481 US 239 (1987)* .

(n55)Footnote 33. *Treas Reg § 1.446-1(c)(2)(i)*.

(n56)Footnote 34. *Rev Rul 69-536, 1969-2 CB 109 ; Rev Rul 86-149, 1986-2 CB 67* .

(n57)Footnote 35. *81 TC 619 (1983)* .

(n58)Footnote 36. *Pierce v Commr, TC Memo 1997-411* .

(n59)Footnote 37. See *IRC § 446(a), (b)*.

(n60)Footnote 38. *IRC § 446(c)(4); Treas Reg § 1.446-1(c)*.

(n61)Footnote 39. *Treas Reg § 1.446-1(c)(1)(iv)*.

(n62)Footnote 40. *IRC § 460*.

(n63)Footnote 40.1. See *Treas Reg §§ 1.460-1 through 1.460-6*.

(n64)Footnote 41. *IRC § 460(f)(1)*.

(n65)Footnote 42. *IRC § 460(e)*.

(n66)Footnote 43. *IRC § 460(e)(5)*.

(n67)Footnote 44. *IRC § 460(b)*.

(n68)Footnote 45. *IRC § 460(b)(1)*.

(n69)Footnote 46. *Id; Treas Reg § 1.460-6(a)(1)*.

(n70)Footnote 47. *IRC § 460(b)(1)*.

(n71)Footnote 48. *IRC § 460(b)(1)*.

(n72)Footnote 49. *IRC § 460(b)(2)*.

(n73)Footnote 50. *IRC § 460(b)(7)*.

(n74)Footnote 51. *IRC § 460(b)(4)*.

(N75)Footnote 52. *IRC § 460(b)*.

(n76)Footnote 53. See *IRC § 460(c)*.

(n77)Footnote 54. *Treas Reg § 1.460-5*.

(n78)Footnote 55. *IRC § 460(b)(5)*.

(n79)Footnote 56. *IRC § 460(b)(6)(B)*.

(n80)Footnote 57. *IRC § 460(b)(6)(A)*.

(n81)Footnote 58. *Treas Reg* § 1.460-6(j).

(n82)Footnote 59. *IRC* § 446(a).

(n83)Footnote 60. *Treas Reg* § 1.446-1(c)(2)(ii).

(n84)Footnote 61. *Patchen v Commr*, 258 F2d 544 (5th Cir 1958) , *affg in part, revg in part* 27 TC 592 (1956) .

(n85)Footnote 62. *Id.*

(n86)Footnote 63. *Rev Rul* 68-35, 1968-1 CB 190 .

(n87)Footnote 64. *IRC* § 446(e); *Treas Reg* § 1.446-1(e)(2)(i).

(n88)Footnote 65. *Rev Proc* 97-37, 1997-2 CB 455 .

(n89)Footnote 65.1. *Cargill Inc v US*, 91 F Supp 2d 1293 (D Minn 2000) ; *Diebold, Inc v US*, 891 F2d 1579 (Fed Cir 1989) ; *US v Kleifgen*, 557 F2d 1293 (9th Cir 1977) ; *Witte v Commr*, 513 F2d 391 (DC Cir 1975) ; ; *Treas Reg* § 1.446-1(e)(2)(i), (ii)(c), (3)(i).

(n90)Footnote 66. *Treas Reg* § 1.446-1(e)(3)(i).

(n91)Footnote 67. 1990-1 CB 57 . See also *Rev Proc* 92-20, 1992-1 CB 685 .

(n92)Footnote 68. *IRC* § 446(b).

(n93)Footnote 69. *IRC* § 448(d)(7).

(n94)Footnote 69.1. *Treas Reg* § 1.446-1(e)(2)(ii).

(n95)Footnote 69.2. *Treas Reg* § 1.446-1(e)(2)(ii)(d).; see Chapter 5 for a discussion.

(n96)Footnote 70. *IRC* § 446(d).

(n97)Footnote 71. *Treas Reg* § 1.446-1(d).

(n98)Footnote 72. *Rev Rul* 57-389, 1957-2 CB 298 .

(n99)Footnote 73. *IRC* § 441.

(n100)Footnote 74. *IRC* § 441(e).

(n101)Footnote 75. *IRC* § 644.

(n102)Footnote 76. *IRC* §§ 441(i); 1378(b).

(n103)Footnote 77. *IRC* §§ 441(i)(2); 269A(b).

(n104)Footnote 78. *IRC* §§ 441(i); 269A(b).

(n105)Footnote 79. *IRC* § 706(b).

(n106)Footnote 80. *IRC* §§ 441(i); 706(b)(1)(C); 1378(b)(2).

(n107)Footnote 81. *Rev Proc* 2002-38 , § 2.02, 2002-22 IRB 1037 ; see *IRC* § 442; *Treas Reg* § 1.441-1(c).

(n108)Footnote 81.1. *Rev Proc 2002-39, 2002-22 IRB 1046* .

(n109)Footnote 82. *IRC § 444(a)*; see § 4.01[7][a], *supra*, for a discussion of the tax year that must be used if the *IRC Section 444* election is not made.

(n110)Footnote 83. *IRC § 444(b)(1)*.

(n111)Footnote 84. *IRC § 444(b)(2)*.

(n112)Footnote 85. *IRC § 444(b)(4)*.

(n113)Footnote 86. *IRC § 444(d)(2)(A)*.

(n114)Footnote 87. *IRC § 444(d)(2)(B)*.

(n115)Footnote 88. *IRC § 444(c)(1)*.

(n116)Footnote 89. *IRC §§ 444(c)(2); 280H*.



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Federal Taxes Affecting Real Estate

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CHAPTER 4 Operating and Leasing Real Estate

1-4 Federal Taxes Affecting Real Estate § 4.02

§ 4.02 Recognition of Income

[1] Rent

Rental income includes all payments received or accrued for the occupancy of real estate, n90 including payments made by lessees to satisfy lessor obligations for items such as taxes, repairs and maintenance, and interest on indebtedness.

n91 An item intended by the parties to serve as a substitute for rent is also taxable as rental income, such as the value of carpeting installed by a tenant for which a rent credit is given. n92

[2] Advance Rent

To protect himself in case of default by the tenant during the term of the lease, the lessor may require some portion of the rent to be paid in advance. The lease may require advance rental payments to be applied against the last few months' rent or against rent over the term of the lease. Advance rentals paid by the tenant on the execution of the lease, whether or not mentioned in the lease, are considered to be taxable income to the lessor in the year of receipt, regardless of his method of tax accounting. n93

Taxpayers have tried various techniques to avoid reporting advance rentals in the year received. The Tax Court has held that rental income received by the sellers of property, attributable to the period after title has passed to the purchaser, is rental income of the purchasers because it relates to the occupancy of real estate owned by the purchaser, and, therefore, is an adjustment to the purchase price. n94 In another case, the lessee refrained from paying rent for five years; instead, the lessee granted the taxpayer a credit on the purchase price of real estate the lessee was selling. The court required the taxpayer to report the credit as ordinary income rather than treating it as a purchase price adjustment. n95 Several other attempts were made to treat advance rentals as proceeds of a loan from lessee to lessor to be repaid from annual rent. These attempts have been unsuccessful primarily because the taxpayers failed to demonstrate that a valid indebtedness was created. n96

Occasionally a lessor may receive a "sign up" bonus in consideration of the granting of the lease. An accrual-basis lessor is required to report bonus rights receivable as taxable income in the year the lease is executed, even though payment may not be received for several years. n97 Generally, a cash-basis landlord is not required to recognize income from advance rents or bonus rents until the amount is received in cash or other property.

The lessee is not entitled to a current deduction for advance rental or bonus payments. Instead, advance rental payments

are deductible in the period to which they relate. n98 The Ninth Circuit, however, has applied the "one year rule" in a land rental situation and allowed a deduction for rent paid by a cash-basis taxpayer in December, even though the lease period extended into 11 months of the next tax year. n99 Lease bonus payments made by the lessee are capitalized and amortized over the term of the lease. n100

The lessor may require a lease bonus payment from the lessee to finance the leasing commission to be paid to the broker. These commissions are capitalized by the lessor to the cost of the lease, and amortized over the lease period. n101 To avoid reporting ordinary income from the bonus without achieving a corresponding deduction, some commentators have suggested that the obligation for the commission be passed over to the lessee. However, this technique will be unsuccessful if the lessee is deemed to have paid an obligation of the lessor.

Another technique for the lessor to avoid bonus income is to shift the obligation of constructing leasehold improvements to the lessee. Because this is an obligation that is created only by the lease agreement itself, shifting the cost of the tenant improvements to the lessee does not relieve the lessor of a prior legal commitment. In most cases, this should not constitute an improvement in lieu of rent. See § 4.07[4], below.

[3] Rents Received Under *IRC Section 467* Rental Agreements

[a] Statutory Framework of *IRC Section 467*

Special statutory rules dictate the manner of tax accounting under any lease that qualifies as a Section 467 rental agreement. n102 If a lease is a Section 467 rental agreement, both the landlord and tenant must take into account for any taxable year the sum of the rent that accrues during the year under the *IRC Section 467* rules and the interest for the year on the unpaid amounts that were taken into account under *IRC Section 467* for prior taxable years. n103

If the lease is a Section 467 rental agreement, one of two sets of rules applies to determine the landlord's accrued rental income. If the agreement is one in which deferred rent is to be paid after the year to which the payment relates, rent must be accrued under the economic rent accrual rules. n103.1 If the agreement is one in which there are rent increases over the term of the lease and a principal purpose for providing increasing rents under the agreement is the avoidance of income tax, then rent must be accrued under the constant rent accrual rules. n103.2

The primary purpose of *IRC Section 467* is to ensure a matching in the reporting of income and expenses by landlords and tenants in order to curb timing abuses that can otherwise occur when a landlord is on the cash method of accounting and a tenant is on the accrual method and to prevent an acceleration or deferral of rental income and expense when one party to the lease is tax sensitive and the other is not (for example, because it has substantial net operating losses). Another purpose is to prevent a building owner from effectively converting ordinary income into capital gain (which is taxed at a lower maximum rate). n104 This could occur if low rents are permitted in the earlier years of a lease, followed by higher rents in later years that in part represent deferred rents attributable to the earlier years. These higher deferred rents would likely be taken into account by a prospective purchaser of a building and result in an increase in the selling price of the building. This scheme would, in effect, convert what would have been rental income into an increase in the selling price. The increased gain from the increased selling price could be taxed at the more favorable capital gains rate.

[b] *IRC Section 467* Rental Agreement Defined

A Section 467 rental agreement is a rental agreement for the use of tangible property (including real estate) under which: (1) there is at least one amount allocable to the use of the property during a calendar year which is to be paid after the close of the calendar year following the year in which such use occurs; or (2) there are increases or decreases in the amount of rent to be paid under the agreement. n105 A Section 467 rental agreement does not, however, include any lease involving total payments of \$250,000 or less. n106

[c] Increasing or Decreasing Rents

Regulations provide several rules regarding increasing and decreasing rents. A rental agreement has increasing or decreasing rent if the annualized fixed rent n106.1 allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term. n106.2 In determining whether a rental agreement has increasing or decreasing rent, however, a rent holiday of three months or less at the beginning of the lease term is disregarded. n106.3

The amount of fixed rent allocated to a rental period is the amount specifically allocated to that period by the rental agreement or, if there is no specific allocation, the amount of fixed rent payable during that period. n106.4

Example:

A and B enter into a rental agreement that provides for the lease of property to begin on January 1 of Year 1, and end on December 31 of Year 4. The rental agreement provides that rent of \$100,000 accrues during each year of the lease term. Under the rental agreement, no rent is payable during Year 1, a payment of \$100,000 is to be made on December 31 of Year 2 and Year 3, and a payment of \$200,000 is to be made on December 31 of Year 4. A and B both select the calendar year as their rental period. Thus, the amount of rent allocated to each rental period is \$100,000. Therefore, the rental agreement does not have increasing or decreasing rent. n106.5

A rental agreement has increasing or decreasing rent if it requires (or may require) the payment of contingent rent, other than contingent rent that is contingent due to specified reasons. The existence of rent that is contingent as the result of one or more of the following provisions is disregarded in determining if a rental agreement has increasing or decreasing rent: n106.6

- (1) A qualified percentage rents provision under which rent is based on the lessee's receipts or sales; n107
- (2) An adjustment based on a reasonable price index; n108
- (3) A provision requiring the lessee to pay third-party costs such as real estate taxes, insurance premiums, and maintenance costs; n109
- (4) A provision requiring the payment of late payment charges; n110
- (5) A loss payment provision for damaged or destroyed property; n111
- (6) A qualified terminal rental adjustment clause (TRAC) provision; n112
- (7) A residual condition provision requiring payments based on the condition of the property at the end of the lease term; n113
- (8) A tax indemnity provision; n113.1
- (9) A variable interest rate provision based on changes in interest rates on the lessor's indebtedness; n113.2 or
- (10) Any other provision provided in regulations or other published guidance issued by the Commissioner, but only if the provision is designated as contingent rent to be disregarded for purposes

of this regulation.

Note:

At present, Treasury has not provided guidance on the tax treatment of contingent rent under *IRC Section 467*. Treatment of contingent rent will eventually be covered under *Regulations Section 1.467-6*, which is now reserved.

[d] Deferred and Prepaid Rent

A rental agreement has deferred rent if the cumulative amount of rent allocated as of the close of a calendar year exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year. n113.3 A rental agreement has prepaid rent if the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year. n113.4

Example:

A and B enter into a rental agreement that provides for the lease of property to begin on January 1 of Year 1, and end on December 31 of Year 4. The rental agreement provides that rent of \$100,000 accrues during each year of the lease term. Under the rental agreement, no rent is payable during Year 1, a payment of \$100,000 is to be made on December 31 of Year 2 and Year 3, and a payment of \$200,000 is to be made on December 31 of Year 4. A and B both select the calendar year as their rental period.

In this example, there is no deferred rent. The rent allocated to Year 1 (\$100,000) does not exceed the cumulative rent payable as of December 31 of Year 2 (\$100,000); the rent allocated to Year 2 and preceding years (\$200,000) does not exceed the cumulative rent payable as of December 31 of Year 3 (\$200,000); the rent allocated to Year 3 and preceding years (\$300,000) does not exceed the cumulative rent payable as of December 31 of Year 4 (\$400,000); and the rent allocated to Year 4 and preceding years (\$400,000) does not exceed the cumulative rent payable as of December 31 of Year 5 (\$400,000). Therefore, because the rental agreement does not have increasing or decreasing rent (see § 4.02[3][c], above) and does not have deferred or prepaid rent, it is not a Section 467 rental agreement. n113.5

[e] Substantial Modification of Rental Agreement

If a substantial modification of a rental agreement occurs after June 3, 1996, the post-modification agreement is generally treated as a new agreement for purposes of determining whether the agreement is a Section 467 rental agreement or a disqualified leaseback or long-term agreement and for purposes of applying the effective date provisions of the final regulations. n113.6 In the case of a transfer of leased property by a lessor or a substitution of a lessee, the transfer or substitution will be treated as a substantial modification only if a principal purpose of the transaction is the avoidance of federal income tax. n113.7 In making this determination, the safe harbors and other principles that generally apply in tax avoidance determinations are taken into account and the Commissioner may treat the post-modification agreement as a new agreement or treat the entire agreement (as modified) as a single agreement. n113.8

In determining whether a modified agreement is a Section 467 rental agreement, or a disqualified leaseback or long-term agreement, the modified agreement is considered to consist only of the terms that relate to the post-modification items. n113.9 However, if the principal purpose of the modification is to avoid the purpose or intent of *IRC Section 467* or regulations thereunder, the Commissioner may treat the entire agreement (as modified) as a single agreement for purposes of *IRC Section 467*. The post-modification agreement, notwithstanding its treatment as a new agreement, will be characterized, in certain cases, in the same manner as the agreement in effect before the modification. For example, if an agreement was a leaseback or was subject to constant rental accrual before its

modification, the post-modification agreement will generally be treated as a leaseback or as subject to constant rental accrual. Similarly, if the agreement was a long-term agreement before its modification and the entire agreement (as modified) is a long-term agreement, the post-modification agreement will be treated as a long-term agreement. n113.10

In accounting for the effects of a substantial modification, the lessor and lessee must take pre-modification items into account under the method of accounting used before the modification. Pre-modification items generally include rent for periods before the modification, interest thereon, and payments allocable thereto, whether made before or after the modification. n113.11 In computing Section 467 rent, Section 467 interest, and the amount of a Section 467 loan with respect to post-modification items, only post-modification items are taken into account. In addition, the parties to the agreement are required to take into account adjustments necessary to prevent duplications and omissions resulting from the modification. n113.12

In the case of a modification that is not substantial, Section 467 rent and interest for periods affected by the modification are determined under the terms of the entire agreement, as modified. In addition, the parties to the agreement are required to recompute the balance of the Section 467 loan under the new terms and to take into account (as either additional rent or a reduction in rent previously taken into account) the change in the loan balance resulting from the modification. They are also required to take into account any amount necessary to prevent duplications or omissions resulting from the modification. n113.13

In determining whether a substantial modification of a lease has occurred, principles applicable to modifications of debt instruments n113.14 are applied. All facts and circumstances are examined to determine whether a substantial modification has occurred. n113.15 Specific criteria for making this determination are not provided in the regulations, but to ensure that relatively insubstantial changes to the terms of a lease agreement and changes that do not implicate the policies of *IRC Section 467* are not treated as substantial modifications under this rule, safe harbors have been added. n113.16

In general, the modifications that are likely to affect the character of a rental agreement for purposes of Section 467 are those that change the amount of timing of rent allocated or rent payable for the use of the property, or the identity of the property taking those amounts into account. Thus, a substantial modification will not result from changes in any provision for the payment of third-party costs or any other provision that is ignored for purposes of determining whether the agreement provides for contingent rents. n113.17 In addition, the refinancing of a lessor's indebtedness on a leveraged lease will generally not be treated as a substantial modification of the lease, subject to compliance with certain conditions and limitations. These conditions and limitations are intended to permit refinancing to avoid classification as a substantial modification in circumstances where the primary objective of the lessee is to take advantage of favorable changes in interest rates. n113.18

A *de minimis* safe harbor also applies. A modification of a rental agreement is not substantial if it is a change in the amount of fixed rent allocated to a rental period that, when combined with all previous changes in the amount of fixed rent allocated to the rental period, does not exceed one percent of the fixed rent allocated to that rental period prior to the modification. n113.19

In the case of a transfer of leased property by a lessor or a substitution of a lessee, the transfer or substitution will be treated as a substantial modification only if a principal purpose of the transaction is the avoidance of federal income tax. n113.20 In making this determination, the safe harbors and other principles that generally apply in tax avoidance determinations are taken into account and the Commissioner may treat the post-modification agreement as a new agreement or treat the entire agreement (as modified) as a single agreement. n113.21

[f] Section 467 Rent

The Section 467 rent for a taxable year is the sum of the following: n113.22

- (1) The fixed rent for any rental periods that begin and end in the tax year;
- (2) A ratable portion of the fixed rent for other rental periods beginning or ending in the tax year; and
- (3) Any contingent rent that accrues in the tax year.

The amount of fixed rent for a rental period depends on the terms of the rental agreement and is either the amount of fixed rent allocated to the period under the agreement, the constant rental amount, or the proportional rental amount. n113.23

[g] Economic Rent Accrual

When a Section 467 rental agreement is one in which deferred rent is to be paid after the year to which the payment relates (and one that does not involve increasing rents over the term of the lease with a tax avoidance purpose), economic accrual rules are used to determine the amount of rent that accrues during the year. Both the landlord and the tenant must use the economic accrual rules. n114

In general, rent accrues in accordance with the allocation of rents set forth in the provisions of the lease agreement. n115 Any rent for a period that is to be paid after the close of that period must be accrued by both the landlord and the tenant, based on the present value of the deferred payments. n116 Finally, interest for the year must be taken into account on amounts that were taken into account under Section 467 for prior taxable years and that are unpaid. n117

For purposes of computing present value and interest, the interest rate to be used is equal to 110 percent of the applicable Federal rate, compounded semiannually. The applicable Federal rate is the rate in effect at the time the agreement is entered into with respect to debt instruments having a maturity equal to the term of the agreement. n118 Regulations set forth rules for determining the amount of interest allocable to a taxable year, n119 as well as computation rules for rental agreements that provide for variable interest rates. n120

[h] Constant Rental Accrual Rules Generally

When a lease is characterized as a Section 467 rental agreement because it involves increasing rents over the term of the lease and has a tax avoidance purpose, constant rental accrual rules are used to determine the amount of rent that accrues during the year. Both the landlord and the tenant must use the accrual rules. n121 Rules comparable to those for increasing rents are also to be used when a rental agreement calls for decreasing payments over the term of the lease. n122 Regulations describe the circumstances in which a rental agreement is deemed to have increasing or decreasing rents that may bring it within the ambit of the constant rental accrual rules. n123

Under the constant rental accrual rules, rental income is deemed to accrue to the landlord in equal amounts for each lease period. This "constant rental amount" is determined by computing the present value of the stream of payments required under the lease and converting this present value to a level payment stream over the lease term. n124

Calculation of rent under the constant-rental accrual method is demonstrated in the following example.

Example:

A five-year lease agreement provides for rent of \$500,000, payable at the end of the fifth year. Assume that 110% of the applicable federal rate compounded semiannually is 8.82%. The constant-rental amount, therefore, is the amount the lessee would have to deposit at the end of each year into an account bearing interest at an effective annual rate of 8.82% to have \$500,000 at the end of the fifth year. Under

1-4 Federal Taxes Affecting Real Estate § 4.02

these conditions, the following amounts result:

Year	Rent	Interest	Total
1	\$ 83,846	\$ --	\$ 83,846
2	83,846	7,395	91,241
3	83,846	15,441	99,288
4	83,846	24,200	108,045
5	83,846	33,734	117,580
	<u> </u>	<u> </u>	<u> </u>
	\$419,230		\$ \$500,000
	<u> </u>	<u> </u>	<u> </u>
		80,770	
	<u> </u>	<u> </u>	<u> </u>

Absent the rules under *IRC Section 467*, an accrual-basis lessee might accrue and deduct \$100,000 rental expense each year, while a cash-basis lessor would not recognize rental income until the \$500,000 was paid in the fifth year. Now, however, under *IRC Section 467*, the lessor and the lessee must annually take the constant-rental amount and the imputed interest into account in determining taxable income, regardless of their overall tax accounting methods. n124.1 Regulations provide rules for determining whether there is adequate interest on fixed rent when a rental agreement has both deferred and prepaid rent. n124.2

[i] Rental Agreements to Which Constant Rental Accrual Rules Apply

The constant rental accrual rules apply only if: (1) the Section 467 rental agreement does not provide for the allocation of rents to specific periods; or (2) the agreement constitutes a "disqualified leaseback or long-term agreement." n125 Constant rental accrual may not be used in the absence of a determination by the Commissioner that the rental agreement is disqualified. The Commissioner, rather than parties to the rental agreement, must make that determination. The determination may be made either on a case-by-case basis or in regulations or other guidance published by the Commissioner providing that a certain type or class of leaseback or long-term agreement will be treated as disqualified and subject to constant rental accrual. n125.1

Planning Note:

Although constant rental accrual may be used only if the Commissioner determines that a rental agreement is disqualified, n125.2 taxpayers wishing to accrue rent in accordance with a constant rental accrual method may in effect do so by providing for an allocation schedule in their rental agreement with tax consequences that approximate the use of the constant rental accrual method. n125.3

It is not always clear whether a payment schedule in a lease constitutes an allocation of rents. Regulations clarify that a rental agreement specifically allocates rent to a specific period if: (1) it unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of using the premises during that period; and (2) the total amount of fixed rent specified is equal to the total amount of fixed rent payable under the lease. A rental agreement stating only when rent is payable does not specifically allocate rent. n126

Beyond this, however, there is little guidance on what constitutes a valid allocation for purposes of *IRC Section 467*. A provision in a lease providing that rent is due in a fixed amount on certain dates has been found sufficient to constitute an allocation of rents, n127 as has a lease provision merely specifying the amount of escalating rents due during the

various years of a 20-year lease. n128

A disqualified leaseback or long-term agreement is any Section 467 rental agreement if: (1) the agreement is part of a leaseback transaction n128.1 or provides for a lease term in excess of 75 percent of the statutory recovery period for the property (not including extensions solely at the option of the lessee); n128.2 and (2) a principal purpose for providing increasing or decreasing rents under the agreement is the avoidance of federal income tax. n129

A "leaseback transaction" is a leaseback to a person who had an interest in the property at any time within the two-year period before the leaseback, or a person related to a person who had such an interest. n131 For purposes of the above 75-percent test, the statutory recovery period for residential rental property and nonresidential real property is 19 years, even if the property is not depreciable under *IRC Section 168*. n132 Therefore, any lease of real property with a term of over 14 years and three months (75 percent of 19 years) may be a disqualified leaseback or long-term agreement if a principal purpose for increasing rents under the agreement is tax avoidance. n133 An agreement entered into after July 18, 1999 may be a disqualified leaseback or long-term agreement regardless of the amount of rental payments and other consideration it requires. n133.1 For leases entered into before July 19, 1999, however, a rental agreement cannot be treated as a disqualified leaseback or long-term agreement unless it requires more than \$2 million in rental payments and other consideration. n133.2

The "lease term" refers to the period during which the lessee has use of the property subject to the rental agreement, including any option of the lessor to renew or extend the term of the agreement. An option of the lessee to renew or extend the term of the agreement is included in the lease term only if it is expected, as of the agreement date, that the option will be exercised. For this purpose, a lessee is generally expected to exercise an option if, for example, as of the agreement date the rent for the option period is less than the expected fair market value rental for that period. The lessor's or lessee's determination that an option period is either included in or excluded from the lease term is not binding on the Commissioner. If the lessee (or a related person) agrees that one or both of them will or could be obligated to make payments in the nature of rent n133.3 for a period when another lessee (the substitute lessee) or the lessor will have use of the property subject to the rental agreement, the Commissioner may, in appropriate cases, treat the period when the substitute lessee or lessor will have use of the property as part of the lease term. n133.4

A combination of substantive guidance of tax avoidance and safe harbors are provided in regulations to permit taxpayers to determine more readily whether their leasebacks or long-term agreements will be determined to be disqualified by the Commissioner. n133.5 All relevant facts and circumstances are taken into account in determining whether a principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax. n133.6

The substantive guidance focuses on the tax rates of the lessor and lessee. If a significant difference between the marginal federal income tax rates of the lessor and lessee can reasonably be expected at some time during the lease term, the agreement will be closely scrutinized, and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent. n133.7

In determining whether there is a significant difference in marginal tax rates of the lessor and lessee, the marginal tax rates are determined not only by reference to the federal income tax status of the taxpayer (i.e., as a corporation, partnership, or individual), but also to the specific circumstances of the taxpayer. n133.8 Thus, if a corporation either is subject to the alternative minimum tax (AMT) or has available net operating losses (NOLs) or credits to carry forward from an earlier tax year, its marginal tax rate will differ from other corporations not subject to the AMT and not having available NOLs or credits. Further, in the case of S corporations or partnerships, the marginal tax rate is determined by taking into account the amounts of income or deduction allocable to their shareholders or partners, and the marginal tax rates of the shareholders or partners. n133.9

Pursuant to statutory directive, n133.10 regulations include several safe harbors under which agreements will not be treated as disqualified leaseback or long-term agreements. n133.11 The failure to meet one of the safe harbors, however,

does not alone cause an agreement to be treated as one in which tax avoidance was a principal purpose for providing increasing or decreasing rent, and therefore a disqualified leaseback or long-term agreement. n133.12 Tax avoidance is not considered a principal purpose for providing increasing or decreasing rent, and a rental agreement will not be treated as a disqualified leaseback or long-term agreement if either of two safe harbors is met: n133.13

- (1) The uneven rent test is met (see *Regulations Section 1.467-3(c)(4)*); or
- (2) The increase or decrease in rent is wholly attributable to one or more of the following provisions:
 - (a) A permissible contingent rent provision; n133.14 or
 - (b) A single rent holiday provision allowing reduced rent (or no rent) for one consecutive period during the lease term, but only if: (1) the rent holiday is for a period of no more than 3 months at the beginning of the lease term and for no other period; or (2) the duration of the rent holiday is reasonable, as determined by local commercial practice as of the agreement date, and does not exceed the lesser of 24 months or 10 percent of the lease term. Rent holidays of up to a year have been considered reasonable under local commercial practice. n133.15

The "uneven rent test" referred to in the first safe harbor above is met if the rents allocable to each calendar year of the lease do not vary from the average annual rents over the entire lease term by more than 10 percent. n133.16 For long-term leases of real estate, a 15-percent variance is permitted. n133.17 A number of "operating rules" apply in determining whether the uneven rent test has been met: n133.18

- (1) Contingent rent attributable to permissible contingent rent provisions is disregarded, as discussed below;
- (2) If the lease term includes one or more partial calendar years, the average rent allocated to each calendar year is the total rent allocated under the rental agreement, divided by the actual length (in years) of the lease term. The rent allocated to a partial calendar year must be annualized;
- (3) For non-real estate rental agreements, an initial rent holiday period and rent allocated to it are disregarded under the uneven rent test if taking that period and rent into account would cause the agreement to fail the uneven rent test;
- (4) For real estate rental agreements, one qualified rent holiday period and any rent allocated to it are disregarded if taking that period and rent into account would cause the agreement to fail the uneven rent test. For this purpose, a qualified rent holiday period is a consecutive period that is an initial rent holiday period or that meets the following requirements:
 - (a) It does not exceed the lesser of 24 months or 10 percent of the lease term,
 - (b) Annualized fixed rent during the period is less than the average rent allocated to all calendar years, and
 - (c) Providing less than average rent for the period is reasonable under local commercial practice; and
- (5) If the rental agreement contains a variable interest rate provision, the uneven rent test is applied by treating the rent as having been fixed under the terms of the rental agreement for the entire lease term

using fixed rate substitutes for the variable rates of interest provided under the terms of the lessor's indebtedness.

Under the second safe harbor above, permissible contingent rent provisions that are allowed to increase or decrease rent without disqualifying the rental agreement include the following: n133.19

- (1) A qualified percentage rents provision under which rent is based on the lessee's receipts or sales; n133.20
- (2) An adjustment based on a reasonable price index; n133.21
- (3) A provision requiring the lessee to pay third-party costs such as real estate taxes, insurance premiums, and maintenance costs; n133.22
- (4) A provision requiring the payment of late payment charges; n133.23
- (5) A loss payment provision for damaged or destroyed property; n133.24
- (6) A qualified terminal rental adjustment clause (TRAC) provision; n134
- (7) A residual condition provision requiring payments based on the condition of the property at the end of the lease term; n135
- (8) A tax indemnity provision; n136
- (9) A variable interest rate provision based on changes in interest rates on the lessor's indebtedness; n137 or
- (10) Any other provision provided in regulations or other published guidance issued by the Commissioner, but only if the provision is designated as contingent rent to be disregarded for purposes of this regulation.

[j] Recapture Rule

If a Section 467 rental agreement is governed by the economic rental accrual rules n138 and not the constant rental accrual rules applicable to disqualified leaseback or long-term agreements, n139 a recapture rule applies if the lessor disposes of the property during the term of the agreement. Under the recapture rule, the "recapture amount" is treated as ordinary income. n140 This treatment reflects a tax policy conclusion that a portion of the sales proceeds is paid for cash flow from rent that is attributable to pre-sale periods but will be collected in post-sale periods.

The recapture amount is the amount of taxable gain (not treated as ordinary income under other recapture provisions), but not in excess of the "prior understated inclusions." n141 The prior understated inclusions are the excess (if any) of the amount that would have been reported as rental income under the constant rental accrual rule for the periods before the disposition over the amounts actually reported. n142 Regulations detail the computation of the recapture amount, provide exceptions to the recapture rule for dispositions by gift, transfers at death, and certain tax-free transactions, and set forth additional disposition rules. n143

[4] Security Deposits

[a] In General

Many leases require the lessee to provide a security deposit to the lessor to guarantee faithful performance of the terms of the lease. A security deposit is property, usually a sum of money or a letter of credit, deposited by a tenant with a landlord to secure the tenant's performance of obligations under a lease. It may be made to secure the tenant's rental payments, maintenance and repairs required of the tenant, the improvement or restoration of the leased premises, or any of the tenant's other obligations under the lease. The landlord is required to repay the deposited security to the tenant at some future time if the tenant meets all the obligations secured, although the landlord may generally use without restriction any money deposited. Alternatively, a lease may require a tenant to make advance payment of rent, which may serve the same function as a security deposit. Security deposits and payments of advance rent are treated quite differently for tax purposes. n144

A security deposit is not included in the landlord's gross income when received; n145 instead, it is included in gross income only if and when the landlord's obligation to return the deposit to the tenant is terminated. n146 A landlord may not offset its income from the tenant's forfeiture of a security deposit after the cancellation of a lease against a "loss" from future rents that it will not collect as a result of the termination of the lease. n147

If the tenant agrees to forfeit the security in exchange for an early lease cancellation, the security is included in the landlord's gross income at the time of the cancellation. The amount includable in gross income may depend on whether the landlord was required to pay interest on the security deposit during the lease term. If interest is paid, the amount included is the amount of security received, or the face amount of the obligation to repay that amount at the end of the lease term. n148 However, if no interest on the security deposit is paid during the lease term, two cases indicate that the amount included in gross income is the present value of the obligation to repay the amount of the security deposit. This would obviously be less than the actual amount of security initially received. n149 The IRS does not acquiesce in this result, and would hold that the entire amount of the security initially received is included in the landlord's gross income at the time of cancellation. n150

Landlords should be certain to document and account for security deposits properly, to avoid recognition of income on receipt. n151 Landlords are also frequently required by local landlord-tenant laws to account carefully for security deposits.

Prepaid rent, of course, is includable in a cash basis lessor's gross income upon receipt. n152 This is true even if, under some circumstances, a refund of the amount may be required. If, however, the sum received is deposited to secure the lessee's performance under a lease and is to be returned at the expiration of the lease, it is not includable in gross income even though the fund is deposited with the lessor and the lessor has temporary use of the money. n153

It is also important from a tenant's perspective to distinguish between a security deposit and a payment of rent (including advance rent). A security deposit may be deducted only in the tax year in which the amount is treated as rent. This occurs when the deposit is forfeited or becomes nonrefundable. n154 The rationale is that contributions to a reserve for contingent future liabilities are not deductible. n155

[b] Security Deposit Distinguished From Advance Rental

The determination whether a payment is a nontaxable security deposit or a taxable advance rental depends on how provisions of the lease treat the payment. n156 The mere labeling of a payment as a security deposit in the lease is relevant, but not dispositive. More important are the terms and conditions in the lease that attach to the payment and the intent of the parties with respect to the payment, as reflected in the lease terms. n157

If the landlord is under no obligation to return a payment to a tenant, the payment will be treated as advance rent. n158 Moreover, if there is a repayment obligation, but the conditions under which the amount is to be repaid to the tenant are limited, unlikely to occur, or under the control of the landlord, the payment is also likely to be characterized as an

advance rent. n159 In contrast, if the lease sets forth reasonable conditions and terms that the payment is to secure, and provides that the payment will be returned to the tenant absent default on those conditions, the payment is more likely to be treated as a security deposit. These conditions can include requirements to stay for the entire lease term and to properly maintain and care for leased property. n160

In some instances, a payment serves dual functions, both as security for a tenant's performance under a lease, and with any amount remaining during the final period of the lease to be applied to rent. The characterization of such a bifurcated payment depends on whether the payment is primarily intended as a security deposit or is primarily intended as an advance payment of rent. The primary purpose of the payment is a question of fact determined by reference to the intentions and acts of the parties as ascertained from the lease agreement and related circumstances. n161 A payment that is intended primarily to secure only payment of rent is normally considered to be advance rent, and not a security deposit. n162 In contrast, a payment made primarily to secure the performance of other lease covenants by a tenant n163 or to secure a property interest n164 is a security deposit. The mere possibility that a payment will be applied to the tenant's last year's rent does not preclude that payment from being a security deposit. n165

The more recent and frequently stated rule is that a landlord's ability to freely use a payment until such time as it must be repaid does not influence whether that payment is a security deposit or advance rent. In this situation, the acknowledged liability of the landlord to account for the deposited sum on the tenant's performance of lease conditions prevents the payment from being treated as advance rent. n166 This rule supersedes earlier cases that somewhat rigidly applied the "claim of right" doctrine and held that a landlord's temporary unrestricted use of a deposit rendered the payment taxable as advance rent. n167 A landlord's obligation to segregate a payment or hold it in trust or escrow is of little, if any, weight in determining whether the payment is a security deposit. n168 An obligation by a landlord to pay interest on a payment may be an indication that a payment is a security deposit rather than advance rent. n169 Yet, if the payment's primary characteristic is that of an advance rent, the landlord's obligation to pay interest on that payment will not convert that payment into a security deposit. n170

[5] Option Proceeds

In a tight real estate market, a tenant may make a payment to its landlord for the right to extend a lease or to expand the area covered by the lease. Such a right should be characterized as an option granted by the landlord to the tenant, and the payment should be characterized as a payment for that option. Option proceeds are not taxable when received by either a cash-or accrual-basis taxpayer. Instead, taxation is deferred until the option either is exercised or lapses. n171 (See Chapter 6 for a more detailed discussion.)

[6] Lease Termination Proceeds

Any amount received by a landlord from a tenant for canceling a lease is ordinary income for the year in which it is received, since it is essentially a substitute for rental payments. n172 If the cancellation payment includes property, the amount includable in gross income is the fair market value of the property at the time of the cancellation. n173 Unavoidable expenses incurred by the landlord that are occasioned by the tenant's forfeiture of the lease--such as title abstract fees or attorney's fees--may be deducted from the amount received. n174

A taxpayer may not offset the value of the payments that would have been received under the cancelled lease against the consideration received for the cancellation of the lease, and thereby assert a capital gain or loss. n175 In addition to any direct payment by the tenant in cancellation of the lease, the landlord may also be allowed to retain any deposit held as security. If the forfeiture of the security is agreed to in exchange for an early lease cancellation, the security is included in the landlord's gross income as ordinary income at the time of the cancellation. (See § 4.02[4][a], *supra*.)

Payments made or obligations incurred by a tenant to its landlord to induce it to modify, extend or renew a lease are treated as advance rentals or bonus payments. n176 Similarly, an amount received by a landlord from a tenant for the

breach of a covenant in the lease is also taxable as ordinary income. n177 However, the value of any tenant improvements remaining on the leased property on termination of the lease is not treated as a lease cancellation payment, and is not includable in the landlord's gross income. n178

A tenant's payment for the release of its liability under the lease to make repairs to damaged property may be treated as a payment in exchange for property rather than as a lease cancellation payment. As such, the payment may be a tax-free recovery of capital to the landlord n179 or (to the extent the amount exceeds the basis of the property) a capital gain. n180

If the lessor sells the leased property to the lessee, thereby effectively canceling the lease, the proceeds are taxed as a sale and not as lease cancellation proceeds, even when the lessee assumes the lessor's mortgage and makes past-due payments. n181

[7] Debt Forgiveness and Cancellation

Quite often in the real estate industry, a creditor may cancel a portion of a debt relating to a troubled real estate project. The business reason for the cancellation will generally be the fact that it will induce the debtor to turn control of the real estate over to the lender voluntarily, thus avoiding a time consuming and expensive foreclosure.

The discharge or cancellation of a debt generally results in gross income to the debtor, n182 unless, for example, the forgiveness occurs in a donative transaction, in which case it is treated as a gift. Income from the discharge of indebtedness is excluded from gross income in the following circumstances: n183

- (1) the discharge occurs in a Title 11 bankruptcy case;
- (2) the discharge occurs when the taxpayer is insolvent;
- (3) the indebtedness discharged is qualified farm indebtedness; n184
- (4) for taxpayers other than C corporations, the indebtedness discharged is qualified real property business indebtedness; n185 or
- (5) the indebtedness discharged is qualified principal residence indebtedness. n186

In a partnership, the eligibility for discharge of indebtedness exclusions is determined at the partner level. n187 Partner guarantees made in connection with partnership activities may also be entitled to the above exclusions. n188 If the debt that is forgiven is owed to a seller of the property by the purchaser, and the debt arose from the purchase transaction, (and assuming that the cancellation does not occur in a Title 11 or insolvency situation), then the cancellation is not included in gross income, but instead is treated as an adjustment to the purchase price. n189 Therefore, in this situation, the buyer-debtor may be able to reduce the basis of an asset that is not depreciable, such as land, and if the property is later sold at a gain, and does not yield ordinary income on the sale. However, this "purchase price" rule only applies to the original purchasers; it is not available if the property has been subsequently transferred.

Notwithstanding the narrow scope of *IRC Section 108(e)(5)*, some older cases hold that if a nonrecourse loan incurred to acquire a specific property is forgiven, and if the amount of the loan is greater than the fair market value of the property, the forgiveness is excluded from income and the basis of the property is correspondingly reduced, whether or not the owner is the original purchaser. n190 (See Chapter 12.) However, the Service rejects this analysis and contends that the older cases have implicitly been overruled. n191 The Service has issued a ruling setting forth its disagreement with the older cases. n192 The ruling addresses the tax consequences to a debtor upon the reduction of the principal on an undersecured nonrecourse debt held by a non-purchase-money creditor (the creditor was not the seller of the property

secured by the debt). The ruling holds that the debtor may not simply reduce his basis in the property but must realize discharge of indebtedness income under *IRC Section 61(a)(12)*. n193

Revenue Ruling 91-31 does not address the treatment of nonrecourse indebtedness in applying the insolvency exclusion in *IRC Section 108*. In a separate ruling, the IRS has ruled that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent under *IRC Section 108(d)(3)*, but only to the extent that the excess nonrecourse debt is discharged. n194 n195-197

Example:

In Year 1, A borrows \$1 million from C and signs a note payable to C for that amount. The note bears interest at a fixed market rate payable annually. The note is secured by an office building valued in excess of \$1 million that A acquires from B with the proceeds of the note. A is not personally liable on the note. In Year 2, when the value of the building is \$800,000 and the outstanding principal on the note is still \$1 million, C agrees to modify the terms of the note by reducing the note's principal amount to \$825,000. The modified note bears adequate stated interest within the meaning of *IRC Section 1274(c)(2)*. At the time of the modification, A's only other assets have an aggregate fair market value of \$100,000, and A is personally liable to D on other indebtedness in the amount of \$50,000.

In this situation, \$175,000 of A's \$200,000 excess nonrecourse debt is discharged and, therefore, that portion of the excess nonrecourse debt is taken into account in determining whether, and to what extent, A is insolvent under *IRC Section 108(d)(3)*. Thus, A has liabilities of \$1,025,000, consisting of the \$50,000 for which A is personally liable, plus the portion of the nonrecourse debt equal to the sum of the \$800,000 fair market value of the property securing the nonrecourse debt and the \$175,000 of excess nonrecourse debt that is discharged. Because A's \$1,025,000 of liabilities exceed the \$900,000 of A's assets (\$800,000 plus \$100,000) by \$125,000 immediately before the indebtedness is discharged, A is insolvent to the extent of \$125,000. Accordingly, under *IRC Section 108(a)(1)(B)* and *108(a)(3)*, A must include on \$50,000 of the \$175,000 of discharged indebtedness (\$175,000 - \$125,000) in income under *IRC Section 61(a)(12)*.

[8] Recharacterizations and Constructive Receipt of Rents

The Service may recharacterize amounts designated as "rents" if it finds that the underlying transaction is a sale of property rather than a lease. This is likely to occur if the tenant is acquiring an equity or ownership interest in the leased property. n198 It can also occur in a lease with a later option to purchase, especially if the "rents" called for are inflated, and the option purchase price is unreasonably low. In that case, the Service may collapse the entire lease-option contract and treat the entire transaction as a sale. Amounts designated as rents may be recharacterized as installment payments on the sale of the property and taxed accordingly. n199

Other recharacterizations of "rent" are also possible, usually when a lease is between related parties or involves a rent that is unreasonably high or low. Excessive rents paid by a controlled corporation to a shareholder-landlord, for example, may be recharacterized as constructive dividends n200 or, if the shareholder is also an employee, as compensation. n201

Similarly, if a corporation rents out property to shareholders rent-free or at a below-market rent, the excess of the fair rental value over the amount of rent paid may be treated as a corporate distribution, taxable as a dividend to the shareholder. n202

Excessive rents paid by a shareholder to a controlled corporation may be recharacterized by the Service as a

contribution to capital. n203

Rents also may be reallocated among parties to reflect the true substance of a transaction. When there is a reservation-of-rents clause connected with a sale of rental property, for example, rents purportedly reserved to a seller of property may be reallocated as rental income to the purchaser. This reallocation occurs if the amounts reserved are, in substance, part of the consideration paid for the acquisition of property. The rent is treated as income to the purchaser that is then paid over to the seller as part of the purchase price. n204

The Service may also find a taxpayer in constructive receipt of rent even if no rent is actually paid. Any income, including rental income, is constructively received if it is credited to a taxpayer's account, set apart, or otherwise made available to the taxpayer without restriction. n205 In a close corporation context, constructive receipt of rental income has been found when a corporation fails to pay rent to a controlling shareholder. Rental income is considered "otherwise made available" if a controlling shareholder has both the right and power to obtain the rent, and there are sufficient funds to pay the rent. n206 Even the lack of ready cash to pay rent does not prevent constructive receipt if the corporation has the ability to borrow funds necessary for payment. n207 The accrual of a rental expense on the books of an accrual basis closely-held corporation is considered evidence of constructive receipt of rental income by a shareholder-landlord of the corporation. n208

[9] Self-Employment Tax and Rentals From Real Estate

Rentals from real estate and deductions attributable to them are not generally included in a taxpayer's net earnings from self employment unless they are received in the course of a trade or business as a real estate dealer. n208.1 Payments received under the Conservation Reserve Program n208.2 have been held not to be excludable as rentals from real estate for this purpose and, therefore, are subject to the self-employment tax. n208.3

Rentals from real estate may be included in net earnings from self employment that are subject to the self-employment tax if the following two requirements are met: n208.4

(1) The rentals are derived under an arrangement between the owner or tenant and another individual under which the individual is to produce agricultural or horticultural commodities, and the owner or tenant is to materially participate in the production or management of those commodities.

(2) There is, in fact, material participation by the owner or tenant in the production or management of those commodities.

Under this standard, the Eighth Circuit in a consolidated appeal has reversed three Tax Court decisions, n208.5 and held that the mere existence of an arrangement requiring material participation in agricultural production does not automatically make rents under that arrangement subject to the self-employment tax. It therefore held that cash rent from the rental of farmland between spouses or from a husband and wife to the husband's corporation was not subject to the self-employment tax if market rates of rent were paid. The Eighth Circuit held that there had to be a nexus between the rents received by the taxpayers and the "arrangement" that required the landlords' material participation for the rents to be treated as "derived under" those arrangements, as required by *IRC Section 1402(a)(1)*. In other words, the mere existence of an arrangement requiring and resulting in material participation in agricultural production did not automatically transform rents received into self-employment income. Rather, it was only where the payment of those rents comprised part of such an arrangement that those rents could be said to "derive" from the arrangement. The Eighth Circuit stated that market-rate rents strongly suggested that a rental arrangement stood on its own as an independent transaction, and that it was not part of an "arrangement" for participation in agricultural production. n208.6

The Tax Court reached the same result in a later case, based on its finding that rent paid by a corporation to the taxpayer was a fair market rent; the court also found there was no nexus between that rent and employment arrangement with the

corporation, largely because of the obligation of the corporation to pay rent in any event, without regard to whether the taxpayers performed any activities. n208.6.1

In another case, however, the taxpayers weren't so lucky. The Tax Court held that rent received by the taxpayers from their corporation for use of a large hog barn was subject to the self-employment tax under *IRC § 1402(a)(1)*, primarily because there was no evidence that the rent paid was a fair market rent or that the taxpayers received compensation from their activities connected with the barn other than the rent. The rent the taxpayers received depended entirely on the number of hogs that were processed through the barn, and this depended on their performance of activities in connection with the barn. n208.6.2

[10] Payments Under Certain Cost-Sharing Conservation Programs

Unless a taxpayer elects not to have the exclusion apply, n208.6.3 the excludable portion of payments received under federal conservation programs set forth in *IRC Sections 126(a)(1) through (8)* is not included in gross income. n208.6.4 The excludable portion of payments received under a small watershed program administered by the Secretary of Agriculture may also be excluded from gross income if a determination is made that the program is substantially similar to the type of programs described in *IRC Sections 126(a)(1) through (8)*. n208.6.5 The excludable portion of State and local payments made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife may also be excluded from gross income. n208.6.6 Any payment excluded from gross income cannot be added to the basis of the property, n208.6.7 and no deduction or credit is allowed with respect to any expenditure that is properly associated with an amount excluded from gross income. n208.6.8

The excludable portion of a payment is limited to the portion that (1) is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife, (2) does not substantially increase the income derived from the property, and (3) is not properly associated with a deductible expense. Payments in the nature of rent or compensation for services do not qualify for the exclusion. n208.6.9

FOOTNOTES:

(n1)Footnote 90. *Treas Reg § 1.61-8*.

(n2)Footnote 91. *Treas Reg § 1.61-8(c)*.

(n3)Footnote 92. *Sleiman, Jr et al v Commr, TC Memo 1997-530* .

(n4)Footnote 93. *Treas Reg § 1.61-8(b)*.

(n5)Footnote 94. *Ellison v Commr, 80 TC 378 (1983)* .

(n6)Footnote 95. *Famous Foods, Inc v Commr, 215 F Supp 206, 11 AFTR2d 987 (WD Pa 1963)* .

(n7)Footnote 96. *US v Williams, 395 F2d 508, 22 AFTR2d 5047 (5th Cir 1968)* .

(n8)Footnote 97. *Commr v Lyon, 97 F2d 70, 21 AFTR 323 (9th Cir 1938)* .

(n9)Footnote 98. *Main & McKinney Bldg Co v Commr, 113 F2d 81 (5th Cir) , cert denied 311 US 688 (1940)* (payments over 25-year period allocable to 99-year lease term); *University Properties, Inc v Commr, 45 TC 416 (1966) , affd 378 F2d 83 (9th Cir 1967)* (payments over 3-year period allocable to 35-year lease term); *Cartan v Commr, 30 TC 308 (1958)* (payment in one year allocable to 20-year lease term); see *Baton Coal Co v Commr, 51 F2d 469, 10 AFTR 270 (3d Cir 1931) , cert denied 284 US 674 (1931)* (payments totaling \$101,250 in first seven months of a mineral lease of indefinite duration).

(n10)Footnote 99. *Zaninovich v Commr*, 616 F2d 429 (9th Cir 1980) , revg 69 TC 605 (1978) .

(n11)Footnote 100. *University Properties, Inc v Commr*, 378 F2d 83, 19 AFTR2d 1621 (9th Cir 1967) ; *King Amusement Co v Commr*, 44 F2d 709, 9 AFTR 436 (9th Cir 1930) ; IRC § 178 (the term of the lease sometimes will include renewal periods).

(n12)Footnote 101. *Treas Reg § 1.162-11(a)*; *Seahill Co v Commr*, TC Memo 1964-56 .

(n13)Footnote 102. *IRC § 467*.

(n14)Footnote 103. *IRC § 467(a)*.

(n15)Footnote 103.1. *IRC § 467(b)(1)*; see § 4.02[3][g], below.

(n16)Footnote 103.2. *IRC § 467(b)(2), (3)*; see § 4.02[3][h], below.

(n17)Footnote 104. *IRC § 1(a)-(e), (h)*.

(n18)Footnote 105. *IRC § 467(d)(1), (f)*; *Treas Reg § 1.467-1(c)(1)*; see § 4.02[3][c], below, for a discussion of increasing and decreasing rents.

(n19)Footnote 106. *IRC § 467(d)(2)*; *Treas Reg § 1.467-1(c)(4)*.

(n20)Footnote 106.1. See *Treas Reg § 1.467-1(j)(3)*.

(n21)Footnote 106.2. *Treas Reg § 1.467-1(c)(2)(A)*.

(n22)Footnote 106.3. *Treas Reg § 1.467-1(c)(2)(i)(B)*.

(n23)Footnote 106.4. *Treas Reg § 1.467-1(c)(2)(ii)*.

(n24)Footnote 106.5. *Treas Reg § 1.467-1(c)(3)(iv)*, Example 1(i); see *Treas Reg § 1.467-1(c)(2)(i), (ii)*.

(n25)Footnote 106.6. *Treas Reg § 1.467-1(c)(2)(iii)*.

(n26)Footnote 107. See *Treas Reg § 1.467-1(h)(8)*.

(n27)Footnote 108. See *Treas Reg § 1.467-1(h)(10)*.

(n28)Footnote 109. See *Treas Reg § 1.467-1(h)(15)*.

(n29)Footnote 110. See *Treas Reg § 1.467-1(h)(4)*.

(n30)Footnote 111. See *Treas Reg § 1.467-1(h)(7)*.

(n31)Footnote 112. See *Treas Reg § 1.467-1(h)(9)*.

(n32)Footnote 113. See *Treas Reg § 1.467-1(h)(13)*.

(n33)Footnote 113.1. See *Treas Reg § 1.467-1(h)(14)*.

(n34)Footnote 113.2. See *Treas Reg § 1.467-1(h)(16)*.

(n35)Footnote 113.3. *Treas Reg § 1.467-1(c)(3)(i)*.

(n36)Footnote 113.4. *Treas Reg* § 1.467-1(c)(3)(ii).

(n37)Footnote 113.5. *Treas Reg* § 1.467-1(c)(3)(iv), Example 1(ii); see *Treas Reg* § 1.467-1(c)(3)(i), (ii).

(n38)Footnote 113.6. *Treas Reg* § 1.467-1(f)(1)(i) (special rules apply to substantial modifications occurring on or before May 18, 1999 (*Reg* § 1.467-1(f)(1)(ii)).

(n39)Footnote 113.7. *Treas Reg* § 1.467-1(f)(7)(i).

(n40)Footnote 113.8. *Treas Reg* § 1.467-1(f)(7)(i)(A), (B).

(n41)Footnote 113.9. *Treas Reg* § 1.467-1(f)(2).

(n42)Footnote 113.10. *Treas Reg* § 1.467-1(f)(4)(i), (ii).

(n43)Footnote 113.11. *Treas Reg* § 1.467-7(g)(1)(i), effective for modifications occurring after May 18, 1999.

(n44)Footnote 113.12. *Treas Reg* § 1.467-7(g)(1)(ii), (iii).

(n45)Footnote 113.13. *Treas Reg* § 1.467-7(g)(2).

(n46)Footnote 113.14. See *Treas Reg* § 1.1001-3.

(n47)Footnote 113.15. *Treas Reg* § 1.467-1(f)(5)(ii).

(n48)Footnote 113.16. *Treas Reg* § 1.467-1(f)(6).

(n49)Footnote 113.17. *Treas Reg* § 1.467-1(f)(6)(ii).

(n50)Footnote 113.18. *Treas Reg* § 1.467-1(f)(6)(i).

(n51)Footnote 113.19. *Treas Reg* § 1.467-1(f)(6)(iii).

(n52)Footnote 113.20. *Treas Reg* § 1.467-1(f)(7).

(n53)Footnote 113.21. *Treas Reg* § 1.467-1(f)(7)(i)(A), (B).

(n54)Footnote 113.22. *Treas Reg* § 1.467-1(d)(1).

(n55)Footnote 113.23. *Treas Reg* § 1.467-1(d)(2).

(n56)Footnote 114. *IRC* § 467(a), (b).

(n57)Footnote 115. *IRC* § 467(b)(1)(A).

(n58)Footnote 116. *IRC* § 467(b)(1)(B).

(n59)Footnote 117. *IRC* § 467(a)(2).

(n60)Footnote 118. *IRC* § 467(e)(4); see *IRC* § 1274(d).

(n61)Footnote 119. *Treas Reg* §§ 1.467-1(e)(1), 1.467-2(e)(2), 1.467-4.

(n62)Footnote 120. *Treas Reg* § 1.467-5.

- (n63)Footnote 121. *IRC § 467(a), (b)(2)*.
- (n64)Footnote 122. See *IRC § 467(f)*.
- (n65)Footnote 123. *Treas Reg § 1.467-1(c)(2)*; see § 4.02[3][c], above, for a discussion.
- (n66)Footnote 124. *IRC § 467(b)(2), (e)(1)*.
- (n67)Footnote 124.1. *IRC § 467(b)(2), (e)(1)*; *Treas Reg § 1.467-3(d)*.
- (n68)Footnote 124.2. *Treas Reg § 1.467-2(b)(3)*.
- (n69)Footnote 125. *IRC § 467(b)(3)*.
- (n70)Footnote 125.1. *Treas Reg § 1.467-3(a)*.
- (n71)Footnote 125.2. *Treas Reg § 1.467-3(a)*.
- (n72)Footnote 125.3. *TD 8820*, 64 *Fed Reg* 26848 (May 18, 1999) .
- (n73)Footnote 126. *Treas Reg § 1.467-1(c)(2)(ii)(A)(2)*.
- (n74)Footnote 127. *Ltr Rul 9352002* (9/14/93) ; see *Ltr Rul 9406003* (10/28/93) .
- (n75)Footnote 128. *Picadilly Cafeterias, Inc v US*, 36 *Fed Cl* 330, 96-2 *USTC* P 50,487 (*Ct Cl* 1996).
- (n76)Footnote 128.1. See *Treas Reg § 1.467-3(b)(2)*.
- (n77)Footnote 128.2. See *Treas Reg § 1.467-3(b)(3)*.
- (n78)Footnote 129. *IRC § 467(b)(4)(A), (e)(6)*.
- (n79)Footnote 131. *IRC § 467(e)(2), (5)*; see *IRC § 465(b)(3)(C)*.
- (n80)Footnote 132. *IRC § 467(e)(3)*.
- (n81)Footnote 133. *IRC § 467(b)(4), (e)(3)*.
- (n82)Footnote 133.1. *Treas Reg § 1.467-3(b)(1)(iii)*, eff for leases entered into after 7/18/99.
- (n83)Footnote 133.2. *Treas Reg § 1.467-3(b)(1)(iii)*, before amendment by *TD 8917* .
- (n84)Footnote 133.3. See *Treas Reg § 1.168(i)-2(b)(2)*.
- (n85)Footnote 133.4. *Treas Reg § 1.467-1(h)(6)*, in effect for *IRC § 467* rental agreements entered into after March 6, 2001; taxpayers may choose to apply this regulation to earlier rental agreements, provided that they are described in *Treas Reg § 1.467-9(a)*.
- (n86)Footnote 133.5. *Treas Reg § 1.467-3*.
- (n87)Footnote 133.6. *Treas Reg § 1.467-3(c)(1)*.
- (n88)Footnote 133.7. *Treas Reg § 1.467-3(c)(2)(i)*.
- (n89)Footnote 133.8. *Treas Reg § 1.467-3(c)(2)(iii)*.

(N90)Footnote 133.9. *Treas Reg § 1.467-3(c)(2)(iii)*.

(n91)Footnote 133.10. See *IRC § 467(b)(5)*.

(n92)Footnote 133.11. *Treas Reg § 1.467-3(c)(3)*.

(n93)Footnote 133.12. *Treas Reg § 1.467-3(c)(1)*.

(n94)Footnote 133.13. *Treas Reg § 1.467-3(c)(3)*.

(n95)Footnote 133.14. See *Temp Treas Reg § 16A.126-2T*.

(n96)Footnote 133.15. *Republic Plaza Properties Partnership et al v Commr*, 107 TC 94 (1996) (11.5 months at the beginning of a 24-year lease).

(n97)Footnote 133.16. *Treas Reg § 1.467-3(c)(4)(i)*.

(n98)Footnote 133.17. *Treas Reg § 1.467-3(c)(4)(ii)*.

(n99)Footnote 133.18. *Temp Treas Reg § 16A.126-1T(d)*.

(n100)Footnote 133.19. *Treas Reg § 1.467-3(c)(3)(ii)(A)*; see *Treas Reg § 1.467-1(c)(2)(iii)(B)*.

(n101)Footnote 133.20. See *Treas Reg § 1.467-1(h)(8)*.

(n102)Footnote 133.21. See *Treas Reg § 1.467-1(h)(10)*.

(n103)Footnote 133.22. See *Treas Reg § 1.467-1(h)(15)*.

(n104)Footnote 133.23. See *Treas Reg § 1.467-1(h)(4)*.

(n105)Footnote 133.24. See *Treas Reg § 1.467-1(h)(7)*.

(n106)Footnote 134. See *Treas Reg § 1.467-1(h)(9)*.

(n107)Footnote 135. See *Treas Reg § 1.467-1(h)(13)*.

(n108)Footnote 136. See *Treas Reg § 1.467-1(h)(14)*.

(n109)Footnote 137. See *Treas Reg § 1.467-1(h)(16)*.

(n110)Footnote 138. See § 4.02[3][g], above.

(n111)Footnote 139. See § 4.02[3][h], above.

(n112)Footnote 140. *IRC § 467(c)(1)*.

(n113)Footnote 141. *IRC § 467(c)(2)*; *Treas Reg § 1.467-7(b)(1)*.

(n114)Footnote 142. *IRC § 467(c)(3)*; *Treas Reg § 1.467-7(b)(2)*.

(n115)Footnote 143. *Treas Reg § 1.467-7(b), (c), (e)*.

(n116)Footnote 144. See *J & E Enterprises, Inc v Commr*, 26 TCM 944, TC Memo 1967-191 ; *Clinton Hotel Realty Corp v Commr*, 128 F2d 968 (5th Cir 1942) ; see *Commr v Indianapolis Power & Light Co*, 493 US 203 (1990) .

- (n117)Footnote 145. *Clinton Hotel Realty Corp v Commr*, 128 F2d 968 (5th Cir 1942) .
- (n118)Footnote 146. *Astor Holding Co v Commr*, 135 F2d 47 (5th Cir 1943) ; *Warren Serv Corp v Commr*, 110 F2d 723 (2d Cir 1940) ; *Center Inv Co v Commr*, 43 BTA 46 (1940) ; *Clinton Hotel Realty Corp v Commr*, 128 F2d 968 (5th Cir 1942) .
- (n119)Footnote 147. *Josey v Commr*, 104 F2d 453 (10th Cir 1939) .
- (n120)Footnote 148. See *Warren Serv Corp v Commr*, 110 F2d 723 (2d Cir 1940) .
- (n121)Footnote 149. *Warren Serv Corp v Commr*, 110 F2d 723 (2d Cir 1940) ; *Bradford Hotel Operating Co v Commr*, 244 F2d 876 (1st Cir 1957) ; but see *Commr v Langwell*, 47 F2d 841 (7th Cir 1931) .
- (n122)Footnote 150. *Rev Rul 68-19*, 1968-1 CB 42 ; also see *Commr v Langwell*, 47 F2d 841 (7th Cir 1931) .
- (n123)Footnote 151. *New Capital Hotel, Inc v Commr*, 261 F2d 437, 2 AFTR2d 6003 (6th Cir 1958) .
- (n124)Footnote 152. *Treas Reg § 1.61-8(b)*.
- (n125)Footnote 153. *Mantell v Commr*, 17 TC 1143 (1952) .
- (n126)Footnote 154. *Williams v Commr*, TC Memo 1998-93 .
- (n127)Footnote 155. See *Sebring v Commr*, 93 TC 220 (1989) .
- (n128)Footnote 156. *Hirsch Improvement Co v Commr*, 143 F2d 912 (2nd Cir 1944) , cert denied 323 US 750 (1944) .
- (n129)Footnote 157. *Mantell v Commr*, 17 TC 1143 (1952) ; *Astor Holding Co v Commr*, 135 F2d 47 (5th Cir 1943) .
- (n130)Footnote 158. *Gilken Corp v Commr*, 10 TC 445 (1948) , affd 176 F2d 141 (6th Cir 1949) .
- (n131)Footnote 159. *Hirsch Improvement Co v Commr*, 143 F2d 912 (2nd Cir 1944) , cert denied 323 US 750 (1944) ; *J & E Enterprises, Inc v Commr*, TC Memo 1967-191, 26 TCM 1944 .
- (n132)Footnote 160. *Clinton Hotel Realty Corp v Commr*, 128 F2d 968 (5th Cir 1942) ; *Estate of Barker v Commr*, 13 BTA 562 (1928) .
- (n133)Footnote 161. *Astor Holding Co v Commr*, 135 F2d 47 (5th Cir 1943) ; *Mantell v Commr*, 17 TC 1143 (1952) .
- (n134)Footnote 162. *J & E Enterprises, Inc v Commr*, TC Memo 1967-191, 26 TCM 1944 ; *Rev Rul 72-519*, 1972-2 CB 32 ; *August v Commr*, 17 TC 1165 (1952) .
- (n135)Footnote 163. *J & E Enterprises, Inc v Commr*, TC Memo 1967-191, 26 TCM 1944 .
- (n136)Footnote 164. *Rev Rul 72-519*, 1972-2 CB 32 .
- (n137)Footnote 165. *Clinton Hotel Realty Corp v Commr*, 128 F2d 968 (5th Cir 1942) .
- (n138)Footnote 166. *J & E Enterprises, Inc v Commr*, TC Memo 1967-191, 26 TCM 1944 ; see *Commr v Indianapolis Power & Light Co* 493 US 203 (1990) .

(n139)Footnote 167. See *Gilken Corp v Commr*, 10 TC 445 (1948) , *affd* 176 F2d 141 (6th Cir 1949) ; *Renwick v US*, 87 F2d 123 (7th Cir 1936)

(n140)Footnote 168. *Commr v Indianapolis Power & Light Co*, 493 US 203 (1990) ; see *J & E Enterprises, Inc v Commr*, 26 TCM 944, TC Memo 1967-191 ; *Hirsch Improvement Co v Commr*, 143 F2d 912 (2d Cir 1944) , *cert denied* 323 US 750 (obligation to segregate mentioned but not given controlling weight); but see *New Capital Hotel, Inc v Commr*, 261 F2d 437 (6th Cir 1958) .

(n141)Footnote 169. *Clinton Hotel Realty Corp v Commr*, 128 F2d 968 (5th Cir 1942) ; *Astor Holding Co v Commr*, 135 F2d 47 (5th Cir 1943) .

(n142)Footnote 170. *Rev Rul 72-519*, 1972-2 CB 32 ; *Commr v Lyon*, 97 F2d 70 (9th Cir 1938) .

(n143)Footnote 171. *IRC § 1234*.

(n144)Footnote 172. *Treas Reg § 1.61-8(b)*; *Hort v Commr*, 313 U.S. 28, 61 S. Ct. 757 (1941) ; see *Smith v Commr*, TC Memo 1974-195, 33 TCM 842 ; 1969 *Corp v Commr*, TC Memo 1986-387, 52 TCM 226 .

(n145)Footnote 173. *Smith v Commr*, TC Memo 1974-195, 33 TCM 842 ; 1969 *Corp v Commr*, TC Memo 1986-387, 52 TCM 226 .

(n146)Footnote 174. *Evans v Commr*, 42 BTA 246 (1940) .

(n147)Footnote 175. *Hort v Commr*, 313 US 28, 61 S Ct 757 (1941) ; *Warren Service Corp v Commr*, 110 F2d 723 (2d Cir 1940) .

(n148)Footnote 176. *Jennings & Co v Commr*, 59 F2d 32 (9th Cir 1932) ; *Oliver v Commr*, TC Memo 1965-83, 24 TCM 438 , *affd* 364 F2d 575 (8th Cir 1966) .

(n149)Footnote 177. *Thorpe v Commr*, 42 BTA 654 (1940) .

(n150)Footnote 178. *IRC § 109*.

(n151)Footnote 179. *Hamilton & Main, Inc v Commr*, 25 TC 878 (1956) .

(n152)Footnote 180. *Boston Fish Market Corp v Commr*, 57 TC 884 (1972) .

(n153)Footnote 181. *Nicollet Assoc v Commr*, 37 BTA 350 (1938) .

(n154)Footnote 182. *IRC § 61(a)(12)*; *Treas Reg § 1.61-12*.

(n155)Footnote 183. *IRC § 108(a)(1)*.

(n156)Footnote 184. See § 12.10[2], *infra*.

(n157)Footnote 185. See § 12.10[3], *infra*.

(n158)Footnote 186. See *IRC § 108(a)(1)(E)*, *108(h)*. See § 12.10[4], below, for a detailed discussion of this exclusion.

(n159)Footnote 187. *IRC § 108(d)(6)*.

(n160)Footnote 188. *Gracia v Commr*, TC Memo 2004-147 .

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- (n161)Footnote 189. *IRC § 108(e)(5); House v Commr, TC Memo 1995-92 .*
- (n162)Footnote 190. *Hotel Astoria v Commr, 42 BTA 759 (1940) ; Fulton Gold Corp v Commr, 31 BTA 519 (1934) .*
- (n163)Footnote 191. *Gershkowitz v Commr, 88 TC 984 (1987) , Rev Rul 82-202, 1982-2 CB 36 ; Rev Rul 91-31, 1991-1 CB 19 .*
- (n164)Footnote 192. *Rev Rul 91-31, 1991-1 CB 19 .*
- (n165)Footnote 193. *Rev Rul 91-31, 1991-1 CB 19 .*
- (n166)Footnote 194. *Rev Rul 92-53, 1992-2 CB 48.*
- (n167)Footnote 195-197. [Reserved]
- (n168)Footnote 198. See *Judson Mills v Commr, 11 TC 25 (1948) ; Breece Veneer and Panel Co v Commr, 232 F2d 319 (7th Cir 1956) ; Bowen v Commr, 12 TC 446 (1949) ; East Coast Equipment Co v Commr, 21 TC 112 (1953) .*
- (n169)Footnote 199. *Haggard v Commr, 241 F2d 288 (9th Cir 1956) , affg 24 TC 1124 ; Oesterreich v Commr, 226 F2d 798 (9th Cir 1955) ; see Bowen v Commr, 12 TC 446 (1949) .*
- (n170)Footnote 200. *Thorpe v Commr, TC Memo 1998-115 ; Safway Steel Scaffolds Co of Georgia v US, 590 F2d 1360 (5th Cir 1979) ; Limericks, Inc v Commr, 7 TC 1129 (1946) , affd 165 F2d 483 (5th Cir 1948) ; Jaeger Motor Car Co v Commr, 284 F2d 127 (7th Cir 1960) (improvements by corporate tenant treated as dividend to shareholder/landlord).*
- (n171)Footnote 201. *Langer v Commr, TC Memo 1990-268 .*
- (n172)Footnote 202. *58th St Plaza Theatre, Inc v Commr, 195 F2d 724 (2nd Cir 1952) , cert denied 344 US 882 (1952) ; Rev Rul 58-1, 1958-1 CB 173 .*
- (n173)Footnote 203. See *Estate of Sullivan v Commr, 10 TCM 729 (1951) .*
- (n174)Footnote 204. *Ellison v Commr, 80 TC 378 (1983) , see Bryant v Commr, 399 F2d 800 (5th Cir 1968) , affg 46 TC 848 (1966) .*
- (n175)Footnote 205. *Treas Reg § 1.451-2(a).*
- (n176)Footnote 206. *Hooper v Commr, TC Memo 1995-108 .*
- (n177)Footnote 207. See *Saint Claire Corp v Commr, TC Memo 1997-171 ; AD Saenger, Inc v Commr, 84 F2d 23 (5th Cir 1936) , affg 33 BTA 135 (1935) ; Hyplains Dressed Beef, Inc v Commr, 56 TC 119 (1971) .*
- (n178)Footnote 208. *Fetzer Refrigerator Co v US, 437 F2d 577 (6th Cir 1971) ; OH Kruse Grain & Milling v Commr, TC Memo 1959-110 , affd 279 F2d 123 (9th Cir 1960) .*
- (n179)Footnote 208.1. *IRC § 1402(a)(1); Treas Reg § 1.1402(a)-4(d); Blythe v Commr, TC Memo 1999-11 .*
- (n180)Footnote 208.2. See 16 USC §§ 3831-3836.
- (n181)Footnote 208.3. *Wuebker v Commr, 2000-1 USTC P 50,254 (9th Cir 2000), rev'g 110 TC 431 (1998) .*
- (n182)Footnote 208.4. *IRC § 1402(a)(1); FSA 199917005 , 199917006 , 199917008 .*

(n183)Footnote 208.5. *Bot v Commr, TC Memo 1999-256 ; Hennen v Commr, TC Memo 1999-306 ; McNamara v Commr, TC Memo 1999-333 .*

(n184)Footnote 208.6. *McNamara v Commr/Bot v Commr/Hennen v Commr, 236 F3d 410 (8th Cir 2000) .*

(n185)Footnote 208.6.1. *Johnson v Commr, TC Memo 2004-56 .*

(n186)Footnote 208.6.2. *Solvie v Commr, TC Memo 2004-55 .*

(n187)Footnote 208.6.3. *IRC § 126(c); Temp Treas Reg § 16A.126-2T.*

(n188)Footnote 208.6.4. *IRC § 126(a).*

(n189)Footnote 208.6.5. *IRC § 126(a)(9); see Temp Treas Reg § 16A.126-1T(d).* The IRS has ruled that the Conservation Security Program [*Rev Rul 2006-46, 2006-39 IRB 511* ; see *16 USC §§ 3838-3838c*] and the Forest Health Protection Program [*Rev Rul 2009-23, 2009-32 IRB 177*] qualify for this exclusion.

(n190)Footnote 208.6.6. *IRC § 126(a)(10).*

(n191)Footnote 208.6.7. *IRC § 126(e).*

(n192)Footnote 208.6.8. *IRC § 126(d).*

(n193)Footnote 208.6.9. *IRC § 126(b); Temp Treas Reg § 16A.126-1T(a), (b)(5).*



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Federal Taxes Affecting Real Estate

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CHAPTER 4 Operating and Leasing Real Estate

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§ 4.03 Deductibility of Expenses

Depreciation is covered separately in Chapter 5. This section focuses on expenses that are generally paid in cash. Expenses may be deducted only with respect to real property held in a trade or business or for the production of income. Deductions for otherwise deductible expenses will be denied if, for example, property held for rental purposes is occupied on a rent-free basis. n208.7

[1] Repairs and Maintenance Versus Capital Additions

[a] In General

Repairs and maintenance are expenditures that are intended to maintain the operating efficiency of an asset over its useful life. n209 Capital additions, however, are intended to add to the asset's value, extend its useful life, or adapt it to a different use. n210 The difference between maintenance and repairs (a difference that is of academic interest only) is that maintenance generally is continuing and designed to prevent disruption in service, whereas repairs usually occur in connection with a disruption in service. For example, the cost of lubricating the circulator pump in a hot water heating system is maintenance; the cost of fixing the unlubricated pump that has failed is repairs.

The distinction between repairs/maintenance, on the one hand, and capital expenditures, on the other hand, is much more significant. The Tax Court has described the test for distinguishing between deductible repair expenses and improvements that must be capitalized as the difference between "keeping" and "putting" a capital asset in good condition. n211 The Tax Court has also used a test (the *Plainfield-Union* test) for determining whether an expenditure is capital by comparing the value, use, life expectancy, strength or capacity of the property after the expenditure with the status of the property before the condition necessitating the expenditure. n211.1 A merely incidental expense is currently deductible, but if the repair is an improvement or replacement, or if it increases the property's value or substantially prolongs its useful life, it is capital in nature and is not deductible. n211.2 A repair in the nature of a replacement, to the extent that it arrests deterioration and appreciably prolongs the life of the property, must either be capitalized and depreciated or charged against a depreciation reserve. n211.3

Repair and maintenance expenses are deductible in the year paid or incurred, depending on the taxpayer's accounting method; capital expenditures, however, are additions to basis and, if the asset is depreciable, are recovered through depreciation deductions. Like other deductible expenses, repairs and maintenance must represent ordinary and necessary business expenses and must be incurred in connection with a trade or business n212 or in connection with property held

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for the production of income. n213 In addition, any repair expenses must be substantiated. Failure to substantiate expenditures can result in a denial of the deduction altogether, or in a court's estimating the amount of the deduction (almost always to the taxpayer's detriment) under the *Cohan* rule. n214

Because it is often difficult to distinguish between a repair and a capital addition, taxpayers and the Service often disagree on the proper classification of the expenditures. Whether an expenditure may be deducted or must be capitalized is a question of fact. n214.1 The determination in any given case focuses less on harmonizing prior cases than on analyzing given facts and then engaging in a judicial line-drawing exercise. n214.2 The following tabulation shows how some general types of expenditures may be treated for tax purposes:

Type of Expenditure	 Repair	 Capital Addition
Roofing	Patching leaks and replacing a limited number of shingles	Adding new roof or replacing major portion of existing roof n214.3
Wiring	Mending or temporary replacements	New installations or general replacements
Plumbing	Mending and minor part replacements (washer, etc.)	Major replacements (pump) and rearrangements
Plastering and cementing	Filling cracks and holes	Installation, renovating, remodeling, earthquake retrofitting n214.4
Paving and resurfacing	Minor resurfacing; e.g., problems resulting from ice and cold weather damage	Initial installation and major resurfacing
Fire damage	Cleanup, removal, and temporary replacement	Modernization incident to restoration of former facilities
Mold remediation	Sealing off affected areas, removing dry wall, doors and fixtures, removing mold, installing new drywall, replacing electrical and plumbing fixtures, painting n214.5	Renovation of air conditioning and plumbing systems; roof replacement
Land clearing	Ordinary maintenance, brush clearing	Expenditures in preparation for farming

If repairs and capital additions are made simultaneously to the same item, it is important to keep records that properly distinguish between the two categories of expenditures. If the charges cannot be segregated, the Service may take the position that the entire expenditure is presumed to be a capital outlay. n215

The already unclear distinction between repairs and capital expenditures is made even murkier by the "general plan of rehabilitation" doctrine, which overlays the entire area. Under that doctrine, an expense that is incurred as part of a plan of rehabilitation, improvement or modernization must be capitalized and added to basis, even though the same expense, standing alone, would be currently deductible as a repair. Thus, to discern the proper tax treatment for an item, one needs to know both the nature of the particular expenditure and the overall framework (i.e., alone, or in conjunction with other items) in which it is made. n216 If, however, the renovation involves no substantial structural improvements, expenditures for repairs may still be currently deductible. n217 Whether a plan of rehabilitation exists and whether an item is a part of it are usually questions of fact to be determined by evaluating all surrounding facts and circumstances,

including the purpose, nature, extent and value of the work done. n218

[b] Environmental Cleanup Costs

[i] Expensing of Certain Environmental Remediation Costs Under *IRC Section 198*

Taxpayers may elect to currently deduct, rather than capitalize, qualifying environmental remediation expenditures incurred after August 5, 1997, in tax years ending after that date, n219 and before January 1, 2010. n220 The manner for making the election is specified in *Revenue Procedure 98-47*. n221 The deduction applies for purposes of both the regular tax and the alternative minimum tax. To qualify for the deduction, the expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. n222 In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Company* and *IRC Section 263A* are treated as qualified environmental expenditures. n223

For purposes of the expensing provision, hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use. n224 Effective for expenditures paid or incurred after 2005, n225 hazardous substances also include petroleum products. Petroleum products are defined by reference to *IRC Section 4612(a)(3)*, and thus include crude oil, crude oil condensates, and natural gasoline. n226

With respect to expenditures paid or incurred after December 21, 2000, n227 a qualified contaminated site means any area (1) that is held by the taxpayer for use in a trade or business or for the production of income, or which is property held as inventory or for sale to customers in the ordinary course of the taxpayer's trade or business; and (2) at or on which there has been a release (or threat of release) or disposal of any hazardous substance. n228 A qualified contaminated site does not include any site that is on, or proposed for, the national priorities list as in effect on December 21, 2000. n229 An area is treated as a qualified contaminated site with respect to expenditures paid or incurred during a tax year only if the taxpayer receives a statement from the appropriate State Agency of the State where the area is located that there has been a release (or threat of release) or disposal of hazardous waste substances. n230

Note:

Legislation enacted in 2000 eliminates the targeted area requirement for expenditures paid or incurred after December 21, 2000 and thereby expands eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate State environmental agency. Nevertheless, general tax law principles regarding expensing versus capitalization of expenditures continue to apply to environmental remediation efforts not specifically covered under *IRC Section 198*. n231

With respect to expenditures paid or incurred before December 22, 2000, n232 a qualified contaminated site generally is any property that:

- (1) is held for use in a trade or business, for the production of income, or as inventory;
- (2) is certified by the appropriate state agency to be located within a targeted area; and

(3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). n233

For purposes of pre-December 22, 2000 expenditures, n234 targeted areas generally include the following: n235
n236-238

- (1) empowerment zones and enterprise communities as designated under present law (including supplemental sites designated on December 21, 1994);
- (2) EPA sites announced before February 1, 1997, as subject to one of the 76 EPA Brownfields Pilots;
- (3) any population census tract with a poverty rate of 20 percent or more; and
- (4) certain industrial and commercial sites adjacent to the census tracts described in (3).

[ii] Environmental Cleanup Costs Not Subject to IRC Section 198

Editor's Note:

A current deduction is available in narrow circumstances for qualifying environmental remediation costs under IRC Section 198 paid or incurred before 2010. n239

IRC Section 198 does not apply to the vast majority of environmental cleanup costs. Furthermore, the availability of the deduction under IRC Section 198 does not create any inference about the proper tax treatment of remediation expenditures not covered by that provision. The proper tax treatment of most remediation expenditures is governed by statutes other than IRC Section 198--primarily IRC Sections 162, 165 and 263. Cases, rulings, and other IRS pronouncements regarding environmental remediation costs under those statutes continue to apply. These rules are discussed below.

The proper tax treatment of asbestos removal and other environmental cleanup costs that are not subject to *IRC Section 198* is somewhat unsettled. Whether a particular expense must be capitalized or may be currently expensed depends both on the particular expense involved and the overall context in which it is done--i.e., as part of a larger rehabilitation project. n239.1 The IRS takes a more restrictive view for environmental remediation costs incurred in connection with the production of inventory, and requires these costs to be capitalized as part of inventory costs under *IRC Section 263A*. n239.2

A lively debate over the treatment of environmental cleanup costs ensued from the release of controversial technical advice memoranda in 1992 and 1993 that held that most costs incurred in removing asbestos and remediating soil contaminated by polychlorinated biphenyls (PCBs) must be capitalized. n240 A 1994 ruling provides a more favorable result. In Technical Advice Memorandum 9411002, the taxpayer held a warehouse and related facilities for rental. The related facility included a boiler house containing equipment that was originally used to heat the warehouse. In order to secure a bank loan for expansion of its facility, the taxpayer was required by its lender to abate asbestos in the warehouse and boiler house. The taxpayer was further required to remove all asbestos-containing materials located within its boiler house. To that end, the taxpayer removed boilers and tanks that were contaminated by asbestos and completely cleared the boiler house of all additional asbestos-containing materials. Thereafter, the taxpayer converted the boiler room into a garage and office space, and leased it out.

The lender also required the taxpayer to abate the problem of exposed and damaged asbestos-containing pipe insulation located within its warehouse. Accordingly, the taxpayer retained an asbestos contractor to rewrap and encapsulate the damaged or punctured areas of asbestos-containing pipe insulation and to discard insulation that was too damaged to be rewrapped. Less than 25 percent of the total pipes in the warehouse required encapsulation. The encapsulation process

involved covering the areas of exposed or damaged insulation with a canvas and/or plastic wrapping and applying stainless steel belts and buckles to keep the wrapping in place. In addition, the contractor sealed damaged pipe ends and elbows with a plaster-like material. Upon completion of these procedures, the contractor performed air monitoring to check and certify that asbestos concentrations were at safe levels.

The taxpayer deducted the costs incurred in connection with its asbestos abatement activities in its warehouse and boiler house as an ordinary and necessary business expense. In Technical Advice Memorandum 9411002, the Service observed that the asbestos removal costs enabled the taxpayer to convert its boiler house into a garage and office space. Thus, it found that the expenditures adapted the property to a new or different use and were therefore required to be capitalized. However, the Service also held that the expenditures incurred to encapsulate the damaged insulation in the warehouse neither increased the value of the taxpayer's property nor prolonged its useful life. The wrappings of the damaged pipe insulation reduced, but did not eliminate, the threat of exposure to airborne asbestos fibers. Finally, the expenditures did not enable the taxpayer to operate on a changed, more efficient or larger scale. Accordingly, the encapsulation expenditures were deductible as incidental repair costs.

Courts have followed the IRS position that asbestos removal and other environmental cleanup costs that adapt a property to a new or different use must be capitalized rather than deducted. n240.1 In *Dominion*, the court found that the cost of removing asbestos-containing materials, sludge, and assorted contaminants from a power plant should be capitalized. The expenses in that case were incurred to convert a power plant into property suitable for an entirely new use, as a real estate development. Focusing on the nature of the improvements, the court held that the costs had to be capitalized because they substantially altered the character of the property and permitted it to be used in a different way. The court in *Dominion* also noted that the remediation was unrelated to any deterioration of the asbestos and that the cleanup costs of \$2.2 million "dwarfed the value of the property," which was acquired for less than \$900,000. n240.2 Courts have allowed taxpayers to deduct the cost of removing and encapsulating asbestos, however, if the improvements don't adapt the building for a different use or are relatively minor when compared to the overall value of the property. n240.3

The IRS also has privately ruled that asbestos removal costs that are incurred as part of a larger repair project must also be capitalized and cannot be currently deducted, at least where the asbestos insulation was not treated as a separately depreciable asset. n240.4

Guidance was also issued in 1994 concerning the tax treatment of soil remediation costs. n241 The taxpayer was a manufacturer who, in order to comply with federal, state, and local environmental requirements, remediated the soil and groundwater contaminated by self-produced hazardous waste. The taxpayer also constructed groundwater treatment facilities to extract, treat, and monitor contaminated groundwater. The ruling held that the taxpayer's soil remediating expenditures merely restored its soil and groundwater to their appropriate condition before they were contaminated by the manufacturing operations. The expenditures neither prolonged the useful life of the land nor adapted the land to a new or different use. Accordingly, taxpayer was able to deduct the soil remediation costs as ordinary and necessary business expenses. However, the costs allocable to the construction of the groundwater treatment facilities were required to be capitalized, and depreciated accordingly.

The Service has employed the rationale used in *Revenue Ruling 94-38* to allow a deduction for certain environmental pre-cleanup costs. n242 The deductible costs included the following:

- (1) costs paid to assess and investigate the extent of environmental contamination and remediation alternatives;
- (2) legal fees paid in connection with drafting and negotiating a consulting contract and consent order with the Environmental Protection Agency; and

(3) consulting fees for:

(a) meetings with state politicians, US senators, and the media;

(b) analysis and review of legal work with respect to site conditions and cleanup strategy;
and

(c) developing a strategy for remediation alternatives.

The Service also ruled that the costs of environmental impact studies were deductible because they were not chargeable to a capital account. n243 The Service also noted in the TAM that the costs incurred to clean up land and treat ground water were deductible because they would not increase the value of the property, but would merely restore it to its condition before the taxpayer contaminated it. The Service's rationale for ruling that the various legal fees were deductible was that they did not create or enhance an asset or produce a long-term benefit. n244

The IRS has also ruled that the costs of replacing underground storage tanks containing waste by-products are deductible when the tanks are filled only once and then sealed indefinitely. n244.1

The IRS has also allowed a taxpayer to currently expense environmental cleanup costs resulting from the discharge of waste byproducts from business operations to the extent that they were allocable to contamination occurring during the taxpayer's ownership of the property. The costs included amounts paid or incurred for site investigations and reports, preparation and implementation of remediation action plans, site remediation, and associated legal fees. The IRS ruled that the cleanup costs were allocable to the contamination that occurred during the taxpayer's ownership of the property, which were similar to those found deductible in *Revenue Ruling 94-38*. n244.2 As in that revenue ruling, the costs of cleaning up the hazardous wastes did not increase the value of the site or prolong its useful life. They merely restored it to its condition when the taxpayer acquired it. Significantly, the IRS ruled that the taxpayer's intent to build a new building on the site would not change this conclusion, because the costs allocable to the contamination that occurred during the taxpayer's ownership of the property were merely restorative. For the same reason, the IRS also ruled that those cleanup costs did not need to be capitalized as land preparation costs. The cleanup operations did not improve or substantially change the site, but merely restored it to the condition that existed when the taxpayer acquired it. n244.3

The IRS ruled differently, however, with respect to the cleanup costs that were allocable to contamination that resulted from the discharge of waste byproducts from the operations of the prior owner, before the taxpayer acquired the property. It ruled that these costs had to be capitalized under *IRC Sections 263 and 263A*. n244.4 The IRS has also ruled that soil remediation costs to clean up unknown contamination that existed when the taxpayers purchased the property had to be capitalized. n244.5 Applying a similar rationale, the Sixth Circuit has affirmed a district court holding that soil remediation costs to correct unknown contamination that was present when the taxpayer purchased the property had to be capitalized. The court distinguished environmental remediation costs for property that was contaminated when the taxpayer acquired it (which had to be capitalized) from the same costs incurred by taxpayers to correct environmental damage they have caused (which can be deducted). n244.6

The US Court of Federal Claims, however, has distinguished the *United Dairy Farmers* case rationale n244.7 and allowed a taxpayer to deduct the cost of removing and encapsulating asbestos for an office building. n244.8 The asbestos was in fireproofing material that had been used in constructing an addition to the building in 1972. When the fireproofing material was originally sprayed on the structure, it was stiff and encased the asbestos. By the late 1980s, however, the fireproofing material was deteriorating, and asbestos was flaking off and would crumble if bumped or disturbed. The court allowed the deduction because the asbestos work did not extend the useful life of the building or create a new or different use for the building. Rather, the improvements were made only to keep the office in effective operating condition. The court also found that the expenditures did not appreciably increase the value of the building, but only restored value to the building that existed before the asbestos started flaking and crumbling. The court

distinguished the *United Dairy Farmers* case on the ground that the need for removing and encapsulating the asbestos arose here not from contamination that existed at the time the building was constructed, but because the asbestos became friable over time during the ordinary operation of the office building. Thus, this was not a case where a taxpayer improved property defects that were present when it acquired the property. Rather, it was one where the contamination occurred over time, causing a problem that was not anticipated at the time of construction. It therefore held that the remediation costs were currently deductible. n244.9

NOTE:

The *Cinergy* case may signal a more expansive allowance by courts of asbestos removal costs. Indeed, the court expressly criticized the general focus of the Service's position--which was that if a company acquires property with a seemingly minor flaw or frailty that, over time, deteriorates into a full-blown problem, the cost of remediation must be capitalized. The court's decision implies that costs of addressing asbestos and related problems that are not anticipated by the taxpayer in the original design of a building, and that are not remedied as part of a generalized plan of rehabilitation and renovation may be currently deductible as an ordinary and necessary expense. n244.10

A post-Cinergy Field Service Advice memorandum offers a good view of the IRS position regarding the deduction of certain costs related to environmental remediation liabilities. The memorandum involved an accrual basis manufacturer who had contaminated property in connection with its trade or business. A prior owner had also contaminated the property. The US sued-under CERCLA, and the parties signed a Consent Decree setting forth-remediation liabilities and responsibilities. The taxpayer purchased an exit strategy that consisted of hiring a remediation contractor, and entering into a funding "insurance" contract to cover the costs of the remediation over many years. The contract included a pollution cost cap policy, which covered actual expenses of environmental remediation, and an environmental site liability policy, which covered liabilities arising out of personal injury or property damage resulting from the contamination. Although the taxpayer claimed the contract was an insurance policy, the memorandum stated the cost cap policy was a pre-paid services contract for services to clean up the site. (In doing so, it set forth in great detail the IRS' position on when premiums are and are not for insurance.) It therefore ruled that deductions could be taken only when economic performance occurred--i.e. when the remediation services required under the contract were performed. n244.11 This conclusion agrees with an IRS ruling providing guidance on when an accrual basis taxpayer incurs a liability for services or insurance. The ruling makes clear that the mere execution of a contract, without more, does not establish the fact of liability for services. No deduction can be taken until the services are performed or payment is due. n244.12

The memorandum acknowledged that the site liability policy might constitute insurance. Because the contract covered many years, however, and the premiums were prepaid, the taxpayer had to capitalize premium expenses over the life of the contract. n244.13 For the same reason, fees paid to an agent to service the remediation program to completion also had to be capitalized as fees under a pre-paid services contract. Amounts paid would be deductible as administration services were provided. n244.14

Planning Guide:

Citing the *United Dairy Farmers* case discussed above, the memorandum ruled that the taxpayer could deduct only costs of contamination that was directly attributable to the taxpayer's trade or business, and which did not exist when the taxpayer acquired the property. n244.15 The memorandum offers guidance obtaining information regarding the extent to which any property is contaminated when-purchased by a taxpayer. Closing documents and court filings and decrees may describe the extent of the pre-purchase contamination. For property owned for a long period of time by a taxpayer and used in the taxpayer's trade or business, the memorandum acknowledges the difficulty of obtaining reliable information in this regard. If a taxpayer cannot obtain any evidence of this nature, the memorandum states that the IRS may

consider as reasonable a fractional allocation based on the number of years the taxpayer has owned the property over the total number of years the property has been contaminated. The memorandum also stresses that any deduction under *IRC Section 162* must be decreased by the amount of any insurance proceeds received. n244.16

The IRS has ruled that a corporation may deduct otherwise deductible environmental cleanup costs even though the costs are subject to indemnification under a prior agreement which sold the corporation's stock. The costs are not disallowed as deductions either because they relate back to the sale of the corporation's stock or because they are subject to reimbursement. n244.17

Notwithstanding the authorities allowing a deduction for environmental cleanup costs in certain circumstances, such costs incurred as part of a larger renovation or rehabilitation must be capitalized because of the application of the "general plan of rehabilitation" doctrine. n245 Under that doctrine, expenses incurred as part of a plan of rehabilitation or improvement--including unanticipated expenses, such as costs of removing asbestos, that are discovered to be necessary after renovation has begun--must be capitalized, even if the same expenses might be currently deductible if incurred separately. n246 Capitalization of such costs is required even if the expenditures do not increase the life or value of the building or other asset for which they are incurred. n247

One ruling has made an important distinction with respect to the "plan of rehabilitation" doctrine by allowing contamination cleanup costs incurred on the taxpayer's land to be deducted, even though a building was to be constructed on the property after contamination was removed. The IRS found the situation distinguishable from *Norwest* and other cases applying the plan of rehabilitation doctrine. Unlike the asbestos removal in *Norwest*, which was directly related to the renovation of the building, the taxpayer's environmental cleanup costs in the ruling were not directly related to the construction of the new building. Rather, they related solely to the restoration of the land, an asset separate and apart from the new building. Therefore, the IRS ruled that the costs could not be considered to be a part of a plan of rehabilitation or improvements to its building. n247.1 Similarly, the IRS ruled that, although the cleanup arguably was undertaken to permit or at least to facilitate the construction of the new building, the cleanup costs did not represent a cost of the new building. And since they were also not properly characterized as land preparation costs, they did not need to be capitalized. The IRS made special note that *IRC Section 263A* did not require capitalization of the costs either. Its rationale was that, to the extent the costs were allocable to contamination that occurred during the taxpayer's ownership of the property, they were not allocable to the production of real or tangible personal property, and *IRC Section 263A* applies only when real or tangible personal property is being produced. n247.2

In *Private Letter Ruling 9814030*, the Service made several rulings regarding a taxpayer's involvement in cleanup of chemical groundwater contamination that resulted from seepage of contamination from adjoining land by other companies. The taxpayer entered into an agreement with the companies under which they would fund construction of water treatment facilities to remove contaminants from water drilled on the taxpayer's land. The agreement provided that ownership of the facilities could, in certain circumstances, be transferred to the taxpayer. The companies also were required to reimburse the taxpayer for costs associated with owning and operating the facilities. The taxpayer requested several rulings with respect to the cleanup. The IRS ruled as follows:

- The taxpayer would not recognize any gross income as a consequence of the construction and operation of any treatment facility, as long as ownership of the facility did not pass to the taxpayer.
- The taxpayer could deduct certain costs and expenses incurred in operating any cleanup facility in the tax year in which they were incurred, provided that the taxpayer was not, in fact, reimbursed and had no right or expectation of reimbursement from the participating companies. In addition, to the extent any expenses incurred by the taxpayer were treated as nondeductible because they were reimbursed by or were subject to reimbursement by the participating companies, the reimbursements would not be includable in the taxpayer's gross income (citing to *Revenue Ruling 80-348*). n248

- To the extent that the participating companies made reimbursements to the taxpayer, other than capital expenditures, they would be deductible in the year in which they were made.
- The participating companies could depreciate their unrecovered construction costs with respect to any operating treatment facility not transferred to the taxpayer at the end of a tax year. n249

One case denied a deduction for \$2.2 million in expenditures incurred to clean up environmental contamination at an abandoned electric power station. The cleanup involved removing and disposing of asbestos-containing materials, contaminated sludge, and other materials. The court ruled that although the property had long since been abandoned, the expenditures adapted the power plant to a new use by making it capable of being developed. The court also held that *Revenue Ruling 94-38* applied only when cleanup costs were incurred in connection with the ongoing operations of a business. The court held that *Revenue Ruling 94-38* did not apply to a situation, as here, involving the cleanup of an abandoned property that was not used in ongoing operations. Another factor in the court's decision was evidence that the cleanup substantially increased the value of the property. n249.1

Environmental remediation trusts may be used to fund environmental cleanup costs. Regulations classify an environmental remediation trust as a trust for tax purposes. A trust is an environmental remediation trust if the following requirements are met: n250

- It is formed as a trust under state law.
- The primary purpose of the trust is collecting and disbursing amounts for environmental remediation of an existing waste site (including costs of remedying and removing environmental contamination).
- Contributors to the trust have actual or potential liability for clean-up costs.
- The trust is not a qualified settlement fund within the meaning of *IRC Section 468B*. n251

The final regulations deal only with the classification of an environmental remediation trust as a trust for tax purposes. They do not address or affect the timing or amount of a deduction for environmental remediation costs. n252 The IRS has ruled in one case that insurance proceeds received by a taxpayer for environmental costs and claims reduced the taxpayer's basis in the property resulted in gross income only to the extent those proceeds exceeded the taxpayer's basis in the property. n252.1

Any amounts paid to remediate environmental contamination occurring in prior years do not qualify for relief under *IRC Section 1341* claim of right rules. n252.2

[iii] Environmental Remediation Costs Incurred in Connection with Producing Inventory

The IRS takes a restrictive view regarding the proper tax treatment of environmental remediation costs incurred in connection with the production of inventory. Its position is that costs incurred to clean up land that a taxpayer has contaminated in operating a manufacturing plant cannot be deducted currently but must be capitalized as part of inventory costs under *IRC Section 263A*. Similarly, the IRS takes the position that costs a taxpayer incurs to replace underground storage tanks and depreciation cost recoveries of the groundwater treatment facility must be included in inventory costs to the extent properly allocable to inventory. n252.3

The ruling involved a taxpayer who owned a plant that manufactured property that was inventory in its hands. The manufacturing operations discharged hazardous waste that the taxpayer had buried on previously uncontaminated property. The taxpayer, a C corporation, used an accrual method of accounting. To comply with current applicable

federal, state, and local environmental requirements, the taxpayer incurred costs to remediate the soil and groundwater, and to establish an appropriate system for the continued monitoring of the groundwater to ensure that the remediation removed all hazardous waste. The soil remediation and groundwater treatment restored the land to essentially the same physical condition that existed prior to the contamination. During and after the remediation and treatment, the taxpayer continued to use the land and operate the plant in the same manner as it did prior to the cleanup except that it disposed of any hazardous waste in compliance with environmental requirements. n252.4

The IRS distinguished the environmental remediation costs in *Revenue Ruling 2004-18* from those addressed in past rulings. It noted that *Revenue Ruling 94-38* n252.5 had allowed costs of cleaning up contaminated land and treating groundwater to be deducted as a current expense because those costs did not prolong the useful life of the land or adapt it to a new or different use. That ruling had required the cost of constructing groundwater treatment facilities to be capitalized because they were capital expenditures. The IRS also acknowledged that another ruling had also allowed the costs of replacing underground storage tanks containing waste byproducts to be expensed. n252.6 The IRS distinguished both of the above rulings because they dealt with the capital expenditure/deductible repair issue. Neither ruling discussed the possible inclusion of the cleanup costs as inventory costs under *IRC Section 263A*.

The IRS takes the position that regardless of how the capital expenditure/deductible expense issue is resolved in a given case, a taxpayer with inventories still must apply the rules of *IRC Section 263A* to determine whether deductible repair costs (or repair costs that otherwise had to be capitalized to a depreciable asset) must be included in inventory costs. n252.7

The key fact in the ruling was that the taxpayer incurred the environmental remediation costs to clean up land that it contaminated as part of its ordinary business operations of manufacturing inventory. As a result, those costs were incurred by reason of the taxpayer's production activities, and were allocable to and includable in the taxpayer's inventory costs. n252.8 For the same reason, costs incurred to replace underground storage tanks and depreciation cost recoveries of the groundwater treatment facility had to be included in inventory costs to the extent properly allocable to inventory. n252.9

The above position with respect to environmental contamination costs incurred in manufacturing inventory represents a change in the IRS position. Therefore, a transition rule applies for tax years ending on or before February 6, 2004 under which the IRS it will allow qualifying environmental remediation costs to be deducted. n252.10

Consistent with *Revenue Procedure 2004-18* , a later ruling has held that environmental remediation costs that are incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of its manufacturing activities are incurred by reason of production activities and are properly allocable under *IRC Section 263A* to the inventory produced during the taxable year the remediation costs are incurred. n252.10.1 The ruling makes clear that this allocation to inventory applies in a variety of situations, including any of the following variations: n252.10.2

- the taxpayer is producing a different product in the year of the remediation than the one whose manufacture caused the contamination, and the taxpayer has none of the prior inventory on hand;
- the taxpayer temporarily ceases its manufacturing activities while it remediates the contamination;
- the taxpayer still produces the inventory whose manufacture caused the contamination, but at another site; or
- the taxpayer initially contaminates a remote dump site that it did not own or otherwise use in its manufacturing activities. The taxpayer is not obligated to clean up the site when it buries the waste, but becomes responsible for the cleanup under later federal, state, and local environmental requirements. The remediation does nothing more than restore the site to its physical condition prior to the contamination.

During and after the remediation, the taxpayer continues to manufacture the same product at the same location, but has permanently stopped using the remote dump site to bury waste.

Note:

Any taxpayer using a method of accounting that does not comply with *Revenue Ruling 2004-18* or *Revenue Ruling 2005-42* will be treated as using an impermissible method of accounting. Any change in a taxpayer's treatment of environmental remediation costs to conform with either ruling is a change in method of accounting to which the provisions of *IRC Sections 446* and *481* and the regulations thereunder apply. A taxpayer changing its method of accounting to comply with either revenue ruling must file a Form 3115 in accordance with the automatic change in method of accounting provisions stated in revenue procedures, subject to specified modifications. n252.11

[c] Mold Remediation Costs

In a private ruling of first impression, the IRS has allowed a taxpayer to currently deduct, rather than capitalize, mold remediation costs. The taxpayer owned a nursing facility, and discovered mold in the building that was not present when it purchased the building. The mold had developed from roof leaks and condensation from heating, ventilation, and air conditioning lines. The mold removal project consisted of (1) sealing off and containing the wing of the building where the mold was present; (2) removing approximately 70% of the wall and ceiling drywall and 13 doors; (3) removing all of the faucets, sinks, and most of the electrical fixtures; (4) removing the mold; (5) testing in the affected area to ensure that the mold was completely removed; (6) installing new drywall and replacing a portion of the electrical and plumbing fixtures; and (7) painting. In conducting the project, the taxpayer reused all of the old doors and sinks and most of the electrical fixtures. The IRS employed a straightforward historical repair vs. capital expenditure rationale in its ruling. n252.12 It allowed a current deduction because the effect of the mold remediation project was simply to restore the building to the same physical condition that existed prior to the onset of mold. The new materials used were of substantially similar quality as the materials that were replaced. The existing floor plan was not altered, and no structural components were repaired or replaced. The project did not substantially prolong the useful life of the building, add to its value, or adapt it to a new use. Instead, the project kept the building in efficient operating condition. In addition to the mold remediation, the taxpayer also renovated air conditioning and plumbing systems in the wing and replaced the roof of the entire building, but it capitalized those costs. n252.13

[d] 10-Year NOL Carryback for Certain Environmental Remediation Costs

Generally, a taxpayer may carry back any net operating loss (NOL) to the previous two taxable years. n253 Specified liability losses, however, may be carried back 10 years. n253.1 The purpose of the extended carry back provision is to allow, to the extent possible, the matching of expenses with the period in which the event causing the loss occurred.

A "specified liability loss" includes several items, to the extent they are taken into account in computing the NOL for the taxable year. Among the items included is any amount which meets the following requirements: n253.2

- It is allowable as a deduction for federal income tax purposes under an income tax provision other than *IRC Section 468(a)* (dealing with mining and solid waste reclamation and closing costs) or *IRC Section 468A(a)* (dealing with nuclear decommissioning costs);
- It is in satisfaction of a liability under a federal or State law requiring the remediation of environmental contamination;
- The act (or failure to act) giving rise to the liability occurs at least 3 years before the beginning of the taxable year; and

- The taxpayer used an accrual method of accounting throughout the period(s) during which the act or failure to act occurred.

The IRS Chief Counsel's Office has issued a memorandum concluding that environmental remediation costs that are allocated to inventory under *IRC Section 263A* and recovered through cost of goods sold constitute specified liability losses to the extent they are taken into account in computing an NOL for the taxable year. The memorandum clarifies that the statutory requirement that a specified liability loss item be "allowable as a deduction" n253.2.1 was not intended to distinguish "deductions" from "cost of goods sold." n253.2.2

Example:

In Year 1, T, a manufacturer, has gross receipts of \$20x and cost of goods sold (CGS) of \$15x. T incurs \$10x of environmental remediation costs, \$2x of which is properly allocable to CGS (and is included in the \$15x CGS amount) and the remaining \$8x of which is properly allocable to ending inventory. In addition, T incurs \$25x of deductible business expenses, none of which constitute a specified liability loss. T's NOL is \$20x, and T's specified liability loss is \$2x, computed as follows:

NOL Computation for Year 1:

Gross receipts	\$20x
CGS	(15x) (including \$2x attributable to remediation costs)
Gross income	5x
IRC § 162(a)	
Deductions	(25x)
NOL	[20x]

Specified Liability Loss Computation for Year 1:

NOL	\$20x
Environmental Remediation Costs Included in CGS	2x
Specified Liability Loss (Lesser of NOL or IRC § 172(f) Amounts)	\$2x

The \$8x of environmental remediation costs that is included in ending inventory for Year 1 will be included in T's Year 2 beginning inventory. This \$8x will generate a specified liability loss in the taxable year in which the cost of that inventory is included in T's cost of goods sold, provided that T has an NOL in that taxable year. n253.2.3

The amount of any specified liability loss for a taxable year cannot exceed the net operating loss for that year. n253.3 For purposes of determining the amount of the carryback or carryover, n253.4 a specified liability loss for any taxable year must be treated as a separate NOL for that year, to be taken into account after the remaining portion of the NOL for that year. n253.5 A taxpayer may make an irrevocable election not to have the 10-year carryback apply. n253.6

NOTE:

The 10-year carryback is available only for costs that are otherwise deductible. If an outlay for

environmental remediation is a capital expenditure, n253.7 it cannot be a specified liability loss. n253.8

An IRS Field Attorney Advice Memorandum discusses specified liability losses at some length. The memorandum ruled that premiums paid for a contract that provided a taxpayer with an exit strategy by limiting its liability for environmental remediation costs did not qualify for *IRC Section 172(f)* treatment. The memorandum rejected the taxpayer's characterization of its costs as insurance premiums, but ruled that even if they were so characterized, they did not qualify for the specified liability loss provisions because they were not paid on account of an environmental liability. Rather, the premium costs were incurred for insurance to limit the amount spent to remedy the taxpayer's environmental liabilities. The liability giving rise to the obligation to pay arose under the contract. It was not paid in satisfaction of a liability under a Federal or State law requiring remediation of environmental contamination, as required by the statute. n253.9 The memorandum also ruled that a service fee paid to compensate an agent's handling of the remediation program also did not qualify because it was not paid to satisfy a federal or State liability. n253.10

The memorandum gives useful clarification on claiming the 10-year carryback for qualifying environmental remedial costs, and what constitutes a qualifying "specified liability loss." For all outlays, taxpayers should obtain substantiation of the amounts sufficient to show that they were incurred for a deductible expense, with a breakdown of the costs and activities covered by them. Taxpayers should ensure that none of the items represent non-deductible expenses such as fines and penalties. The memorandum notes that the following costs are eligible for the 10-year carryback as a specified liability loss: n253.11

- Environmental site investigatory costs, including preparation of an investigation report, and preparation of a response action plan;
- Site preparation for clean up;
- EPA or state agency reimbursements for investigatory or remediation costs incurred;
- Excavation and disposal of regulated substances found at the site;
- Containment or encapsulation costs not subject to capitalization under *IRC Section 263(a)*;
- Excavating, stockpiling, or transporting waste;
- Treatment of contaminated soil or water;
- Future monitoring costs to assure success; and
- Remediation costs allocated to inventory under *IRC Section 263A* and in the year recovered through cost of goods sold, but only to the extent they are included in the current year NOL. n253.11.1

The memorandum notes that the following costs do not qualify as a specified liability loss: n253.12

- Remediation costs for contamination that occurred less than three years before the beginning of the taxable year the deduction is claimed;
- Environmental remediation costs allocated to inventory that remains on hand at the end of the taxable year (ending inventory); n253.12.01
- Current compliance costs;

- Fines or penalties;
- Any capital expenditure, including construction of ground water treatment facilities, wells, pipes, pumps, or other equipment; and
- Any legal costs not specifically incurred in determining the amount of the remediation liability, including, but not limited to the following:
 - Negotiating consent decrees;
 - Defending against civil or criminal charges;
 - Defending against third party claims; or
 - Any capital expenditure subject to *IRC Section 263(a)*, including construction of ground water treatment facilities, wells, pipes, pumps or other equipment put in place to monitor or treat the soil or water. n253.12.02

[e] Deduction for Certain Hazardous Substance Costs Related to Disasters

Taxpayers may elect to deduct qualified disaster expenses, effective for amounts paid or incurred after December 31, 2007 in connection with disasters declared after that date and occurring before 2010. n253.12.1 Although *IRC Section 198A* can apply to expenditures other than environmental costs, it also allows the deduction of certain costs relating to hazardous substances. To be deductible under *IRC Section 198A*, the expenditure must meet the following requirements: n253.12.2

- it must be incurred in connection with a trade or business or with business-related property;
- it must be for (1) the abatement or control of hazardous substances that were released on account of a federally declared disaster; (2) the removal of debris from, or the demolition of structures on, real property which is business-related property damaged or destroyed as a result of a federally declared disaster; or (3) the repair of business-related property damaged as a result of a federally declared disaster; and
- it must otherwise chargeable to capital account.

Any deduction taken under *IRC Section 198A* is treated as a depreciation deduction which is recaptured in the case of a sale or other disposition of the property. n253.12.3 Other statutory provisions dealing with expensing of environmental remediation expenditures, n253.12.4 capitalization of demolition costs, n253.12.5 and certain mining and solid waste costs n253.12.6 do not apply to costs expensed under *IRC Section 198A*. n253.12.7

[2] Interest Expense

[a] Definition

Interest is a payment made for the use or forbearance of money. n253.13 Taxpayers may generally deduct only interest paid on their own indebtedness. n253.14 Legal or equitable ownership in property, however, may allow a taxpayer to deduct interest on a mortgage connected with that property even if the taxpayer is not directly liable upon the bond or note secured by that mortgage. In that case, the interest is treated as paid on the taxpayer's own indebtedness. n254 The common situation that arises is where a relative of a taxpayer takes title to property or acquires a mortgage on the

taxpayer's behalf because the taxpayer cannot qualify for a loan. n254.1 Taxpayers have also been permitted to claim mortgage interest deductions even though legal title to the property to which the mortgage relates has been transferred to a trust. n254.2

In determining whether a taxpayer's equitable interest in property is sufficient to support a mortgage interest deduction, courts look to state law to determine the nature of the taxpayer's property rights. n254.3 Courts also consider the following factors to determine whether a taxpayer is an equitable or beneficial owner of the property, including whether the taxpayer: n254.4

- has a right to possess the property and to enjoy its use, rents, or profits;
- has a duty to maintain the property;
- is responsible for insuring the property;
- bears the property's risk of loss;
- is obligated to pay the property's taxes, assessments, or charges;
- has the right to improve the property without the owner's consent; and
- has the right to obtain legal title at any time by paying the balance of the purchase price.

Interest is different from loan fees paid to a lender or loan broker as compensation for services rendered in making the loan available. Furthermore, interest must be distinguished from standby commitment fees that constitute a payment to ensure that financing will be available at some future date.

Frequently, lenders will charge "points" when a loan is first funded. This is a vague term for tax purposes, and the taxpayer should clarify with the lender whether the points are charged as an adjustment to the interest rate or for lending services. Front-end points charged as an adjustment to the interest rate may be deductible as interest, subject to the prepaid interest rules discussed below. Loan servicing fees are amortizable over the term of the loan. n255

Prepayment penalties for mortgages are considered payments for the use or forbearance of money. Thus, they are deductible as interest. n256

As previously mentioned, a taxpayer can only deduct interest incurred on his or her own indebtedness. If property is acquired subject to a liability on which past-due interest is unpaid, the purchaser is not entitled to a deduction for payments made on interest accruing before the date of purchase. n257 Accrual-basis taxpayers should also note that the Service issued an internal memorandum that might be interpreted to mean that accrued and unpaid interest attributable to nonrecourse debt is not deductible by an accrual-basis taxpayer. n258 The Service reasoned that, until the liability is paid, it is not fixed.

If more than one person is liable on a loan, a deduction is not denied to the obligor who makes the interest payment simply because another person is also liable on the debt. n259 However, the interest deduction will not be allowed to a party that is not primarily obligated on the debt. This distinction was of critical importance in disallowing the deduction for interest on payments made by a guarantor of an obligation. n260 Similarly, if property is jointly owned and is subject to indebtedness, either owner may make the payment for interest and claim the deduction. n261

[b] Timing of Deduction for Interest

Taxpayers cannot deduct interest that has been prepaid for periods beyond the current taxable year. Such interest must be capitalized and then deducted in the period to which it relates. n262

When a cash-basis taxpayer pays front-end "points" that represent an adjustment to the interest rate, the "points" represent prepaid interest. n263 Consequently, the "points" must be amortized over the term of the loan. n264

The only exception to this rule is that "points" paid as interest in connection with a mortgage loan for the purchase or improvement of the taxpayer's principal residence can be deducted when paid by the cash-basis taxpayer. n265 Taxpayers eligible to deduct points may, however, amortize them over the term of the loan. n265.1 To ensure the deductibility of points a taxpayer pays, *Revenue Procedure 94-27* n266 specifies that the points must be:

- (1) designated as points on the Uniform Settlement Statement;
- (2) computed as a percentage of the amount borrowed;
- (3) charged under established business practice;
- (4) paid in connection with the acquisition of the taxpayer's principal residence, which acts as security for the loan; and
- (5) paid directly by the taxpayer.

Under the revenue procedure, a taxpayer is not required to pay the points *separately*, as long as the taxpayer pays an amount of cash at closing that is at least equal to the points. The cash paid at closing includes the down payment, escrow deposits, earnest money, etc. The revenue procedure has a number of limitations, including that it does not apply to points allocable to the portion of a mortgage that exceeds the \$1 million limitation of *IRC Section 163(h)(3)(B)(ii)*; to points paid on a loan for home improvement, rather than home acquisition; to points paid on a loan to purchase a residence that is not the taxpayer's principal residence; or to points paid on a refinancing. The statutory rule disallowing a deduction for prepaid interest n266.1 does not prevent a cash-basis taxpayer from deducting prepayments of interest that are in arrears at the time of prepayment. n266.2 *IRC Section 461(g)* denies a deduction for the payment, by a cash-basis taxpayer, of any interest properly allocable to a period after the close of the tax year in which it is paid. Advance payments of accrued interest that are in arrears at the time of payment, however, is deductible, even though not yet due, because it represents a charge for the use or forbearance of borrowed money during the year in which interest was accruing. That the interest is not required to be paid until a later year does not render payment of that interest prohibited as a pre-payment of interest. Rather, the payment is a deductible advance payment of interest. n266.3

Cash-basis taxpayers must be sure they have "paid" interest, as required under Treas Reg § 301.7704-4(e)(1) in order to obtain a current deduction. Generally, interest must be paid with cash or its equivalent. It has been consistently held that interest that is withheld from funds advanced by a lender has not been "paid" within the meaning of *IRC Section 163* until the loan is paid by the borrower. n267 However, in situations when interest has been withheld from loan advances, the original issue discount (OID) rules may override the cash-basis method and require a yield-to-maturity accrual on the difference between the funds advanced and the cash ultimately to be paid. This restriction should not apply, and interest deductions should be allowed, if the interest is paid with funds advanced by a different lender. n268 However, the taxpayer must be able to display the ability to exercise unrestricted control over the funds if he attempts to secure a deduction for interest when that interest is paid with funds advanced by the lender. n269

[c] Investment Interest

The amount of investment interest that noncorporate taxpayers may deduct is limited for any tax year to their net investment income for that year. n270 Any amount disallowed as a deduction under this limitation may be carried

forward indefinitely and deducted in later tax years. Any disallowed deduction may not be carried back to prior years. n271

Planning Tip:

The aggregate disallowed amount (including amounts carried over from prior years) is determined each year. That aggregate figure is treated as investment interest incurred in the following tax year. n272 The amount carried over is not limited by the taxpayer's taxable income for the taxable year in which the interest is paid or accrued. n273

The term "investment interest" generally refers to any interest otherwise allowable as a deduction that is paid or accrued on indebtedness properly allocable to property held for investment. n274 Investment interest also includes any amount allowable as a deduction in connection with personal property used in a short sale. n275 It also includes interest incurred by an individual in connection with the purchase of stock in a C corporation. n276 The term does not include qualified residence interest, as defined in *IRC Section 163(h)(3)*, or interest that is taken into account under *IRC Section 469* in computing income or loss from a passive activity of the taxpayer.

Planning Tip:

Temporary regulations provide rules for allocating interest expense among personal, investment and business activities. They require that any disbursement of debt proceeds and the interest accrued on that debt be traced to a specific personal, passive activity, portfolio, or business expenditure. n277 The tracing rules provide taxpayers with substantial flexibility but require careful planning when receiving and spending loan proceeds.

Net investment income is defined as the excess of investment income over investment expenses. n278 Investment income includes the sum of the following items: first, gross income from property held for investment; second, the excess of net gain from the disposition of property held for investment over the net capital gain determined by only taking into account gains and losses from dispositions of property held for investment; third, so much of the net capital gain from the disposition of property held for investment (or if less, the net gain from disposition of property held for investment) that the taxpayer elects to take into account as investment income; n279 and fourth, the amount of qualified dividend income (i.e. dividends that qualify for capital gains treatment) n279.1 that the taxpayer elects to treat as investment income. n279.2

A taxpayer who makes the election referred to above regarding net capital gain from the disposition of property must forego the favorable capital gains rates on those capital gains. n280 Therefore, it is advantageous to make the election only if the taxpayer expects to be unable to deduct excess investment interest expense within a reasonable time or, possibly, if the taxpayer expects to be subject to the alternative minimum tax. The election must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized. The election must be made on Form 4592, Investment Interest Expense Deduction, in accordance with the form and instructions. n281 The election is revocable with the consent of the Commissioner. n282

Investment income that is allowed to be taken into account for purposes of the investment interest limitation does not include interest income taken into account in computing income from passive activities. n283 Although the Congressional Committee reports accompanying the enactment of *IRC Section 163(d)* state that income from rental real estate activities in which a taxpayer actively participates is not investment income, this was presumably because all rental real estate activities were then subject to the passive activity loss limitations. n284 *IRC Section 469(c)(7)* now provides that certain rental real estate activities may not be passive activities. Income from activities described in *IRC Section 469(c)(7)* as to which the taxpayer materially participates should nevertheless remain excluded from "investment income" for purposes of *IRC Section 163(d)*. n285

Investment expenses include deductions (other than interest) that are directly connected with the production of investment income. n286 Investment expenses do not include any expenses taken into account in determining income or loss from a passive activity. n287

Property held for investment includes the following: n288 first, any property that produces portfolio income under the passive activity loss rules; n289 and second, any interest in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate. Property held for investment does not include property from which a taxpayer intends to earn an income from operating. In one case, the Tax Court allowed the taxpayer to deduct interest paid for loans to purchase, renovate, and operate two nursing homes because the nursing homes were not held for investment, but were purchased to provide self-employment income to the taxpayer and his former spouse. Although the taxpayer hoped to sell the properties at a profit when he retired, the Tax Court found that any investment motive at the time of purchase was remote or nonexistent, and therefore the limit imposed by *IRC § 163(d)* did not apply. n289.1

The terms "activity," "passive activity" and "materially participate" have the same meanings under the investment interest limitations as under the passive activity rules. n290

Income such as interest, dividends or royalty income is not always classified as investment income. If that income is considered to be derived in the ordinary course of a trade or business, the activity that produced the income is a business activity rather than an investment. Examples of investment-type income excluded from the scope of the interest limitation include: interest and dividends from the inventory of a dealer in stocks or bonds, and interest on installment obligations arising from the sale of business property.

In general, all noncorporate taxpayers are subject to the investment-interest limitation. Therefore, the rules apply to both individuals and trusts and include allocations and distributions to them from passthrough entities such as partnerships and S corporations. n291 Although the actual application of the limitation on investment-interest deductions occurs only on the tax return of the individual or trust, the determination of whether a particular item of interest expense is subject to the limitation is often made at the partnership or S corporation level.

Because corporate taxpayers are not subject to the limitation, a determination that a partnership's investments are covered by the investment-interest rules affects only the allocations to the noncorporate partners. n292

Once the activities subject to the limitation are identified, the calculation of net investment income (NII) is generally straightforward. However, because NII is net of all deductible expenses other than interest, significant issues can arise in allocating nonspecific expenses among the taxpayer's investment and business activities. Because NII establishes a ceiling on currently deductible investment interest, the taxpayer often fares better as more income is allocated to investment activities and more deductible expenses are allocated to business. n293 This could be true even if the business produces passive losses, because the rules for deducting previously disallowed amounts vary under the two limitations. Suspended interest deductions are only allowed if there is adequate NII, whereas suspended passive-activity losses are allowed, without regard to income, upon a complete taxable disposition of an activity.

The statutory definition that investment expenses used in calculating NII *means* those definitions "directly connected with the production of investment income" n294 suggests strongly that expenditures having a dual purpose, or which have only an indirect relationship to investment income, cannot be characterized as an investment expense. However, the importance of the allocation almost guarantees that the Service and taxpayers will disagree on this issue, especially when a single entity or taxpayer engages in both types of activities. n295 Although expense-allocation issues may be exacerbated, determining the amount of the investment expense is otherwise relatively easy. The expense items used to calculate NII are the items otherwise deductible in computing taxable income. This means that normally deductible expenses that are either disallowed or deferred under other tax provisions are not considered in calculating NII for the

year (e.g., only those investment expenses that are allowed after application of the 2 percent adjusted gross income floor for miscellaneous expenses are considered). n296

[d] Imputed Interest

Interest may be imputed when property is sold on a deferred payment contract and no interest factor is provided or the stated interest is too low. In such a case, a portion of each payment under the contract is treated as interest. n297

Imputed interest may be treated as investment interest if it is attributable to an investment activity. (See § 4.03[2][c], above, and Chapter 7.)

[e] Interest Versus Principal

Taxpayers may agree on how payments by the debtor are to be applied towards interest and principal. For example, the parties can agree that the entire principal balance be repaid before any payments of interest are made. n298 However, this principle does not override the original issue discount rules. n299

Most loan documents denote the portions of each payment that constitute interest and principal. Occasionally, payments or partial payments are made without a prior existing agreement. Generally, in these cases, the debtor can specify the manner in which the payments should be accounted. n300 However, if the debtor does not account for the payment, the creditor's accounting will override. n301 Proper documentation will reward the debtor in these situations. n302 If neither party properly accounts for the payment, the general rule is that accrued unpaid interest will be deemed to be paid first, then principal, subject to the application of local law. n303 The use of the "Rule of 78" to front-load interest expense deductions is routinely disallowed. n304

[f] Interest to Carry Tax-Exempt Bonds

Through successful investing or financing, a taxpayer may hold substantial equity in real estate. This equity may be refinanced with the proceeds used to purchase other investments. Frequently, tax-exempt securities are attractive investments for high-bracket taxpayers. However, the unwary investor may be caught in a potential tax trap, because the interest on indebtedness incurred to purchase or carry securities producing tax-exempt interest income is not deductible. n305 This rule could apply even to indebtedness secured by real estate. Any time a portfolio of investments includes tax-exempt securities and there are liabilities that are not directly traceable to personal or business activities, the Service may seek to establish that a portion of the taxpayer's interest expense is not deductible. n306

Taxpayers have successfully argued that interest on purchase money financing for real estate should not generally be disallowed even if the taxpayer also carries tax-exempt securities. This has been true because purchase money financing is the customary method of acquiring real estate. n307

[g] Allocation of Interest Expense From Pass-Through Entities

The IRS has provided guidance concerning the tax treatment under the various deduction limitations applicable to interest, of interest expense relating to debt incurred by pass-through entities (S corporations and partnerships). n308 Generally, the interest should be allocated among the assets of the entity using any reasonable method (e.g., pro rata based on fair market value, adjusted basis, etc.) and take its tax characterization from the tax characteristics of those entities. To the extent that debt is incurred for a contribution to the capital of a pass-through entity, the taxpayer has the additional option of tracing the debt proceeds to the expenditures of the entity under the interest tracing rules. Therefore, the character of the interest expense as passive or investment interest will be determined by the character of the assets to which it is allocated.

Interest expense on debt-financed distributions by pass-through entities will be allocated in accordance with the owner's use of the distributed proceeds. The partner or S corporation shareholder receiving such a distribution is essentially

treated as receiving the loan proceeds from the entity's debt. Therefore, the character of the interest expense allocated to that partner or shareholder is determined by his use of the proceeds distributed.

Example:

ABC Partnership borrows \$300,000 at 10 percent interest and distributes debt proceeds of \$100,000 to partner A. A then uses \$60,000 to purchase an interest in a real estate limited partnership and \$40,000 to purchase a new car. In accordance with the general rule, \$6,000 (60 percent of the \$10,000 in pass-through interest expense from ABC) will be deemed from a passive activity and \$4,000 (40 percent of the \$10,000 in pass-through interest) will be treated as personal interest.

In addition to the general rule, a pass-through entity may allocate distributed debt proceeds and interest expense to other expenditures of the entity for the taxable year in which the distribution was made, with any excess allocated under the general rule above.

[h] Self-Charged Interest Provisions

If a partnership or S corporation uses funds borrowed from its partners or shareholders to make passive activity expenditures (for example, to purchase rental real estate), the entity's interest expense and each owner's share of the interest expense generally must be treated as a passive activity deduction. n308.1 Yet, income from interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business does not qualify as passive income, but is instead portfolio income. n308.2 Because passive activity deductions cannot offset portfolio income, absent any specific relief, the owner cannot deduct the passive interest expense from the portfolio income earned from the loan. In substance, however, the owner has simply paid interest to itself.

The regulations provide relief for such loans and allow partners and S corporation shareholders to offset nonpassive interest income and passive interest deductions from the same loans. n309 This is accomplished by allowing the lending partner or shareholder to recharacterize nonpassive interest income from the loan as passive income to the extent of the taxpayer's allocation of passive interest expense from the same transaction. The recharacterized amounts of interest income are determined under formulas designed to prevent them from exceeding the taxpayer's interest income or passive interest deductions from the self-charged lending transaction. n309.1 Regulations also clarify that lending transactions to which the self-charged rules apply include guaranteed payments for the use of capital under *IRC* § 707(c). n309.2

The self-charged interest provisions also apply to transactions other than loans from partners or shareholders to a partnership or S corporation. The self-charged rules apply to loans *from* an S corporation or partnership *to* its shareholders or partners. n309.3 They also apply to lending transactions between identically owned passthrough entities (i.e. where each owner of the borrowing entity has the same proportionate ownership interest in the lending entity). n309.4

Taxpayers may avoid application of the self-charged interest rules if the passthrough entity makes an election for its taxable year to do so. The manner and timing of the election are specified in the regulations. The election may be revoked only with the consent of the Commissioner. n309.5

There are several limitations to the self-charged interest provisions: n309.6

- they apply only to self-charged items recognized in the same taxable year; n309.7
- they do not contain any special rules for capitalized items;

- they do not apply to non-loan transactions involving rental real estate activities, such as the payment of management fees and salaries; and
- they do not apply to transactions between entities other than S corporations and partnerships, such as trusts, estates, REMICs, or housing cooperatives.

[i] Other Limitations on Interest Expense

Other limitations on the interest deduction are discussed elsewhere in this volume. These include construction period interest, Chapter 3; interest paid from loan proceeds, Chapter 12; interest paid to carry property, Chapter 10; and qualified residence interest, Chapter 9.

[3] Real Property Taxes

[a] In General

A deduction is allowed for state, local and foreign real property taxes and for state and local (but not foreign) personal property taxes. The deduction is allowed in the tax year in which the taxes are paid or accrued. The deduction is allowed whether or not the tax is incurred in connection with a trade or business or income-producing activity. n310

A cash-basis taxpayer deducts property taxes, other than those incurred during a construction period, when paid whether the liability is prepaid or represents a significant amount of past-due taxes. A cash-basis taxpayer may deduct prepaid real property taxes only by establishing that the prepayment represents assessed, rather than estimated, taxes, and that the taxes are due in the year they are paid. n310.1 However, significant deductions based on prepaid property taxes generally cannot be generated because, to be deductible, the payment must be for either an actual personal liability of the taxpayer or a lien on the property at the time of the payment, n311 whereas real property taxes are generally not a personal liability of the property owner and such taxes are generally not a lien on the property until assessed or due.

If the property is purchased during the year, the property taxes must be allocated between the buyer and the seller. n311.1 This statutory apportionment rule applies whether or not the purchaser and seller apportion the tax. n311.2 A purchaser who pays real property taxes that are allocated to the seller cannot deduct them, n311.3 but must capitalize them and add them to the basis of the acquired property. n311.4 It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is any way intended to reflect, real estate taxes allocable to the seller. n312 Similarly, if a lender pays property taxes that accrued before it forecloses and takes title, those payments become an additional cost of the property. n313

Apparently, either a tenant-in-common or a co-owner of an undivided interest in real property can pay the entire property tax expense and claim the deduction. n313.1 This is a sensible rule even when the property taxes do not become a personal liability of the owners because a co-owner may need to pay the entire taxes on a parcel of property in order to protect a partial interest in that property when the other co-owners are insolvent or simply refuse to pay taxes.

Real property taxes may be deducted only by the taxpayer upon whom they are imposed, n314 or by a beneficial or equitable owner of the property, when legal title is held by another person. n314.1 Thus, a taxpayer who is not a legal or equitable owner, cannot deduct real property taxes. n314.2 Real property taxes that are not deductible under *IRC Section 164* because they are paid by a non-owner may, nevertheless, be deductible under *IRC Section 162* if the payment is an ordinary and necessary expense of the taxpayer's trade or business. This could occur if nonpayment of the taxes would have a direct and proximate adverse consequence to the taxpayer's own business. n314.3 Using this rationale, the Tax Court in one case reluctantly allowed a taxpayer to deduct its payment of real property taxes owed by a partnership in which he held an interest through an S corporation. n314.4 In another, the court allowed a real estate professional who held a mortgage and deed of trust in a parcel of land owned by the borrower to deduct property taxes he paid on the

parcel. The borrower had filed for bankruptcy and payments on the mortgage had stopped. The taxpayer paid the tax to forestall seizure of the property in satisfaction of the borrower's tax liability. n314.5

In order to prevent a default in the payment of property taxes, lenders sometimes require use of an impound account. The owner's monthly payment for debt service will also include a pro rata payment for property taxes, which the lender accumulates to pay for the taxes when due. A cash-basis owner is entitled to a deduction only when payment is made by the lender to the taxing authority. n315

An accrual-basis taxpayer can use either of two methods to deduct property taxes: the lien date method or a ratable method pursuant to a Section 461(c) election. Under the lien date approach, the taxes can be deducted when the tax becomes either a personal liability or a lien on the property. n316 Because the lien date often precedes the payment date by several months, this is a good way to accelerate the deduction. Under the ratable method, if a Section 461(c) election is properly made, the accrual-basis taxpayer may deduct the property taxes ratably over the period to which they relate. n317

A Section 461(c) election may be made without the consent of the Commissioner for the first taxable year in which the taxpayer incurs real property taxes. n318 A separate election may be made for each separate trade or business (or each separate non-business activity, if accounted for separately). To make an election for any other period, or to revoke an election, the taxpayer must obtain the consent of the Commissioner by submitting a request for permission to make an election to the IRS within 180 days after the beginning of the taxable year to which the election is first applicable. n319 However, the Service first announced that a Section 461(c) election, or revocation of such an election, for the 1991 taxable year could be made without the consent of the Commissioner n320 as long as the procedures set out in *Revenue Procedure 92-28* were followed. n321 Thereafter, these procedures were extended to apply to accrual method taxpayers that wish to make such an election for their first taxable years beginning after December 31, 1992. n322

A taxpayer that prepays its taxes in response to a prepayment discount from the local government is entitled to deduct the entire amount of taxes, i.e., prepayment discount plus cash prepayment; however, the discount must be included in taxable income. n323

Only property taxes must benefit the general public welfare and be levied at a uniform rate against all property over which the taxing authority has jurisdiction will be deductible. Assessments for local benefits such as streets, sidewalks, sewers, and similar improvements are not deductible even if an incidental benefit may inure to the general public. n323.1 Nondeductible assessments generally are capitalized and treated as part of the property's costs and may be taken into account in determining gain or loss on the sale of the property.

Legal fees connected with real property taxes are also deductible. In one case, the Tax Court allowed a deduction for fees paid for the preparation and filing of an abatement request with the assessor regarding non-business real property taxes. The fees were deductible under *IRC Section 212(3)* because they were incurred in the connection with the determination, collection or refund of a tax. They were deductible, however, only as a miscellaneous itemized deduction, subject to the 2-percent floor applicable to those deductions. n324

[b] Temporary Additional Standard Deduction for Real Property Taxes

A temporary provision which applies only to taxable years beginning in 2008 or 2009 allows an additional standard deduction for state and local property taxes for taxpayers who do not itemize deductions. n324.1 The provision increases an individual taxpayer's standard deduction for a taxable year beginning in 2008 or 2009 by the lesser of (1) the amount allowable to the taxpayer as a deduction for State and local real property taxes, or (2) \$500 (\$1,000 in the case of a joint return). n324.2 No taxes deductible in computing adjusted gross income are taken into account in computing the increased standard deduction. n324.3

[4] Operating Expenses

Operating expenses such as utilities, repairs and maintenance, management, rent, accounting, clerical, advertising, and general and administrative expenses are normally deducted when paid by a cash-basis taxpayer or when incurred by an accrual-basis taxpayer. These expenses are deductible whether the property is held for use in a trade or business or held for investment. Any amount deducted must be ordinary and necessary. n324.4 For example, rent payments paid in excess of the fair market of the property may not be nondeductible, if they are in fact something else, such as a disguised dividend. Rental agreements between related parties are subject to close scrutiny. n324.5

A frequent question is how far in advance can a cash-basis taxpayer pay operating expenses and still claim a deduction when paid. One appellate court adopted a test that asks whether the benefit of the expenditure extends substantially beyond the close of the taxable year. The court apparently measured "substantially beyond" as one year from the time the payment was made. Thus, a cash-basis taxpayer was allowed to deduct a one-year rental payment that extended 11 months beyond the close of the taxpayer's year-end. n325 However, this rule may not be accepted in other courts or by the Service.

[5] Payments to Related Parties

Special rules apply to limit or defer deductions for payments to related parties. One set of rules applies to related taxpayers with different accounting methods. Thus, expenses otherwise deductible under an accrual method payable to a related party on a cash method may only be deducted as of the day the amount is included in income of the person to whom the payment is made. n326 A frequent situation is one where an accrual-basis corporation accrues interest on a debt to a cash-basis shareholder holding more than 50 percent of the corporate stock. If the debtor-corporation has a calendar year-end, the interest accrued to the shareholder but unpaid at December 31 will not be deductible currently unless paid by that date; if not paid currently, deductibility will be deferred until the subsequent year during which payment is made. Rules detailing what constitutes a related party, which are set forth in *IRC Sections 267(b) and (c)*, are complex and should be reviewed each time real estate transactions occur within a closely controlled group.

The Service also has a very broad power to reallocate items of income and expense between controlled organizations, trades, or businesses if necessary in order to clearly reflect the income of the entities. n327 Payments to related parties should always approximate similar arm's-length transactions, or the Service can argue that the true economic substance of the transaction is disguised, and then recast the transaction. For example, if a father rents property from his son and pays him an extraordinarily high rate of rent, the Service may assert that a portion of the rent is a disguised nondeductible gift.

[6] Economic Performance

For accrual method taxpayers, liabilities are incurred and taken into account for tax purposes only when the following conditions are met: n328

- (1) all events have occurred that establish the fact of liability;
- (2) the amount can be determined with reasonable accuracy; and
- (3) economic performance has occurred with respect to the liability.

Economic performance generally occurs when the activities giving rise to the taxpayer's obligation are actually performed. n329 If a taxpayer's liability arises out of the providing of services or property to the taxpayer by another, economic performance occurs as the services or property are provided. n330 If a taxpayer's liability arises out of the use of property provided to the taxpayer, economic performance occurs ratably over the period of time the taxpayer is

entitled to use the property, unless the taxpayer's liability is more appropriately determined by reference to the frequency or volume of use of the property or the income from the property. n331 See also Chapter 11 for a detailed discussion of economic performance. For example, in the case of rent, economic performance is deemed to occur as the property is used by the taxpayer; in the case of merchandise, salaries or payments to contractors, economic performance is deemed to occur when the merchandise or service is provided.

[7] Rental Expenses as Offset to Self-Employment Income

A taxpayer cannot offset losses from a real estate rental business against other self-employment income when computing income subject to the self-employment tax unless the taxpayer is in the trade or business of being a real estate dealer. n332 In computing self-employment income, any deductions attributable to rentals from real estate must, therefore, be excluded unless the rentals are received in the course of a trade or business as a real estate dealer. n333

[8] Rental Expenses When Taxpayer Has Title or Equity in Property

Rent paid by a taxpayer is deductible as a business expense only with respect to property to which the taxpayer has not taken and is not taking title, or in which the taxpayer has no equity. n334 This rule prevents a taxpayer from deducting rent paid for property that is actually being purchased. The rule has been applied to disallow a deduction to a sole proprietor for one-half of the rent paid on property he owned with his wife as tenants by the entirety. n335

[9] Expenditures to Remove Architectural and Transportation Barriers

A taxpayer may elect to expense, rather than capitalize, qualified architectural and transportation barrier removal expenditures of up to \$15,000 per year. n335.1 A current deduction is allowed for the expenditures for which the election is made. n335.2 Qualified expenditures include those for the purpose of making any facility or public transportation vehicle owned or leased by the taxpayer for use in connection with the taxpayer's trade or business more accessible to, and usable by, handicapped and elderly individuals. n335.3 Handicapped individuals include those with physical or mental disabilities (including blindness or deafness) that are a functional limitation to employment or which substantially limit one or more major life activities. n335.4 Barrier removal expenditures are deductible only if the taxpayer establishes that the resulting removal of the barrier(s) meets the standards promulgated by the Secretary with the concurrence of the Architectural and Transportation Barriers Compliance Board and set forth in regulations. n335.5

The election is made by claiming the deduction as a separate item identified as such on the taxpayer's timely filed (including extensions) income tax return for the taxable year for which the election is to apply. n335.6 The election applies to all qualifying expenditures made and is irrevocable after the date by which the election must have been made. n335.7 The taxpayer must keep supporting records and documentation, including any adjustments to basis made for expenditures in excess of the amount deductible. n335.8

COMMENT:

A separate credit is available for certain expenditures by small businesses to provide access to disabled individuals. n335.9 See Chapter 5 for a discussion.

[10] Energy Efficient Commercial Building Property Deduction

[a] In General

A current deduction is allowed for the cost of "energy efficient commercial building property" placed in service during the taxable year. n335.10 The maximum deduction allowed with respect to any building for a tax year is the excess (if

any) of the product of \$1.80 times the square footage of the building, over the aggregate amount of the deductions under *IRC Section 179D(a)* with respect to the building for all prior taxable years. n335.11

Usually, the owner of the building who places the qualified property in service will be the taxpayer entitled to the deduction. n335.12 For qualifying property installed on or in property owned by a federal, state, or local government or a political subdivision thereof, however, the Secretary is ordered to promulgate a regulation to allow the allocation of the deduction to the person primarily responsible for designing the property in lieu of the owner of the property. That person will be treated as the taxpayer for purposes of the deduction. n335.13

If a deduction is allowed under *IRC Section 179D* with respect to any energy efficient commercial building property, the basis of that property must be reduced by the amount of the deduction so allowed. n335.14

[b] "Energy Efficient Commercial Building Property" Defined

Only the cost of "energy efficient commercial building property" is eligible for the deduction. n335.15 This includes property installed in connection with a building's interior lighting, heating, cooling, ventilation, or hot water systems, and property installed as part of a building envelope. n335.16 The property must be depreciable or amortizable and must be installed on or in a building located in the U.S. n335.17 It must also fall within a specified engineering standard of property. n335.18

Finally, the property must generally be certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets certain minimum requirements. n335.19 Certification procedures are to be established by the Secretary. n335.20 An alternative certification requirement may apply for property installed in systems that meet energy-savings targets to be established by the Secretary in regulations. Only a partial deduction is permitted, however, if this alternative certification is used. n335.21

The IRS has set forth in *Notice 2006-52* a process that allows a taxpayer who owns a commercial building and installs property as part of the commercial building's interior lighting systems, heating, cooling, ventilation, and hot water systems, or building envelope to obtain a certification that the property satisfies the statutory energy efficiency requirements. n335.22 The notice also provides for a public list of software programs that may be used in calculating energy and power consumption for purposes of *IRC Section 179D*. n335.23

[c] Availability of Partial Deduction

A partial deduction under *IRC Section 179D* may be available for property that is not certified in accordance with *IRC Section 179D(c)(1)(D)* and *IRC Section 179D(d)(6)*, but which is certified as complying with energy-savings targets established by the Secretary for interior lighting, heating, cooling, ventilation, and hot water systems. n335.24 The maximum deduction allowed with respect to any building for a tax year when this alternative certification is used is the excess (if any) of the product of \$.60 times the square footage of the building, over the aggregate amount of the deductions under *IRC Section 179D(a)* with respect to the building for all prior taxable years. n335.25

[11] Soil and Water Conservation Expenditures, and Endangered Species Recovery Expenditures

Farmers may deduct, rather than capitalize, expenditures for soil and water conservation of farmland, or for the prevention of erosion of farmland. n335.26 The amount deductible cannot exceed 25 percent of the gross income derived from farming during the year. Any excess may be carried forward to future years. n335.27 Farmers may also deduct qualified expenditures for endangered species recovery. n335.28

Farmers may also elect to deduct costs of fertilizers and similar items used to enrich, neutralize, or condition land used

in farming, and costs of applying those materials to land. n335.29

FOOTNOTES:

(n1)Footnote 208.7. *Sandoval, Jr v Commr, TC Memo 2001-310*, *affd on other grounds* 67 *Fed. Appx.* 252 (5th Cir 2003); *Prince Trust v Commr*, 35 TC 974 (1961).

(n2)Footnote 209. See, eg, *Beck v Commr, TC Memo 1994-122* (cost of replacement carpeting for rental units may be deducted).

(n3)Footnote 210. *Id* (cost of new fence must be capitalized); *Vest v Commr, TC Memo 1993-243*, *affd* 96-2 *USTC* P 50,573 (7th Cir 1996) (construction costs for temporary structure that was demolished two years later, and architect retainer fee must be capitalized); *Hearne v US*, 71 *AFTR2d* 93-1994, 1993-1 *USTC* P 50,334 (WD Tex 1993) (improvements, including new fences, roads, clearing of rocks and trees, replacement of sheds and barns must be capitalized).

(n4)Footnote 211. *Vanalco, Inc v Commr, TC Memo 1999-265*, *affd* 300 *F3d* 1023 (9th Cir 2002); *Schroeder v Commr, TC Memo 1996-336*; *Stark v Commr, TC Memo 1999-1* (cost of new roof and new gate had to be capitalized).

(n5)Footnote 211.1. *Plainfield-Union Water Co v Commr*, 39 TC 333 (1962); see *Vanalco, Inc v Commr, TC Memo 1999-265*, *affd* 300 *F3d* 1023 (9th Cir 2002); *Norwest Corp & Subs v Commr*, 108 TC 265 (1997).

(n6)Footnote 211.2. *Wolfsen Land & Cattle Co v Commr*, 72 TC 1 (1979).

(n7)Footnote 211.3. *Treas Reg* § 1.162-4; see *Trask v Commr, TC Memo 2010-78* (2010).

(n8)Footnote 212. *IRC* § 162.

(n9)Footnote 213. *IRC* § 112.

(n10)Footnote 214. *Trask v Commr, TC Memo 2010-78* (2010) (no deduction allowed for unsubstantiated repair expenditures); *Obot v Commr, TC Memo 2005-195*; *Brodsky v Commr, TC Memo 2001-240*; *Novoa v Commr, TC Memo 1998-192*; *Drake v Commr, TC Memo 1997-487*; *Blythe v Commr, TC Memo 1999-11*; see *Cohan v Commr*, 39 *F2d* 540 (2d Cir 1930).

(n11)Footnote 214.1. *INDOPCO, Inc v Commr*, 503 *US* 79 (1992); *Plainfield-Union Water Co v Commr*, 39 TC 333 (1962); *Vanalco, Inc v Commr, TC Memo 1999-265*, *affd* 300 *F3d* 1023 (9th Cir 2002); *Norwest Corp & Subs v Commr*, 108 TC 265 (1997).

(n12)Footnote 214.2. See *Vanalco, Inc v Commr, TC Memo 1999-265*; *Badger Pipe Line Co v Commr, TC Memo 1997-457*; *Jordan v Commr, TC Memo 2000-206* (cost of new barn or substantial improvement to one must be capitalized).

(n13)Footnote 214.3. *Tsakopoulos v Commr, TC Memo 2002-8*, *affd on other grounds* 2003-1 *USTC* P 50,513 (9th Cir 2003). Roofing work is sometimes characterized as a repair, but only if the repair is of a recurring nature, part of a regular maintenance program, or necessary due to storm damage. See *Vanalco, Inc v Commr, TC Memo 1999-265*, *affd* 2002-2 *USTC* P 50,583 (9th Cir 2002) (replacement of 10.6 percent of roof was deductible repair); *Pierce Estates, Inc v Commr*, 16 TC 1020 (1951); *Thurner v Commr*, 11 *TCM* 42 (1952); *Pontel Family Estate v Commr, TC Memo 1981-303*; *Rev Rul* 2001-4, 2001-1 *CB* 295.

(n14)Footnote 214.4. *Wilson v Commr, TC Memo 2002-61*.

(n15)Footnote 214.5. *Ltr Rul* 200607003.

(n16)Footnote 215. *Ruttenberg v Commr*, TC Memo 1986-414 ; *Smiley v Commr*, TC Memo 1999-390 .

(n17)Footnote 216. *US v Wehrli*, 400 F2d 686 (10th Cir 1968) ; *Stoeltzing v Commr*, 266 F2d 374 (3d Cir 1959) ; *Jones v Commr*, 242 F2d 616 (5th Cir 1957) ; *California Casket Co v Commr*, 19 TC 32 (1952) ; *Norwest Corp & Subs v Commr*, 108 TC 358 (1997) ; see *Schroeder v Commr*, TC Memo 1996-336, 72 TCM 185 (1996) ; *Rutter v Commr*, TC Memo 1986-407 ; *Jackson v Commr*, TC Memo 1994-106 (repairs that are part of a plan of rehabilitation to convert condemned, uninhabitable real property into viable rental property must be capitalized); *Trask v Commr*, TC Memo 2010-78 (2010) .

(n18)Footnote 217. *Moss v Commr*, 831 F2d 833 (9th Cir 1987) .

(n19)Footnote 218. *US v Wehrli*, 400 F2d 686 (10th Cir 1968) ; *Vanalco, Inc v Commr*, TC Memo 1999-265 , *affd sub nom Smith v Commr* 300 F3d 1023 (9th Cir 2002) .

(n20)Footnote 219. *IRC § 198*.

(n21)Footnote 220. *IRC § 198(h)*.

(n22)Footnote 221. See Rev Proc 98-47, 1998-2 CB 319 . The IRS may grant extensions for making an election under *IRC § 198* (*Ltr Rul 200229031* ; *Ltr Rul 200614007*).

(n23)Footnote 222. *IRC § 198(b)(1)*.

(n24)Footnote 223. *IRC § 198(b)(2)*.

(n25)Footnote 224. *IRC § 198(d)*.

(n26)Footnote 225. Pub Law No 109-432, 109(c).

(n27)Footnote 226. *IRC § 198(d)(1)(B)*.

(n28)Footnote 227. See Public Law 106-554, § 162(c).

(n29)Footnote 228. *IRC § 198(c)(1)*.

(n30)Footnote 229. *IRC § 198(c)(2)*.

(n31)Footnote 230. *IRC § 198(c)(3)*; see *IRC § 198(a)(1)(B)*.

(n32)Footnote 231. See [ii], below, for a discussion.

(n33)Footnote 232. See Public Law 106-554, § 162(c).

(n34)Footnote 233. *IRC § 198(c)(1)*, before amendment by Public Law 106-554, § 162.

(n35)Footnote 234. See Public Law 106-554, § 162(c).

(n36)Footnote 235. *IRC § 198(c)(2)*, before amendment by Public Law 106-554, § 162.

(n37)Footnote 236-238. Reserved.

(n38)Footnote 239. *IRC § 198(h)*. See [i], above, for a discussion.

(n39)Footnote 239.1. See Rev Proc 94-38, 1994-1 CB 35 .

(n40)Footnote 239.2. *Rev Rul 2004-18, 2004-1 CB 509* ; see § 4.01[1][b][iii], below, for a discussion.

(n41)Footnote 240. TAMs 9240004, 9315004. *TAM 9315004* noted that it would be given further consideration in connection with a study project on environmental cleanup costs.

(n42)Footnote 240.1. *Dominion Resources, Inc v US, 219 F3d 359 (4th Cir 2000)* .

(n43)Footnote 240.2. *Id.*

(n44)Footnote 240.3. *Cinergy Corp v US, 55 Fed Cl 489 (US Ct of Fed Claims 2003)* .

(n45)Footnote 240.4. *FSA 200035021* .

(n46)Footnote 241. *Rev Rul 94-38, 1994-1 CB 35* .

(n47)Footnote 242. *TAM 9627002* , *revq TAM 9541005* .

(n48)Footnote 243. See *Rev Rul 80-245, 1980-2 CB 72* .

(n49)Footnote 244. See *Commr v Tellier, 383 US 687 (1966)* ; *Commr v Heiniger, 320 US 467 (1943)* .

(n50)Footnote 244.1. *Rev Rul 98-25, 1998-1 CB 998* .

(n51)Footnote 244.2. *Ltr Rul 199952075* ; see *Rev Rul 94-38, 1994-1 CB 35* .

(n52)Footnote 244.3. *Ltr Rul 199952075* .

(n53)Footnote 244.4. *Ltr Rul 199952075* .

(n54)Footnote 244.5. *Ltr Rul 200108029* .

(n55)Footnote 244.6. *United Dairy Farmers, Inc v US, 107 F Supp 2d 937 (SD Ohio 2000)* , *affd 267 F3d 510 (6th Cir 2001)* .

(n56)Footnote 244.7. *United Dairy Farmers, Inc v US, 267 F3d 510 (6th Cir 2001)* .

(n57)Footnote 244.8. *Cinergy Corp v US, 55 Fed Cl 489 (US Ct of Fed Claims 2003)* .

(n58)Footnote 244.9. *Id.*

(n59)Footnote 244.10. *Id.*

(n60)Footnote 244.11. Chief Counsel Memorandum 20071801F (May 4, 2007), *citing Treas Reg § 1.461-1(a)(2); IRC § 461(h)(2)(A)(i)*.

(n61)Footnote 244.12. *Rev Rul 2007-3, 2007-4 IRB 350* .

(n62)Footnote 244.13. See *Treas Reg § 1.263(a)-4(d)(3)*.

(n63)Footnote 244.14. Chief Counsel Memorandum 20071801F (May 4, 2007).

(n64)Footnote 244.15. *United Dairy Farmers, Inc v US, 267 F3rd 510 (6th Cir 2001)* .

(n65)Footnote 244.16. Chief Counsel Memorandum 20071801F (May 4, 2007).

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(n66)Footnote 244.17. *FSA 199942025* .

(n67)Footnote 245. *Norwest Corporation and Subsidiaries v Commr*, 108 TC 265 (1997) .

(n68)Footnote 246. *Norwest Corporation and Subsidiaries v Commr*, 108 TC 265 (1997) ; see *US v Wehrli*, 400 F2d 686 (10th Cir 1968) ; *Stoeltzing v Commr*, 266 F2d 374 (3d Cir 1959) ; *Jones v Commr*, 242 F2d 616 (5th Cir 1957) ; *California Casket Co v Commr*, 19 TC 32 (1952) .

(n69)Footnote 247. *Norwest Corporation and Subsidiaries v Commr*, 108 TC 265 (1997) .

(n70)Footnote 247.1. *Ltr Rul 199952075* , citing *Moss v Commr*, 831 F2d 833 (9th Cir 1987) ; *Rev Rul 70-392*, 1970-2 CB 33 .

(n71)Footnote 247.2. *Ltr Rul 199952075* .

(n72)Footnote 248. *1980-2 CB 31* .

(n73)Footnote 249. See *Rev Rul 79-264*, 1979-2 CB 92 .

(n74)Footnote 249.1. *Dominion Resources, Inc v US*, 48 F Supp2d 527 (ED Va 1999) , *affd* 219 F3d 359 (4th Cir 2000) .

(n75)Footnote 250. *Treas Reg § 301.7704-4(e)(1)*.

(n76)Footnote 251. See *Treas Reg § 1.468B-1(a)*.

(n77)Footnote 252. See *Treas Reg § 301.7701-4(e)*.

(n78)Footnote 252.1. *Ltr Rul 200108029* .

(n79)Footnote 252.2. *Rev Rul 2004-17*, 2004-1 CB 516 ; *Reynolds Metals Co v US*, 389 F Supp 2d 692 (ED Va 2005) ; *Alcoa, Inc v US*, 406 F Supp 2d 580 (WD Pa 2005) . *affd* 509 F3d 173 (3d Cir 2007) .

(n80)Footnote 252.3. *Rev Rul 2004-18*, 2004-1 CB 509 .

(n81)Footnote 252.4. *Id.*

(n82)Footnote 252.5. *Rev Rul 94-38*, 1994-1 CB 35 , discussed in § 4.03[1][b][ii], above.

(n83)Footnote 252.6. See *Rev Rul 98-25*, 1998-1 CB 998 , discussed in § 4.03[1][b][ii], above.

(n84)Footnote 252.7. *Rev Rul 2004-18*, 2004-1 CB 509 , citing *Treas Reg § 1.263A-1(e)(3)(ii)(l)*.

(n85)Footnote 252.8. *Rev Rul 2004-18*, 2004-1 CB 509 , citing *Treas Reg § 1.263A-1(e)(3)(i)*.

(n86)Footnote 252.9. *Rev Rul 2004-18*, 2004-1 CB 509 .

(n87)Footnote 252.10. *Id.*

(n88)Footnote 252.10.1. *Rev Rul 2005-42*, 2005-28 IRB 67 .

(n89)Footnote 252.10.2. *Rev Rul 2005-42*, 2005-28 IRB 67 .

(n90)Footnote 252.11. *Rev Rul 2005-42*, 2005-28 IRB 67 ; *Rev Rul 2004-18*, 2004-1 CB 509 ; see *Rev Proc 2002-9*, 2002-1 CB 327 , as amplified, clarified, and modified by *Rev Proc 2002-54*, 2002-2 CB 432 and *Rev Proc 2002-19*,

2002-1 CB 696 .

(n91)Footnote 252.12. See *Treas Reg* §§ 1.162-4, 1.263(a)-1(b).

(n92)Footnote 252.13. *Ltr Rul* 200607003 .

(n93)Footnote 253. *IRC* § 172(b)(1)(A)(i).

(n94)Footnote 253.1. *IRC* § 172(b)(1)(C), (f).

(n95)Footnote 253.2. *IRC* § 172(f)(1)(B)(i)(IV), (ii).

(n96)Footnote 253.2.1. See *IRC* § 172(f)(1)(B)(i).

(n97)Footnote 253.2.2. AM 2008-012 (12/19/08). The memorandum was expanded on in IRS Industry Director's Directive #2 on Specified Liability Losses (see LMSB-04-0309-011 (June 6, 2009)).

(n98)Footnote 253.2.3. AM 2008-012 (Dec 19, 2008).

(n99)Footnote 253.3. *IRC* § 172(f)(2).

(n100)Footnote 253.4. See *IRC* § 172(b)(2).

(n101)Footnote 253.5. *IRC* § 172(f)(5).

(n102)Footnote 253.6. *IRC* § 172(f)(6).

(n103)Footnote 253.7. See *United Dairy Farmers, Inc v US*, 267 F3d 510 (6th Cir 2001) , discussed at § 4.03[1][b][ii], above.

(n104)Footnote 253.8. See *IRC* § 172(f)(1)(B)(i).

(n105)Footnote 253.9. Chief Counsel Memorandum 20071801F (May 4, 2007); see *IRC* § 172(f)(1)(B)(i)(IV).

(n106)Footnote 253.10. Chief Counsel Memorandum 20071801F (May 4, 2007).

(n107)Footnote 253.11. Chief Counsel Memorandum 20071801F (May 4, 2007); see *IRC* § 172(f).

(n108)Footnote 253.11.1. See AM 2008-012 (Dec 19, 2008), expanded in IRS Industry Director's Directive #2 on Specified Liability Losses (see LMSB-4-0309-011 (June 19, 2009)).

(n109)Footnote 253.12. Chief Counsel Memorandum 20071801F (May 4, 2007); see *IRC* § 172(f).

(n110)Footnote 253.12.01. See AM 2008-012 (Dec 19, 2008), expanded in IRS Industry Director's Directive #2 on Specified Liability Losses (see LMSB-4-0309-011 (June 19, 2009)).

(n111)Footnote 253.12.02. See AM 2008-012 (Dec 19, 2008), expanded in IRS Industry Director's Directive #2 on Specified Liability Losses (see LMSB-4-0309-011 (June 19, 2009)).

(n112)Footnote 253.12.1. *IRC* § 198A(a).

(n113)Footnote 253.12.2. *IRC* § 198A(b).

(n114)Footnote 253.12.3. *IRC* § 198A(d); see *IRC* § 1245.

(n115)Footnote 253.12.4. See *IRC* § 198.

(n116)Footnote 253.12.5. See *IRC* § 280B.

(n117)Footnote 253.12.6. See *IRC* § 468.

(n118)Footnote 253.12.7. *IRC* § 198A(e).

(n119)Footnote 253.13. *Deputy v Du Pont*, 308 US 488, 23 AFTR2d 808 (1940) .

(n120)Footnote 253.14. *Hynes v Commr*, 74 TC 1266 (1980) ; *Golder v Commr*, 604 F2d 34 (9th Cir 1979) ; *Nelson v Commr*, 281 F2d 1 (5th Cir 1960) ; *Rushing v Commr*, 58 TC 996 (1972) ; *Smith v Commr*, 84 TC 889 (1985) , *affd without publ opinion* 805 F2d 1073 (DC Cir 1986) ; *Adams v Commr*, TC Memo 2010-72 (2010) .

(n121)Footnote 254. *Treas Reg* § 1.163-1(b); *Baird v Commr*, 68 TC 123 (1977) ; *Belden v Commr*, TC Memo 1995-360, 70 TCM 274 (1995) ; *Uslu v Commr*, TC Memo 1997-551 ; *Trans v Commr*, TC Memo 1999-233 ; *Adams v Commr*, TC Memo 2010-72 (2010) .

(n122)Footnote 254.1. *Uslu v Commr*, TC Memo 1997-551 ; *Trans v Commr*, TC Memo 1999-233 .

(n123)Footnote 254.2. *Adams v Commr*, TC Memo 2010-72 (2010) ; *Derr v Commr*, 77 TC 708 (1981) (beneficiary of Illinois land trust had most attributes of ownership).

(n124)Footnote 254.3. *Adams v Commr*, TC Memo 2010-72 (2010) (Michigan law applied to determine taxpayer's property rights to property in a trust because the property was located in Michigan and the trust agreement provided that Michigan law applied).

(n125)Footnote 254.4. *Adams v Commr*, TC Memo 2010-72 (2010) ; *Blanche v Commr*, TC Memo 2001-63 (2001) , *affd* 33 Fed Appx 704 (5th Cir 2002) .

(n126)Footnote 255. *Cao v Commr*, TC Memo 1994-60 , *affd* 78 F3d 594, (9th Cir 1996) (disallowance of deduction for a portion of the loan origination fee upheld where taxpayers failed to show that points related to purchase or improvement of principal residence); *Moore v Commr*, TC Memo 1994-503 ; see [b], below, for a discussion of prepaid interest rules. See *Lange v Commr*, TC Memo 2005-176 (loan origination fee related to refinanced loan could not be amortized because there was no evidence of the loan's term or proof that the loan proceeds were used for business or investment purposes). Points are discussed in detail in Chapter 12.

(n127)Footnote 256. *Rev Rul* 57-198, 1957-1 CB 94 .

(n128)Footnote 257. *Est of Broadhead v Commr*, 391 F2d 841, 21 AFTR2d 851 (5th Cir 1968) .

(n129)Footnote 258. *GCM* 36964 .

(n130)Footnote 259. *New McDermott, Inc v Commr*, 44 BTA 1035 (1941) .

(n131)Footnote 260. *US v Golder, Jr*, 604 F2d 34, 44 AFTR2d 79-5251 (9th Cir 1979) .

(n132)Footnote 261. *Rev Rul* 71-268, 1971-1 CB 58 .

(n133)Footnote 262. *IRC* § 461(g).

(n134)Footnote 263. *Id.*

(n135)Footnote 264. *Jackson v Commr*, TC Memo 2005-159 ; *Rubnitz v Commr*, 67 TC 621 (1977) ; *Novoa v*

Commr, TC Memo 1998-192 ; see IRC § 461(g)(1).

(n136)Footnote 265. *IRC § 461(g)(2).*

(n137)Footnote 265.1. *See IRC § 461(g)(2); Ltr Rul 199905033 .*

(n138)Footnote 266. *1994-1 CB 613 .*

(n139)Footnote 266.1. *See IRC § 461(g).*

(n140)Footnote 266.2. *Dana Corp v US, 174 F3d 1344 (Fed Cir 1999) .*

(n141)Footnote 266.3. *Dana Corp v US, 174 F3d 1344 (Fed Cir 1999) .*

(n142)Footnote 267. *Cleaver v Commr, 158 F2d 342, 35 AFTR2d 517 (7th Cir 1946) .*

(n143)Footnote 268. *Crown v Commr, 77 TC 582 (1981) .*

(n144)Footnote 269. *See Noble v Commr, 79 TC 751 (1982) ; Battelstein v IRS, 631 F2d 1182, 47 AFTR2d 81-390 (5th Cir 1980) .*

(n145)Footnote 270. *IRC § 163(d)(1).*

(n146)Footnote 271. *IRC § 163(d)(2).*

(n147)Footnote 272. *IRC § 163(d)(2).*

(n148)Footnote 273. *Rev Rul 95-16, 1995-1 CB 9 .*

(n149)Footnote 274. *IRC § 163(d)(3)(A).*

(n150)Footnote 275. *IRC § 163(d)(3)(C).*

(n151)Footnote 276. *Rev Rul 93-68, 1993-2 CB 72 .*

(n152)Footnote 277. *Temp Treas Reg § 1.163-8T.*

(n153)Footnote 278. *IRC § 163(d)(4)(A).*

(n154)Footnote 279. *IRC § 163(d)(4)(B).*

(n155)Footnote 279.1. *See IRC § 1(h)(11)(B) for a definition.*

(n156)Footnote 279.2. *IRC § 163(d)(4)(B).* The elective rule for qualified dividends is effective generally for tax years beginning after Dec 31, 2002 and before Jan 1, 2009). Pub Law No 108-27, §§ 302(f), 303 (effective date and sunset date provisions).

(n157)Footnote 280. *Treas Reg § 1.163(d)-1(a).*

(n158)Footnote 281. *Treas Reg § 1.163(d)-1(b).*

(n159)Footnote 282. *Treas Reg § 1.163(d)-1(c).*

(n160)Footnote 283. *IRC § 163(d)(4)(D).*

- (n161)Footnote 284. See *IRC* § 469.
- (n162)Footnote 285. See *IRC* § 163(d)(5)(A)(ii).
- (n163)Footnote 286. *IRC* § 163(d)(4)(C).
- (n164)Footnote 287. *IRC* § 163(d)(4)(D).
- (n165)Footnote 288. *IRC* § 163(d)(5).
- (n166)Footnote 289. See *IRC* § 469(e)(1).
- (n167)Footnote 289.1. *Rosser v Commr, TC Memo 2001-79* .
- (n168)Footnote 290. *IRC* § 163(d)(5)(C).
- (n169)Footnote 291. *IRC* §§ 702(a)(7), 1366(a)(1); *Treas Reg* § 1.702-1(a); *Rev Rul 84-131, 1984-2 CB 37* .
- (n170)Footnote 292. See *IRC* § 163(d).
- (n171)Footnote 293. See *IRC* § 163(d)(4).
- (n172)Footnote 294. *IRC* § 163(d)(4)(C).
- (n173)Footnote 295. See *Christian v Commr, TC Memo 1995-12* .
- (n174)Footnote 296. See *IRC* §§ 67, 163(d)(4).
- (n175)Footnote 297. *IRC* § 483.
- (n176)Footnote 298. *O'Dell v Commr, 26 TC 592 (1956)* , *nonacq 1956-2 CB 10* , *withdrawn, and acquiescence substituted 1963-1 CB 4* .
- (n177)Footnote 299. *IRC* § 1273(a)(2) (definition of "stated redemption price at maturity").
- (n178)Footnote 300. See *Rev Rul 70-647, 1970-2 CB 38* .
- (n179)Footnote 301. *In re NBH Land Co v US, 78-1 USTC P 9358 (D Colo 1978)*.
- (n180)Footnote 302. But see *Est of Ratliff v Commr, 101 TC 276 (1993)* (notes provided that principal was to be paid before interest; Tax Court held notes did not, as a matter of law, control allocation of payments for income tax purposes).
- (n181)Footnote 303. *Mason v US, 453 F Supp 845 (ND Cal 1968)* .
- (n182)Footnote 304. *Rev Rul 83-84, 1983-1 CB 97* ; *Prabel v Commr, 882 F2d 820 (3rd Cir 1989)* ; *Mulholland v US, 28 Fed Cl 320 (Ct Cl 1993)* *affd in unpublished opinion 22 F3d 1105 (Fed Cir 1994)* .
- (n183)Footnote 305. *IRC* § 265(a)(2).
- (n184)Footnote 306. *Rev Proc 72-18, 1972-1 CB 740* , *as clarified by Rev Proc 74-8, 1974-1 CB 419* , *and modified by Rev Proc 87-53, 1987-2 CB 669* ; *Mariorenzi v Commr, TC Memo 1973-141* ; *McDonough v Commr, TC Memo 1977-50* , *aff'd 577 F2d 234 (4th Cir 1978)* .
- (n185)Footnote 307. *Israelson v US, 367 F Supp 1104, 33 AFTR2d 74-451 (D Md 1973)* .

(n186)Footnote 308. *Notice 89-35, 1989-1 CB 675* .

(n187)Footnote 308.1. *IRC § 469(e)(1); Temp Treas Reg § 1.163-8T*.

(n188)Footnote 308.2. *IRC § 469(e)(1)*.

(n189)Footnote 309. *Treas Reg § 1.469-7*.

(n190)Footnote 309.1. *Treas Reg § 1.469-7(a)(1), (c)*.

(n191)Footnote 309.2. *Treas Reg § 1.469-7(a)(1)*.

(n192)Footnote 309.3. *Treas Reg § 1.469-7(d)*.

(n193)Footnote 309.4. *Treas Reg § 1.469-7(e)*.

(n194)Footnote 309.5. *Treas Reg § 1.469-7(g)*.

(n195)Footnote 309.6. See *Treas Reg § 1.469-7*.

(n196)Footnote 309.7. *Treas Reg § 1.469-7(a)(1)*.

(N197)Footnote 310. *IRC § 164(a)(1), (2)*.

(n198)Footnote 310.1. *Estate of Frederick R Hoffman v Commr, TC Memo 1999-395 aff'd 8 Fed Appx 262 (4th Cir 2001)* ; *Hradesky v Commr, 540 F2d 821 (5th Cir 1976)* , *affg per curiam 65 TC 87 (1975)* ; *Lewis v Commr, TC Memo 1983-741* .

(n199)Footnote 311. *Keil Properties v Commr, 24 TC 1113 (1955)* , *acq 1956-1 CB 4* .

(n200)Footnote 311.1. *IRC § 164(d)(1)*.

(n201)Footnote 311.2. See *Treas Reg § 1.164-6(b)(1)(i)*.

(n202)Footnote 311.3. *IRC § 275(5)*.

(n203)Footnote 311.4. *Treas Reg § 1.1012-1(b)*.

(n204)Footnote 312. *Treas Reg § 1.1012-1(b)*.

(n205)Footnote 313. *John Hancock Mut Life Ins v Commr, 10 BTA 736 (1928)* ; *Est of Lucy S Schieffelin v Commr, 44 BTA 137 (1941)* .

(n206)Footnote 313.1. *Powell v Commr, TC Memo 1967-32* .

(n207)Footnote 314. *Treas Reg § 1.164-1(a)*.

(n208)Footnote 314.1. *Estate of Movius v Commr, 22 TC 391 (1954)* .

(n209)Footnote 314.2. *Blanche v Commr, TC Memo 2001-63* ; but see *Griffin v Commr, TC Memo 2002-6* , vacated and remanded *315 F3d 1017 (8th Cir 2003)* , on remand *TC Memo 2004-64* ; *Jones v Commr, TC Memo 2006-176* (lessee not allowed a deduction for property taxes paid under a real property lease-option agreement; the court found that the agreement was an option, and not a purchase or sale agreement, and that the taxpayer did not have an equity ownership interest in the property that supported an property tax deduction).

(n210)Footnote 314.3. See *Hood v Commr*, 115 TC 172 (2000) ; *Lohrke v Commr*, 48 TC 679 (1967) ; *Griffin v Commr*, TC Memo 2002-6 , vacated and remanded 315 F3d 1017 (8th Cir 2003) , on remand TC Memo 2004-64 .

(n211)Footnote 314.4. *Griffin v Commr*, TC Memo 2002-6 , vacated and remanded 315 F3d 1017 (8th Cir 2003) , on remand TC Memo 2004-64 (the result in the case turned largely on a burden of proof issue under IRC § 7491 that the 8th Circuit resolved in favor of the taxpayer).

(n212)Footnote 314.5. *Trask v Commr*, TC Memo 2010-78 (2010) . The Tax Court did not clarify whether the deduction was allowed under IRC § 162 or IRC § 164.

(n213)Footnote 315. *Rev Rul 78-103*, 1978-1 CB 58 .

(n214)Footnote 316. *Treas Reg § 1.461-1(a)(2)*.

(n215)Footnote 317. *IRC § 461(c)(1)*.

(n216)Footnote 318. *Treas Reg § 1.461-1(c)(3)(i)*.

(n217)Footnote 319. *Treas Reg § 1.461-1(c)(3)(ii)*; *Rev Proc 83-77*, 1983-2 CB 594 .

(n218)Footnote 320. *Ann 91-89*, 1991-25 IRB 48 .

(n219)Footnote 321. *Rev Proc 92-28*, 1992-1 CB 745 .

(n220)Footnote 322. *Rev Proc 94-32*, 1994-1 CB 627 .

(n221)Footnote 323. *Consolidated Edison of NY, Inc v US* 10 F3d 68 (2d Cir 1993) .

(n222)Footnote 323.1. *IRC § 164(c)(1)*; *Treas Reg § 1.164-4(a)*.

(n223)Footnote 324. *Craft v Commr*, TC Memo 2005-197 ; see *IRC § 67*.

(n224)Footnote 324.1. *IRC § 63(c)(1)(C)*, (7).

(n225)Footnote 324.2. *IRC § 63(c)(1)(C)*, (7).

(n226)Footnote 324.3. *IRC § 63(c)(7)*.

(n227)Footnote 324.4. *IRC §§ 162, 212*.

(n228)Footnote 324.5. *Hunt & Sons, Inc v Commr*, TC Memo 2002-65 .

(n229)Footnote 325. *Zaninovich v Commr*, 616 F2d 429, 45 AFTR2d 80-1442 (9th Cir 1980) .

(n230)Footnote 326. *IRC § 267(a)(2)*.

(n231)Footnote 327. *IRC § 482*.

(n232)Footnote 328. *Treas Reg §§ 1.446-1(c)(1)(ii)*, 1.461-4(a).

(n233)Footnote 329. *Treas Reg § 1.461-4*.

(n234)Footnote 330. *Treas Reg § 1.461-4(d)(2)*.

(n235)Footnote 331. *Treas Reg § 1.461-4(d)(3)*.

(n236)Footnote 332. *IRC § 1402(a)(1); Mooney v Commr, TC Memo 1993-204, affd without published opinion 97-1 USTC ¶ 50,382 (9th Cir 1997)*. This limitation may not apply to a farmland owner's share cropping revenues; see § 4.02[9] for a discussion of the self-employment tax and rentals from real estate.

(n237)Footnote 333. *IRC § 1402(a)(1)*.

(n238)Footnote 334. *IRC § 162(a)(3)*.

(n239)Footnote 335. *Cox v Commr, TC Memo 1993-326, affd 121 F3d 390 (8th Cir 1997)* (Eighth Circuit implied that no deduction was allowable, but IRS had challenged only half of the deduction).

(n240)Footnote 335.1. *IRC § 190(a), (c)*.

(n241)Footnote 335.2. *IRC § 190(a)(1)*.

(n242)Footnote 335.3. *IRC § 190(b)(1)*.

(n243)Footnote 335.4. *IRC § 190(b)(3)*.

(n244)Footnote 335.5. *IRC § 190(b)(2); see Treas Reg § 1.190-2*.

(n245)Footnote 335.6. *Treas Reg § 1.190-3(a)*.

(n246)Footnote 335.7. *Treas Reg § 1.190-3(b)*.

(n247)Footnote 335.8. *Treas Reg § 1.190-3(c)*.

(n248)Footnote 335.9. *IRC § 44*.

(n249)Footnote 335.10. *IRC § 179D(a)*, effective for property placed in service after Dec 31, 2005 [Pub L No 109-58, § 1331(d)], and before Jan 1, 2014 [*Treas Reg § 1.1031(a)*].

(n250)Footnote 335.11. *IRC § 179D(b)*.

(n251)Footnote 335.12. *See IRC § 179D(a)*.

(n252)Footnote 335.13. *IRC § 179D(d)(4)*.

(n253)Footnote 335.14. *IRC §§ 179D(e), 1016(a)(31)*.

(n254)Footnote 335.15. *IRC § 179D(c)*.

(n255)Footnote 335.16. *IRC § 179D(c)(1)(C)*.

(n256)Footnote 335.17. *IRC § 179D(c)(1)(A), (B)*.

(n257)Footnote 335.18. *IRC § 179D(c)(1)(B)(ii)*. The standard is Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America, as in effect on April 2, 2003 [*IRC § 179D(c)(2)*].

(n258)Footnote 335.19. *IRC § 179D(c)(1)(D)*.

(n259)Footnote 335.20. *IRC § 179D(d)(6)*.

(n260)Footnote 335.21. *IRC § 179D(d)(1)(A)*; see [c], below for a discussion.

(n261)Footnote 335.22. *See IRC § 179D(c)(1), (d).*

(n262)Footnote 335.23. *Notice 2006-52, 2006-1 CB 1175 , amplified by Notice 2008-40, 2008-14 IRB 725 .*

(n263)Footnote 335.24. *IRC § 179D(d)(1)(A)(ii), (B).* These targets are to be set forth in regulations, which have not yet been issued. [*IRC § 179D(d)(1)(B), (g)*]. Interim targets have been set forth in the statute for lighting systems, but these targets are to apply only until regulations are issued [*IRC § 179D(f)*].

(n264)Footnote 335.25. *IRC § 179D(b), (d)(1)(A)(ii).*

(n265)Footnote 335.26. *IRC § 175(a).*

(n266)Footnote 335.27. *IRC § 175(b).*

(n267)Footnote 335.28. *IRC § 175(a), (c)(3)(A),* effective for amounts paid or incurred after 12/31/08 [Pub Law No 110-234, § 15303(c)].

(n268)Footnote 335.29. *IRC § 180(a).*



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Federal Taxes Affecting Real Estate

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CHAPTER 4 Operating and Leasing Real Estate

1-4 Federal Taxes Affecting Real Estate § 4.04

§ 4.04 Leasing: A Financing Tool

Leasing is a tax-oriented method of financing the use of real estate. Numerous business, economic, capital availability, and tax reasons often make leasing a method of financing the use of real property that is more appropriate than purchasing. The source of this type of financing is usually financial institutions and individuals in high tax brackets who desire sound real estate investments. The remaining portion of this chapter focuses on the income tax ramifications of real estate leasing transactions.

[1] Advantages to Lessors

When significant residual values are anticipated, financial institutions are finding that leasing can result in a higher rate of return than traditional lending. In an inflationary economy, many assets have a higher residual dollar value than originally anticipated. Since the residual value of the real estate may substantially increase the profit on an owner-lessor's investment, the effect of residual value should not be overlooked in leasing negotiations.

A primary motive for investing in real estate may be as an inflation hedge. The lease terms are critical to the accomplishment of this objective. For example, if property is subject to a non-escalating 50-year lease, the value of the lease to the lessor will decrease if the rate of inflation increases and the usefulness of the investment in real estate as an inflation hedge will be reduced.

[2] Advantages to Lessees

Conservation of working capital is generally important to the lessee. The lessee may not have the cash available to buy property or may have exhausted normal financing sources, particularly during periods of tight money. Although the lessee may be unable to borrow, it may be able to lease property or may find that leasing has less burdensome cash flow requirements than equity financing. The tax benefits to the lessor and to the lessee depend on the relationship between the depreciation stream and any other tax incentives flowing from the real estate, and the principal amortization required by long-term lenders. If the tax benefits from ownership are substantial, a real estate user that is not able to utilize all of the current tax benefits from direct ownership may trade the tax benefits and the potential residual value in return for a lower carrying cost. Conversely, a high tax bracket real estate user may be willing to forego residual value and pay an even higher periodic rental in exchange for the right to deduct 100 percent of the periodic payment. Finally, a lessee may deduct ordinary and necessary rental payments as a trade or business expense, so long as:

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- (1) the amount is reasonable;
- (2) the lessee has not taken and is not taking title to the property; and
- (3) the lessee has no equity in the property. n336

FOOTNOTES:

(n1)Footnote 336. *IRC § 162(a)(3); Wyson v Commr, TC Memo 1998-128* (deduction denied for excessive rent paid to related corporate lessor).



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§ 4.05 Sale-Leaseback Transactions

The importance of leasing as a financing tool is illustrated in the context of sale-leaseback transactions.

As a special device, a sale-leaseback transaction has a number of tax characteristics of which the prospective seller-lessee and purchaser-lessor should be aware. If properly executed, such a transaction can be used to both tax and financial advantage.

[1] Advantages to a Seller--Lessee

Ordinarily, the sale of real property used in a business or held for the production of income will result in a capital gain, or an ordinary loss, unless the "sale" is consummated as part of a like-kind exchange under *IRC Section 1031*. (See § 8.01, *infra*.) (The gain may be "recaptured" as ordinary income when accelerated depreciation has been claimed.) n337 A leaseback results in rental payments that are deductible from ordinary income by the seller/lessee. The capital gain/ordinary income tax rate differential provides increased incentives for the seller to consummate sale-leaseback transactions. n338

An advantage to the seller is the generation of working capital (namely, the sale proceeds) that is, perhaps, not otherwise available. The seller may obtain the full market value of the property, or even a premium, depending upon the terms of the accompanying lease. Naturally, these proceeds are offset by the applicable income tax liability on any gain recognized on the sale that is not sheltered by other losses or credits.

Because the rent will generally be established at a rate that takes into account the full value of the property, including the land, the seller may, through rental payments, obtain a tax deduction for the value of the land. In contrast, no similar deduction would be available if the property were retained and only the buildings were depreciated. This results because the rental payments under the accompanying lease are fully deductible by the lessee, even though the rentals include amounts attributable to the value of the land.

A seller/lessee that desires to retain the right to use the property upon termination of the lease may wish to negotiate for a purchase option in the lease agreement. The buyer-lessor may be willing to grant such an option if its yield will be satisfactory on an overall basis even if the option is exercised. Such an option, however, depending upon its terms and other facts and circumstances, may cause the Service to disregard the sale and leaseback form of the transaction and

consider it a loan. n338.1 Fundamentally, a sale-leaseback converts present equity to cash, for which the seller has more profitable uses in mind than a continuing investment in real estate.

[2] Advantages to a Buyer--Lessor

Aside from pure investment considerations, a major advantage to the buyer sometimes lies in the tax aspects. If the depreciation deduction is in excess of the principal payment, then the buyer has an opportunity to shelter the rental income and possibly other sources of passive activity income. n339 However, current depreciation rates for real estate, particularly non-residential real estate, make this an unlikely tax benefit scenario. However, from an economic perspective, at the termination of the initial lease, the buyer may have recovered its initial investment in the property, and may lease the property again, sell it, or engage in a sale/leaseback of the property. The particular decision will depend on the market conditions and the buyer's capital needs, among other factors.

[3] Limitations on Tax Benefits

The Code contains a restriction that may prevent the parties to a sale-leaseback transaction from concocting a rent schedule that maximizes their tax benefits. *IRC Section 467* contains rules that prohibit the front loading of rent in certain specific transactions, including a "disqualified leaseback." This term is defined as a leaseback transaction in which tax avoidance is a principal purpose of an increasing rent schedule. n340

[4] Sale-Leaseback Between Related Parties

Some special problems may arise when the parties to a sale-leaseback transaction are related. Any gain on the sale of real property subject to depreciation between a partnership and its controlling partner or two partnerships under common control would be ordinary income, not capital gain. n341 Similarly, a loss on a sale between related parties (including, but not limited to, the controlled partnerships described above) will be disallowed to the seller/lessee and, although the related buyer-lessor may be entitled to benefit from the disallowed loss, that benefit is available to the buyer-lessor when the property is eventually sold to an unrelated party. n342

FOOTNOTES:

(n1)Footnote 337. *IRC §§ 1231, 1245, 1250.*

(n2)Footnote 338. See *IRC § 1(a), (b), (c), (h), (i).*

(n3)Footnote 338.1. See § 4.06[1] for a discussion.

(n4)Footnote 339. See *IRC § 168.*

(n5)Footnote 340. *IRC § 467(b)(4);* see § 4.02[3] for a discussion of *IRC § 467.*

(n6)Footnote 341. *IRC § 707(b)(2).*

(n7)Footnote 342. *IRC § 267(a), (d).*



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§ 4.06 Evaluating the Validity of Sale-Leaseback and Other Leasing Transactions

[1] Sale-Leaseback Transactions

A basic tax issue in a sale-leaseback arrangement is whether the transaction will be treated as a sale-leaseback, with the buyer being treated as the owner-lessor of the property and the seller being treated as the lessee, or instead will be treated as a financing arrangement for tax purposes, with the "buyer" being treated as a lender. If the transaction is held to be a financing arrangement, payments between the parties will be treated as loan payments, rather than as rent. In such a situation, the buyer/lessor would treat the lease payments as loan amortization and interest income and would not be allowed to claim depreciation. The seller/lessee would not have a gain on the purported sale, and would allocate only a portion of the lease payments to interest expense, and would retain the right to depreciation.

The courts have consistently looked to various factors to determine the validity of sale-leaseback transactions: n342.1

- economic substance n343 and tax-independent motives;
- a purchase price that approximates fair market value;
- a third-party loan transaction;
- either no purchase option in favor of the "lessee," or only an option to purchase at arm's-length terms that would prevent the lessee-optioner from building up significant equity in the property during the lease term (a purchase option price that is geared to the unamortized principal advanced by the "lessor" indicates that a transaction is a financing arrangement rather than a sale-lease-back); n343.1
- rent that approximates fair market value, including whether renewal rentals at the end of the lease term are set at fair market value (the inclusion of an interest component is indicative of a financing arrangement, and not a sale-leaseback transaction); n343.2
- the existence of useful life of property in excess of the lease term;
- the reasonable possibility that the purported owner of the property can recoup its investment in the

property from the income and residual value of the property;

- who bears the risks and responsibilities of ownership during the lease period;
- the tax and accounting treatment of the transaction; n343.3 and
- the intent of the parties.

Any transaction purporting to be a transfer or sale-leaseback transaction must be carefully structured. Failure to do so may result in the entire transaction being ignored for tax purposes, n344 or treated as a financing arrangement. n344.1

It is the position of the Service that a sale-leaseback transaction with the leaseback term (including renewal options) exceeding 30 years represents a like-kind exchange for tax purposes. n344.2 Accordingly, any loss on the sale would be deferred under the rules for tax-free exchanges. n345 Similarly, a sale-leaseback transaction with a lease term of less than 30 years would allow a loss to be recognized. n345.1 There is some judicial support for the Service's position. n346 However, the Second and Third Circuits and the Tax Court have held that a taxable sale takes place when the purchaser pays fair value for the property and receives a fair rent on the leaseback. n347 Given the mixed positions of the courts, care should be taken in structuring sale-leasebacks that result in a realized loss.

The following are suggested elements to be included to preserve a valid sale-leaseback transaction: n347.1

- The property should be sold at fair market value and supported by an independent appraisal.
- Rent should be at fair market value and also supported by an independent appraisal. Level or increasing rental payments are desirable.
- It is preferable, although not mandatory, to have a sufficient number of other factors that are favorable, e.g., three parties in the sale-leaseback arrangement: the seller-lessee, the purchaser-lessor and the institutional lender.
- The lease term should be less than the economic life of the property. Renewal options should only provide for a fair market rental value at the time the option is exercisable.
- Refrain from including repurchase options. If one is necessary, it should either approximate the expected fair market value of the property at its exercise date, or the repurchase price should be established at fair market value pursuant to an independent appraisal to determine value at that time.
- All condemnation and insurance payments in excess of liabilities of the property should be awarded to the purchaser-lessor.
- Record the "business purpose" for the transaction and follow the formalities and document language of a sale-leaseback. Avoid loan structure or language.
- Evaluate the economics of the transaction from the perspective of the buyer-lessor as an owner of the subject property in order to avoid having the transaction viewed as being created solely for tax purposes.
- If other factors do not strongly support the desired sale-leaseback treatment, consider structuring the lease as one that is not a pure net lease by keeping the purchaser-lessor responsible for some expenses.

In a field service advice memorandum, the IRS has outlined in detail several of the legal theories that may be applied in

analyzing the economic substance of a sale-leaseback transaction. It indicated three lines of attack: n347.2

- As indicated above, determining whether the transaction is more akin to a secured financing than a sale.
- *Sham Doctrine*. Under this theory, the economic substance of the transaction is considered in determining whether the transaction's form is other than its purported characterization; the ruling cites to factors from a US Supreme Court case which, if present, will allow the form of a sale-leaseback transaction to be respected. n347.3
- *Step-Transaction Doctrine*. This doctrine may also result in the disallowance of the tax consequences of a sale-leaseback transaction through the application of the "end-result test" of the step-transaction analysis. Under this test, an inquiry is made as to whether the sale-leaseback transaction at issue, as well as any related transactions that are concomitant to it, are a series of formally separate steps that are really pre-arranged parts of a single transaction that was intended at the outset. If so, the steps of the transaction are collapsed so that tax effect is given only to the end result.

In summary, the existence of a valid lease or sale-leaseback depends on the true substance of the transaction. If the purported lessor in a leasing transaction gives up the equity rights to the lessee, it may be considered to be a sale. n348 If the purported seller-lessee in a sale-leaseback transaction retains its equity in the property, this may be a financing transaction. n348.1

[2] Off Balance Sheet Financing or "Synthetic Leases"

The other side of the "sale-leaseback" coin is often a financing arrangement, and a taxpayer may in a given situation wish to have a series of transactions categorized as a financing arrangement rather than a lease arrangement. A "synthetic lease" or "synthetic real estate financing" is a method used to provide off-balance sheet financing to a corporation for the acquisition and development of a commercial facility or site, with substantial credit support for debt issued by or through an investor or capital source, usually a financial institution. Although nominally secured by real estate assets, a synthetic lease is underwritten on the basis of a guaranteed minimum revenue stream and the financial strength and credit rating of the lessee or guarantor. A synthetic lease is treated as an operating lease for financial accounting purposes, but, if properly structured, may be treated as a financial arrangement for tax purposes. The lessee/corporate user retains the tax benefits and operating control associated with ownership and debt, but for financial accounting purposes does not have to book the lease obligation as a liability or the leased property as an asset. The off-balance sheet financing from a synthetic lease substantially enhances the financial ratios of the lessee/corporate user because neither the real estate asset nor any financing liability or equity ownership appears on the balance sheet. Synthetic leases are used primarily by large, publicly-traded businesses. n348.2

The same factors used in analyzing the validity of a sale-leaseback arrangement are used to analyze a synthetic lease. Whether the transaction is a sale or a lease is a question of fact that must be ascertained from the intent of the parties as evidenced by the contract read in light of all facts and circumstances. n348.3 If the arrangement is treated as a financing arrangement, the transferee of the property (the nominal lessee) cannot deduct its payments as rent, but can, as the owner, claim depreciation and also claim interest deductions on borrowings associated with the financing agreement. n348.4

FOOTNOTES:

(n1)Footnote 342.1. *Torres v Commr*, 88 TC 702 (1987) ; *Est of Thomas v Commr*, 84 TC 412 (1985) ; *Mukerji v Commr*, 87 TC 926 (1986) ; *Helvering v F & R Lazarus & Co*, 308 US 252 (1939) ; *Sun Oil Co v Commr*, 562 F2d 258 (3d Cir 1977) ; *American Realty Trust v US*, 497 F2d 1194 (4th Cir 1974) ; *Illinois Power Co v Commr*, 87 TC 1417 (1986) ; *Hilton v Commr*, 74 TC 305 (1980) , *aff'd* 671 F2d 316 (9th Cir 1982) ; *Belz Inv Co v Commr*, 72 TC 1209

(1979) , *aff'd* 661 F2d 76 (6th Cir 1981) ; *Guaderrama v Commr/Benavidez v Commr*, TC Memo 2000-104 , *aff'd* 21 Fed Appx 858 (10th Cir 2001) . TAM 200115003 (IRS found complex series of transactions constituted a sale and not a sale/leaseback). In Ltr Rul 200346007 , because of factual disputes between the taxpayer and the audit committee reviewing the transaction, the IRS was unable to determine whether a complex sale/leaseback of the taxpayer's corporate headquarters was valid or was in fact a financing device. The ruling gives an excellent example of the IRS analysis of the sale/leaseback issue.

(n2)Footnote 343. A transaction lacking economic substance will be deemed a sham and any tax benefits claimed will be disallowed. See, eg, *Bodor v Commr*, TC Memo 1993-456 , *aff'd* 1 1995 U.S. App. LEXIS 9095 (6th Cir 1995) (transfer-leaseback of real estate deemed to be sham without economic substance since purported transferors remained owners of properties after transfer and no economic relationships were altered).

(n3)Footnote 343.1. *Guaderrama v Commr/Benavidez v Commr*, TC Memo 2000-104 , *aff'd* 21 Fed Appx 858 (10th Cir 2001) ; *Sun Oil Co v Commr*, 562 F2d 258 (3d Cir 1977) .

(n4)Footnote 343.2. *Guaderrama v Commr/Benavidez v Commr*, TC Memo 2000-104 , *aff'd* 21 Fed Appx 858 (10th Cir 2001) ; *Judson Mills v Commr*, 11 TC 25 (1948) .

(n5)Footnote 343.3. See FSA 199927039.

(n6)Footnote 344. See Manning, *et al v Commr*, TC Memo 1993-127 (deductions denied on ground that property in installment sales agreement not owned by taxpayers/lessors; two-year delay in signing agreement, backdating of agreement, improprieties in signing contract, failure to record contract, failure to notify mortgagee of sale, and the lessees' belief they still owned property led court to conclude taxpayers did not own property for tax purposes).

(n7)Footnote 344.1. *Helvering v F & R Lazarus & Co*, 308 US 252 (1939) ; *Sun Oil Co v Commr*, 562 F2d 258 (3d Cir 1977) ; *American Realty Trust v US*, 497 F2d 1194 (4th Cir 1974) ; *Illinois Power Co v Commr*, 87 TC 1417 (1986) ; *Hilton v Commr*, 74 TC 305 (1980) , *aff'd* 671 F2d 316 (9th Cir 1982) ; *Belz Inv Co v Commr*, 72 TC 1209 (1979) , *aff'd* 661 F2d 76 (6th Cir 1981) ; *Guaderrama v Commr/Benavidez v Commr*, TC Memo 2000-104 , *aff'd* 21 Fed Appx 858 (10th Cir 2001) .

(n8)Footnote 344.2. See *Treas Reg* § 1.1031(a)-l(c).

(n9)Footnote 345. *IRC* § 1031.

(n10)Footnote 345.1. *Ltr Rul* 200346007 (IRS ruled that a sale-leaseback with an initial lease term of 26 years was not a like-kind exchange). If a taxpayer has a right to renew an initial lease term, the renewal periods are added to the initial lease term in determining whether the 30-year benchmark is met (see *Rev Rul* 78-72, 1978-1 CB 258).

(n11)Footnote 346. *Century Elec Co v Commr*, 192 F2d 155, 41 AFTR 205 (8th Cir 1951) ; *Missouri Pac RR Co v US*, 497 F2d 1386, 204 Ct Cl 837 (1974) .

(n12)Footnote 347. *Jordan Marsh Co v Commr*, 269 F2d 453, 4 AFTR2d 5341 (2d Cir 1959) ; *City Investing Co*, 38 TC 1 (1962) , *nonacq* 1963-2 CB 6 ; *Leslie Co v Commr*, 539 F2d 943, 38 AFTR2d 76-5458 (3d Cir 1976) ; *Crowley, Milner & Co v Commr*, 689 F2d 635 (6th Cir 1982) .

(n13)Footnote 347.1. See *Torres v Commr*, 88 TC 702 (1987) ; *Est of Thomas v Commr*, 84 TC 412 (1985) ; *Mukerji v Commr*, 87 TC 926 (1986) .

(n14)Footnote 347.2. FSA 199927039 .

(n15)Footnote 347.3. See *Frank Lyon Co v US*, 435 US 561 (1978) .

(n16)Footnote 348. See, eg, *In re Craddock*, 92-2 USTC P 50,598 (Bankr D Colo 1992), *affd in part and revd in part* 95-2 USTC P 50,475 (D Co 1995)(debtor claimed two transactions were financing transactions; Bankruptcy Court determined from evidence, including lease indicating debtor was lessee and lessor's interest in rents was as cash collateral, that transactions were sales of real estate).

(n17)Footnote 348.1. See *Torres v Commr*, 88 TC 702 (1987) ; see FSA 199920003 .

(n18)Footnote 348.2. See Ltr Rul 199920003 for a ruling detailing the difficulty of tax characterization of synthetic leases; see John C Murray, *Off-Balance Sheet Financing: Synthetic Leases*, 32 Real Property, Probate and Trust Journal 193 (Summer 1997).

(n19)Footnote 348.3. *Haggard v Commr*, 24 TC 1124 (1955) .

(n20)Footnote 348.4. IRC §§ 163, 168; see FSA199920003 .



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§ 4.07 Tax Considerations in Negotiating a Lease

In negotiating the lease agreement, the parties should be aware of the tax consequences of the various provisions as well as the business and legal points.

[1] Lease Acquisition Costs

[a] In General

Costs incurred by a landlord to acquire a lease or secure a particular tenant are not currently deductible, but ordinarily must be amortized over the term of the lease. This rule applies to nearly all costs related to securing a lease or obtaining tenants, including attorney's fees, n349 brokerage commissions for negotiating or securing a lease, n350 title charges, n351 "rent up" fees paid to management companies to obtain tenants, n352 and costs of other management services pertaining to acquiring a lease or obtaining tenants. n353 Amounts paid at the inception of a lease for future management or other services must also be capitalized and amortized over the lease term. n354 Costs of litigation involving a lease must also be amortized over the life of the lease. n355

Lease acquisition costs must generally be capitalized and amortized regardless of the length of the lease term, n356 or whether the landlord is a cash basis or accrual basis taxpayer. n357 Some taxpayers in the real estate rental business amortize the costs over an average lease term regardless of the actual terms of the leases to which particular acquisition costs relate. n357.1

The rationale for capitalizing lease acquisition costs is that they are connected with the acquisition of an asset (the lease) that has a benefit beyond the year of the expenditure. n358

In determining the period over which lease acquisition costs must be amortized, the term of the lease would generally not include renewal options for periods for which the parties reasonably expect the lease to be renewed. n359 However, if the parties are economically compelled to exercise an option to renew, then the renewal period may have to be considered. n360 Although the rule that the commission must be amortized ratably over the term of the lease is fairly well settled, it does not reflect the economic fact that the calculation of the amount of the commission may be based primarily upon the rental income to be received by the landlord during the earlier years of the lease, because fixed rental payments received toward the end of a long-term lease have considerably less value than the initial payments.

Attorneys fees should be carefully reviewed to be certain that only the fees applicable to a successful lease agreement are capitalized. For example, legal services rendered for general business, operating, and income tax advice are, generally, currently deductible. Fees paid to an attorney in connection with an unsuccessful effort to secure a lease are currently deductible. n361 However, if the attorney subsequently successfully negotiates a lease with another party and does not allocate his bill or his services between the successful and unsuccessful leases or itemize any other deductible portion of his fees, then the entire fee may be capitalizable to the cost of the executed lease. n362

Costs incurred to modify an existing lease must also be capitalized over the term of the modified lease. The rationale for capitalizing, rather than deducting, the costs is that the modified lease is a capital asset to the taxpayer, and expenses incurred to modify it are therefore treated as capital expenditures. n362.1

If the property is sold, unamortized leasehold costs become a part of the landlord's adjusted basis in the property and are applied against the sales proceeds to determine gain or loss on the transaction. n363

Expenses incurred by a tenant in acquiring a lease must be capitalized and amortized over the term of the lease. When a lease is terminated prior to its stated term, any unamortized expenses are deductible in the year of termination. n364 If the tenant purchases the property prior to the termination of the lease, any unamortized expenses are to be added to the tenant's costs of the property. n365

[b] Treatment of Lease Acquisition Costs on Early Termination of Lease

If a lease terminates before the end of the lease term, any remaining unamortized lease acquisition costs are generally deductible as a loss in the year of the termination. n366 If the landlord disposes of the property, however, no deduction for the remaining unamortized lease acquisition costs is allowed. If the property is sold, the unamortized costs are added to the landlord's basis in the property and are taken into account for purposes of determining any gain or loss on the disposition, or become part of the basis of the property received if the disposition is a non-recognition exchange. n367 If the property is disposed of in a nontaxable liquidation, such as the liquidation of a partnership, and distributed to the partners, they may continue amortizing the lease acquisition costs over the remaining lease term. n368

[2] Lessee's Improvements

[a] In General

The value of improvements made by a lessee that revert to the lessor upon termination of the lease, generally are not taxable to the lessor and do not increase its depreciable basis in the property. n369 Note that this is generally a favorable result to the landlord, because any initial tax cost would otherwise significantly outweigh the present value of the tax benefit from the additional depreciation. Lessee improvements that are made in lieu of rent are taxable to the lessor as ordinary income. n369.1 Furthermore, lessee improvements may be treated as constructive dividends to a shareholder-lessor if the lease is a sham or the shareholder is the primary beneficiary of the improvements. n369.2

If the lessor sells leased land after the improvements have been constructed by the tenant, the new owner may not begin to depreciate the portion of its cost allocable to the improvements until the end of the lease term. No current depreciation is allowable because the new landlord only has a reversionary interest in the improvements. The basis of the improvements is the amount paid for the property less the amount the property would have been worth without the improvements. n370

The cost of improvements made to leased property by the lessee is recovered under the modified ACRS rules, without regard to the lease term. (See Chapter 5.) The cost of the improvement is thus recovered over the applicable recovery period, even if the lease term is significantly shorter. If the lessee does not retain the improvement upon termination of the lease, the lessee's loss is computed by reference to the adjusted basis of the improvements at the time of the lease

termination. n371

Planning Tip:

Frequently, the lessee will be in a higher tax bracket than the lessor, because lessors often generate significant shelter from their overall real estate activities. Under these circumstances, there may be an overall net tax savings if the lessor constructs the improvements, and if the lessee bears the additional cost thereof through an increased rent, which will be deductible in full as paid or accrued over the term of the lease.

If a lease requires a tenant to restore the premises to their original condition, the tenant may deduct such costs, when incurred, if the costs are incurred in the last year of the lease. Otherwise, the costs must be amortized over the remaining term of the lease. A rigorous restoration provision requiring the tenant to restore the premises completely to their original condition could possibly cause a lessor to lose its right to depreciate the premises. Such a provision would, of course, be quite burdensome to the lessee. To avoid these problems, a lease could state that, "except for ordinary wear and tear," the tenant is required to restore the premises to their original condition upon the termination of the lease.

[b] Treatment of Construction Allowance Provided to Lessee

Construction allowances provided by a lessor to a lessee may be excluded from the lessee's gross income if statutory requirements are met. n372

Allowances provided either in cash or as a rent reduction can qualify for the exclusion. n372.1 The following requirements must be met for the exclusion to apply:

- The lease must be a short-term lease (15 years or less) of retail space; n372.2
- The allowance must be for the purpose of the lessee's constructing or improving qualified long-term real property used in the lessee's trade or business; and
- The lessee's trade or business must be located at the retail space. n372.3

The exclusion applies only to the extent that the allowance does not exceed the amount expended by the lessee on the construction or improvement. n372.4 The term "qualified long-term real property" means non-residential real property that is a part of and is located at the retail space and which reverts to the lessor at the termination of the lease. n372.5

Regulations clarify the exclusion in several ways. n372.6 First, the statutory definition of "retail space" is amplified. "Retail space" means real property leased, occupied, or otherwise used by a lessee in its trade or business of selling tangible personal property or services to the general public. n372.7 Regulations clarify that retail space includes not only the space where the retail sales are made, but also space where activities supporting retail activities are performed (such as administrative offices, storage areas, and employee lounges). This can include offices for a wide variety of tradespeople, salespeople, and professions. n372.8 In addition, products and services are treated as being made available to the general public (as required by *IRC § 110(c)(3)*) even if only specialized customers or clients are targeted. n372.9

Regulations also amplify the construction allowance requirement of the statute. A qualified lessee construction allowance is any amount received in cash or treated as a rent reduction, provided the purpose and expenditure requirements are met. n372.10

Regarding the purpose requirement, the lease agreement for the retail space must "expressly provide" that the construction allowance is for the purpose of those improvements or construction. Otherwise the exclusion from gross

income is not available. The required construction allowance provisions may be contained in either the lease agreement or in another document executed contemporaneously with the lease or during the term of the lease. n372.11 In a revenue ruling, the IRS has clarified that the purpose requirement does not require a lease agreement to provide that an *entire* construction allowance is for the purpose of constructing or improving qualified long-term real property. Only the portion of the construction allowance actually expended on qualified long-term real property for use in the lessee's trade or business at the retail space, however, may qualify as a qualified lessee construction allowance. n372.12

Planning Guide:

This interpretation by the IRS gives approval to lease provisions that provide a construction allowance and add a clarification, "To the extent the construction allowance is spent on qualified long-term real property, it is for the purpose of constructing or improving qualified long-term real property for use in [the lessee's] business at the retail space." The above lease provision will permit the allowance used for the qualifying purpose to fall within the exclusion of *IRC § 110(a)*, even if the lessee may retain any excess over the amount it actually spends constructing or improving the retail space. That excess, however, must be included in the lessee's gross income. n372.13

Regarding the expenditure requirement, the construction allowance must be expended by the lessee in the year received, subject to an "8-1/2 month rule," under which the lessee has 8-1/2 months after the close of the taxable year in which the construction allowance is received to spend the allowance. n372.14 Provided the lessee has not depreciated the expenditures, reimbursements received in a tax year after the year in which the expenditures are made by the lessee are considered timely for purposes of the expenditure requirement. n372.15

The lessor must treat the amounts expended on the construction allowance as non-residential real property owned by the lessor for all purposes, including the provision that allows lessors to take losses with respect to certain leasehold improvements abandoned at the end of the term of the lease. n373 However, the exclusion provided for the lessee is not conditioned on the lessor's complying with this requirement. n373.1

Both the lessor and lessee must furnish specified information to the IRS by attaching a statement containing specified information with a timely filed (including extensions) tax return for the taxable year in which the construction allowance was paid by the lessor or received by the lessee. n373.2 Failure to do so may result in penalties being imposed under *IRC § 6721* for failure to file correct information returns. n373.3

The Conference Committee report relating to the *Taxpayer Relief Act of 1997* states that no inference is intended as to the treatment of amounts that are not subject to *IRC Section 110*, and that present law, including case law and the IRS issue paper on the tax treatment of such amounts, will continue to apply where applicable. Under this authority, reimbursements paid to a lessee for capital expenditures made to buildings owned by the landlord are not gross income to the lessee. n374

[3] Improvements in Lieu of Rent

Many leases, particularly leases of raw land, will require a lessee to make improvements to the property. Such a requirement may, as an economic matter, require the lessee to make expenditures for the improvements that take the place of rent they would otherwise be required to pay. Improvements of this type made by a lessee are generally not included in the lessor's gross income, either at the time the improvements are made n374.1 or at the end of the lease. n375 However, if the improvements are in fact "in lieu of rent," the landlord will recognize ordinary income for the amount of the improvements that are "in liquidation in kind of lease rentals," and the tenant will be entitled to a corresponding deduction for rent. n376 Whether the lessee's improvements are in lieu of rent income depends on the intent of the parties, which may be indicated by the terms of the agreement or by the surrounding circumstances. n377 How the parties to the lease treat the improvements on their books and tax returns is also relevant. n377.1

Case law gives some indication of when a tenant's improvements are considered a substitute for rent, and therefore includable in the landlord's gross income. In any given case, however, the ultimate determination depends on the parties' intent. n378 The most obvious circumstances where rent is intended occur when a lease provides for a specific dollar amount of credit against otherwise payable rent in consideration of improvements made or to be made by the lessee, n379 or when a lease provides that the cost of improvements is to be credited against rent. n380

If the improvements to be made are uncertain as to time and amount, and no specific dollar amount of rental credit is provided, it is unlikely that they will be intended by the parties to be rent. n381 That a particular improvement is of a specialized nature or special type of construction in order to meet the particular needs of the tenant is also an indication that the improvement is not rent. n382 On the other hand, if the improvement merely enhances the value of the property, it is more likely that the improvement was made in lieu of rent.

The lessor will acquire a depreciable interest in an improvement made by the tenant in lieu of rent. n383 The lessee will have a depreciable interest in improvements made by it that are not in lieu of rent. n384

Planning Tip:

Since this is an issue on which the intent of the parties is of great weight, if not determinative, the lease should specifically state the intention of the parties as to the rent/non-rent status of any improvements required to be made by the lessee.

[4] Security Deposits

As discussed in § 4.02[4], above, security deposits constitute another point of negotiation. If the tenant agrees to post a security deposit, the landlord may have received the equivalent of a nontaxable and interest-free loan but the tenant will have made a payment that is neither currently deductible nor amortizable. n385 These advantages may be lost if the tenant requires the funds to be maintained in a separate trust with interest credited to his account. If payments are treated as prepaid rent (e.g., prepayment of the last month's or last year's rent), the lessor must include the payment in income when received. n386 The lessee, however, will generally be precluded from taking a deduction for a security deposit until the deposit is forfeited. n387

[5] Lease Inducements

The amount and character of the lease inducements that a landlord will be willing to provide vary widely, depending on such factors as the strength or weakness of the leasing market, the landlord's belief as to the direction of the market trend, the need of a developer to pre-lease a certain amount of office space in order to obtain financing for a proposed project or to achieve a positive cash flow on an existing property that must remain in compliance with existing financing covenants, and the degree to which the property is leveraged and the landlord has sufficient resources to carry a partially vacant property through a slow rental market. Five common types of lease inducements sometimes offered in the commercial marketplace are:

- (1) rent holidays;
- (2) cash payments;
- (3) landlord-funded improvements to the tenant's space;
- (4) leases that also give the tenant an equity interest in the leased property; and

(5) compensating tenants for existing lease obligations.

Each of these leasing arrangements may have different tax consequences to the lessor and the lessee, and these consequences will have a significant effect on the cost or benefit of choosing one type of arrangement over another.

[a] Rent Holiday

The most commonly used lease inducement is a rent holiday. A rent holiday is a period at the beginning of the lease during which either no rent is required to be paid, or the rent is substantially reduced. From the landlord's perspective, rent holidays are preferable to lowering the rent by an economically equivalent amount over the entire term of the lease, because the lower annual rent may be perceived as an indication that the property is of a lesser value. In general, no rent will be includable in the landlord's gross income and no rent will be deductible by the tenant during the rent holiday. Leases providing for rent holidays are subject to the rules of *IRC Section 467*, because the rent increases over the term of the lease as a result of the rent holiday. However, a reasonable rent holiday will not trigger the application of the *IRC Section 467* rent leveling rules, and thus income and expenses under the lease may be taken into account in accordance with the terms of the lease, unless the constant rent accrual provisions apply. n388 The maximum permitted length of a rent holiday is uncertain, but the term must be reasonable. Reasonableness of the rent-free term depends on local rental practices. Rental holidays of almost one year have been permitted. n389 (See § 4.02[3].)

[b] Cash Payments

In a slow rental market, a lessor may pay a cash bonus to a potential tenant or to a third party to induce the tenant to sign a lease. For example, cash payments may be made to relieve the tenant of remaining obligations on an old lease, to help defray the lessee's moving expenses, or to simply induce the tenant to sign the lease.

A cash payment by a lessor must be capitalized and amortized over the term of the tenant's lease. n390 The payment will be current ordinary taxable income for the lessee, n391 unless the payment qualifies as an excludable construction allowance under *IRC Section 110*. n392

If the prospective tenant is currently leasing space elsewhere, the lessor might pay the tenant's old lessor a lump sum to release the tenant from the lease. In such an instance, the tenant should have imputed ordinary income from the payment, which relieved the tenant of its obligation under the lease. The income, in turn, should be offset by an imputed deduction to the tenant in the same amount. These results are identical to the tenant receiving the payment directly from the lessor and using it to pay the old lessor to be released from the old lease. In either instance, the lessor's payment is treated as a lease inducement payment which is capitalized and amortized over the term of the tenant's new lease.

Alternatively, a landlord may agree to pay the tenant's existing rental obligations as they come due (or the tenant may assign its current lease to the new landlord). The Service would probably take the position that the landlord's assumption of the tenant's rental payments is nevertheless a lease acquisition cost that must be amortized over the term of the new lease. At least one court, however, has rejected this view and has allowed a current deduction for payments made by a landlord who assumed a prospective tenant's lease obligations. The landlord paid rents due under the tenant's old lease and was permitted a deduction, to the extent that the rents paid exceeded the rents received from subleasing the property. The court characterized the payments not as acquisition costs of securing a tenant, but as payments made by the landlord *vis-a-vis* its status as a sublessee of the tenant's old lease. The court found the amounts were paid only as an obligation under the assigned lease, and therefore were deductible as rent. n393

[c] Tenant Improvements

The lessor may either provide a construction allowance or "work letter" against which the tenant can draw in making improvements to its space, or make the improvements directly for the lessee. The tenant improvements would then

belong to the lessor for tax purposes. If the lease does not make clear that this is the intent of the parties (or if this is not the result under local law), the advances under the work letter could be viewed as an indirect cash payment to the tenant, which the tenant would have to take into income. To achieve the desired tax result the lease should spell out the parties' intent. Assuming the lessor is the owner of the improvements, depreciation on such assets would be determined under the normal MACRS method regardless of the term of the lease. n394 If leasehold improvements made by the lessor are irrevocably disposed of or abandoned by the lessor at the end of the lease term, however, the lessor may treat the abandonment as a disposition of the improvements and claim a loss with respect to any remaining adjusted basis of the improvements at that time. This provision allows lessors to write off the costs of abandoned improvements at the time the lease is terminated, rather than requiring the lessor to continue to write off the abandoned improvements over their remaining recovery period. n395

Improvements made by a tenant are generally not income to the owner unless they are made in lieu of rent. See [3], above, for a discussion of when tenant improvements are treated as a substitute for rent.

[d] Equity Leases

Another inducement that landlords may offer to tenants in a slow rental market is an ownership or quasi-ownership interest in the underlying leased property. The tenant can become a partial owner of the property by various means (e.g., through the acquisition of a limited partnership interest, or through a mere contractual arrangement to share in the property's future appreciation). The tenant may share in any tax benefits that stem from the property (if it owns an *actual* ownership interest in the property, or in a pass-through entity that owns the property), or may share only in distributions of cash flow and the proceeds from a sale or a refinancing of the property (if it holds only a "quasi-ownership" interest).

One of the primary issues in the context of an equity lease in which a tenant acquires a capital and profits interest in the partnership or limited liability company that owns the property is whether the tenant has transferred "property" in exchange for its partnership interest. No gain or loss is generally recognized to a partnership or any of its partners if property is contributed to a partnership in exchange for a partnership interest. However, property is generally not transferred to the partnership by the tenant in an equity lease. A tenant that acquires a capital interest in a partnership may have to recognize income on its receipt of the partnership interest if it does not contribute property with a fair market value equal to the equity represented by the partnership interest received. The partnership might also recognize income with respect to the same transaction, on a deemed disposition of a pro rata portion of its assets at their fair market value, and would then be able to amortize the value of the partnership interest conveyed to the tenant over the term of the lease as a lease acquisition cost.

An alternative method, which may avoid the recognition of income to the landlord and tenant, would be to give the tenant a partnership interest with no current value. For example, if a developer transfers a partnership interest to the tenant and the tenant-partner only receives a share of the net cash flow in excess of what the property is currently generating and only receives sales proceeds in excess of the property's current fair market value, the interest may not have any current value for income tax purposes and the receipt of that interest should not result in current income recognition. n396

As an alternative to an actual ownership interest in the property or in the entity that owns the property, the parties may agree to give the tenant a contractual right to share only in the property's future appreciation. Under this type of arrangement, the tenant generally does not receive any current interest in the property other than a nontransferrable contractual right to share in the proceeds of a future sale or refinancing. n397 The parties may agree on a future valuation of the property for this purpose based on an appraisal or formula clause if no actual sale takes place.

[e] Compensating Tenants for Existing Lease Obligations

In competitive commercial leasing markets, lessors must become even more creative in structuring lease inducements. Often a prospective tenant may be contractually obligated for an existing lease that does not expire for several years. In order to induce the prospective tenant into leaving the old office, the landlord may agree to assume and take an assignment of the existing lease from the tenant to the new landlord or to structure a sublease from the tenant to the new landlord.

When it assigns the existing lease to the new landlord, the tenant may be able to deduct its remaining adjusted basis in the tenant-owned leasehold improvements. n398 However, the Internal Revenue Service may view the value of the leasehold improvements as a cost to the tenant of acquiring the new lease. The landlord may be able to currently deduct rent and other expenses of the assigned lease in excess of income earned, although the Service might assert that the assignee-landlord's net loss incurred with respect to the old space must be amortized over the term of the new lease. n399

Alternatively, the new landlord could sublease the old leasehold from the new tenant, which results in the tenant remaining obligated for the balance of the existing (old) lease. Accordingly, the tenant would recognize rental income equal to the new landlord-sublessor's payments and rent expense in the amount specified in the existing lease agreement. If this approach is taken, the tenant would continue to amortize its basis in tenant improvements with respect to the existing lease over their original depreciable lives.

Lease inducements can be a major factor in obtaining tenants in a slow marketplace. However, not all lease inducements have the same effect, and the differences can have significant tax consequences to the parties. Determining which lease inducement is most beneficial requires an in-depth review of the tax position of both the lessor and the lessee.

FOOTNOTES:

(n1)Footnote 349. *Davidson v Commr*, 27 BTA 158 (1932) ; *Young v Commr*, 59 F2d 691 (9th Cir 1932) , cert denied 287 US 652 (1932) .

(n2)Footnote 350. *Renwick v US*, 87 F2d 123 (7th Cir 1936) ; *Young v Commr*, 59 F2d 691 (9th Cir 1932) , cert denied 287 US 652 (1932) ; *Bonwit Teller & Co v Commr*, 53 F2d 381 (2nd Cir 1931) , cert denied 284 US 690 (1932) ; *Rev Rul 70-408*, 1970-2 CB 68 ; *Seahill Co v Commr*, TC Memo 1964-56, 23 TCM 408 ; *Spinks Realty Co v Burnet*, 62 F2d 860 (DC Cir 1932) , cert denied 290 US 636 (1933) .

(n3)Footnote 351. *Young v Commr*, 59 F2d 691 (9th Cir 1932) , cert denied 287 US 652 (1932) .

(n4)Footnote 352. *Rev Rul 81-161*, 1981-1 CB 313 ; *Sorrell, Jr v Commr*, TC Memo 1987-351, 53 TCM 1362 .

(n5)Footnote 353. *Strouth v Commr*, TC Memo 1987-552, 54 TCM 1009 ; *Griffiths v Commr*, 70 F2d 946 (7th Cir 1934) , affg 25 BTA 1292 (1932) ; see *Thielking v Commr*, 53 TCM 618, TC Memo 1987-201 ; *Bourg v Commr*, TC Memo 1961-65, 20 TCM 425 (engineering fees).

(n6)Footnote 354. *Seligman v Commr*, 84 TC 191 (1985) , affd 796 F2d 116 (5th Cir 1986) .

(n7)Footnote 355. *Babbage v Commr*, 27 BTA 57 (1932) .

(n8)Footnote 356. *Munger v Commr*, 14 TC 1236 (1950) ; *Thielking v Commr*, 53 TCM 618, TC Memo 1987-201 ; *Renwick v US*, 87 F2d 123 (7th Cir 1936) ; *Young v Commr*, 59 F2d 691 (9th Cir 1932) , cert denied 287 US 652 (1932) .

(n9)Footnote 357. *Roby Realty Co v Commr*, 19 BTA 696 (1930) ; *Rev Rul 70-408*, 1970-2 CB 68 .

(n10)Footnote 357.1. See CCA 200836001 (the ruling denied a request by the taxpayer under *IRC § 446(e)* to change its method of accounting to amortize leasehold acquisition costs over the actual terms of leases to which the

costs related because the proposed change was not a change in method of accounting).

(n11)Footnote 358. *Thielking v Commr*, 53 TCM 618, TC Memo 1987-201 ; *Strouth v Commr*, TC Memo 1987-552, 54 TCM 1009 ; *Griffiths v Commr*, 70 F2d 946 (7th Cir 1934) , *affg* 25 BTA 1292 (1932) .

(n12)Footnote 359. See *The Birmingham News Co v District Director of Internal Revenue*, 224 F Supp 670 (ND Ala 1963) .

(n13)Footnote 360. See *Jos N Neel Co v Commr*, 22 TC 1083 (1984) .

(n14)Footnote 361. *Davidson v Commr*, 27 BTA 158 (1932) .

(n15)Footnote 362. *Galt v Commr*, 19 TC 892 (1953) .

(n16)Footnote 362.1. *US Bankcorp v Commr*, 111 TC 231 (1998) ; *Denver & Rio Grande Western Ry Co v Commr*, 32 TC 43 , *aff'd on other grounds* 279 F2d 368 (10th Cir 1960) (expenses incurred to draft a lease assumption agreement); *Lieber v Commr*, TC Memo 1993-391 (financial advisory fees paid to obtain lower interest rates on mortgages paid pursuant to leases); *Rev Rul 73-176*, 1973-1 CB 146 (lease modification payments that taxpayer treated as additional rent were capital expenditures because they constituted consideration for a release from the lessee's future rental obligations to pay higher rent for more space); *TAM 200145003* .

(n17)Footnote 363. *Post v Commr*, 109 F2d 135, 24 AFTR 207 (2d Cir 1940) .

(n18)Footnote 364. *Boos v Commr*, 30 BTA 882 (1934) .

(n19)Footnote 365. *Id.*

(n20)Footnote 366. *Oliver Iron Mining Co v Commr*, 13 TC 416 (1949) ; see *Treas Reg § 1.165-2(a)*.

(n21)Footnote 367. *Post v Commr*, 109 F2d 135 (2d Cir 1940) .

(n22)Footnote 368. See *Wolan v Commr*, 184 F2d 101 (10th Cir 1950) ; *Plaza Inv Co v Commr*, 5 TC 1295 (1945) (dealing with a nontaxable corporate liquidation under prior law).

(n23)Footnote 369. *IRC § 109*.

(n24)Footnote 369.1. *Treas Reg § 1.109-1(a)*; see [3], below, for a discussion.

(n25)Footnote 369.2. *Spera v Commr*, TC Memo 1998-225 .

(n26)Footnote 370. *Geneva Drive-In Theatre, Inc v Commr*, 622 F2d 995, 46 AFTR2d 80-5488 (9th Cir 1980) .

(n27)Footnote 371. *IRC § 168(i)(8)*.

(n28)Footnote 372. *IRC § 110*.

(n29)Footnote 372.1. *IRC § 110(a)*.

(n30)Footnote 372.2. *IRC § 110(a)(1), (c)(2)*.

(n31)Footnote 372.3. *IRC § 110(a)(2)*.

(n32)Footnote 372.4. *IRC § 110(a)*.

- (n33)Footnote 372.5. *IRC § 110(c)(1).*
- (n34)Footnote 372.6. *Treas Reg § 1.110-1, eff generally for leases entered into on or after 10/5/00.*
- (n35)Footnote 372.7. *IRC § 110(c)(3).*
- (n36)Footnote 372.8. *Treas Reg § 1.110-1(b)(2)(iii); see IRC § 110(c)(3).*
- (n37)Footnote 372.9. *Treas Reg § 1.110-1(b)(2)(iii).*
- (n38)Footnote 372.10. *Treas Reg § 1.110-1(b)(3),(4).*
- (n39)Footnote 372.11. *Treas Reg § 1.110-1(b)(3).*
- (n40)Footnote 372.12. *Rev Rul 2001-20, 2001-18 IRB 1144 .*
- (n41)Footnote 372.13. *Rev Rul 2001-20, 2001-18 IRB 1144 .*
- (n42)Footnote 372.14. *Treas Reg § 1.110-1(b)(4)(ii)(A).*
- (n43)Footnote 372.15. *Treas Reg § 1.110-1(b)(4)(ii)(B).*
- (n44)Footnote 373. *IRC § 110(b); see IRC § 168(i)(8).*
- (n45)Footnote 373.1. *Treas Reg § 1.110-1(b)(5).*
- (n46)Footnote 373.2. *Treas Reg § 1.110-1(c)(2), (3); see IRC § 110(d).*
- (n47)Footnote 373.3. *Treas Reg § 1.110-1(c)(4).*
- (n48)Footnote 374. *Price v Commr, TC Memo 1999-142 ; see Gray v Commr, 10 TC 590 (1948) ; Rev Rul 67-407, 1967-2 CB 59 .*
- (n49)Footnote 374.1. *ME Blatt Co v US, 305 US 267, 59 S Ct 186 (1938) .*
- (n50)Footnote 375. *IRC § 109.*
- (n51)Footnote 376. *Treas Reg § 1.109-1(a). Your Health Club, Inc v Commr, 4 TC 385 (1944) ; McGrath v Commr TC Memo 2002-231 , affd without published opinion 2003-2 USTC 50,663, 92 AFTR 2d 6159 (5th Cir 2003) ; Hopkins Partners, Cleveland Airport Hotel Limited Partnership v Commr, TC Memo 2009-107 .*
- (n52)Footnote 377. *Treas Reg § 1.61-8(c); see Beecham, Inc v US, 1973 US Dist LEXIS 11616 (ED Tenn 1973) (holding that lessee's reimbursement to lessor for the costs of improvements made by lessor did not constitute rent).*
- (n53)Footnote 377.1. *Hopkins Partners, Cleveland Airport Hotel Limited Partnership v Commr, TC Memo 2009-107 (lessee treated cost of improvements as a rent expense on its books and tax returns; court held improvements were a rent substitute); Brown v Commr, 22 TC 147 (1954) , affd 220 F2d 12 (7th Cir 1955) (lessee treated cost of improvements as a rent expense; court held improvements were a rent substitute); Cunningham v Commr, 26 TC 670 (1957), affd 258 F2d 231 (9th Cir 1958) (lessee treated the cost of improvements as a capital expense, not a rent expense; court held the improvements were not a rent substitute).*
- (n54)Footnote 378. *ME Blatt Co v US, 305 US 267, 59 S Ct 186 (1938) .*
- (n55)Footnote 379. *Your Health Club, Inc v Commr, 4 TC 385 (1944) .*

(n56)Footnote 380. *Hopkins Partners, Cleveland Airport Hotel Limited Partnership v Commr*, TC Memo 2009-107 ; *Brown v Commr*, 22 TC 147 (1954) , *affd* 220 F2d 12 (7th Cir 1955) .

(n57)Footnote 381. *ME Blatt Co v US*, 305 US 267, 59 S Ct 186 (1938) .

(n58)Footnote 382. *Cunningham v Commr*, 28 TC 670 (1957) , *acq* 1958-2 CB 4 , *affd* 258 F2d 231 (9th Cir 1958) .

(n59)Footnote 383. *Brown v Commr*, 22 TC 147 (1954) , *affd* 220 F2d 12 (7th Cir 1955) .

(n60)Footnote 384. *Duffy v Central RR Co*, 268 US 55, 45 S Ct 429 (1925) ; *Hopkins Partners, Cleveland Airport Hotel Limited Partnership v Commr*, TC Memo 2009-107 . See Chapter 5 for a detailed discussion of depreciation by lessees.

(n61)Footnote 385. *Clinton Hotel Realty Corp v Commr*, 128 F2d 968, 29 AFTR2d 758 (5th Cir 1942) ; *Rev Rul* 72-519, 1972-2 CB 32 .

(n62)Footnote 386. *Williams v Commr*, TC Memo 1998-93 ; *Hirsch Improvement Co v Commr*, 143 F2d 912, 32 AFTR2d 1104 (2d Cir 1944) .

(n63)Footnote 387. See § 4.02[2], *supra*.

(n64)Footnote 388. *IRC* § 467(b)(1), (2).

(n65)Footnote 389. *Republic Plaza Properties Partnership v Commr*, 107 TC 94 (1996) .

(n66)Footnote 390. *Bonwit Teller & Co v Commr*, 53 F2d 381, 10 AFTR2d 656 (2d Cir 1931) , *cert denied* 284 US 690 ; *Rev Rul* 81-161, 1981-1 CB 313 (payment to management company). But see *Daly v Commr*, 37 F2d 728, 8 AFTR2d 10018 (SDNY 1930) (payment deductible).

(n67)Footnote 391. *IRC* § 61(a). But see *May Dept Stores Co v Commr*, TC Memo 1974-253 , *affd per curiam* 519 F2d 1154 (8th Cir 1975) ; *Federated Dept Stores Inc v Commr*, 426 F2d 417, 27 AFTR2d 70-1269 (6th Cir 1970) (payments constituted nontaxable contributions to capital).

(n68)Footnote 392. See *IRC* § 110; see § 4.07[2][b] for a discussion of *IRC* § 110.

(n69)Footnote 393. *379 Madison Avenue, Inc v Commr*, 60 F2d 68 , 1932 USTC P 9397 (2d Cir 1932), *revd* 23 BTA 29 (1931) .

(n70)Footnote 394. See *Grinalds v Commr*, TC Memo 1993-66 (taxpayer attempted to depreciate improvements made for lessees over five-year useful lives of leases; Tax Court held improvements had to be depreciated over 31.5-year ACRS recovery period).

(n71)Footnote 395. *IRC* § 168(i)(8)(B) (applicable to improvements disposed of or abandoned after June 12, 1996).

(n72)Footnote 396. See *Rev Proc* 93-27, 1993-2 CB 343 ; *St John v Commr*, 53 AFTR2d 84-718 (DC Ill 1983). *Cf Campbell v Commr*, 943 F 2d 815 (8th Cir 1991) , *revd* TCM 1990-236.

(n73)Footnote 397. See *Pounds v Commr*, 372 F2d 342, 19 AFTR2d 514 (5th Cir 1967) (interest acquired by broker).

(n74)Footnote 398. *IRC* § 165.

(n75)Footnote 399. *379 Madison Avenue, Inc v Commr*, 60 F2d 68 (2d Cir 1932) , *revd* 23 BTA 29 (1931) .



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Federal Taxes Affecting Real Estate

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CHAPTER 4 Operating and Leasing Real Estate

1-4 Federal Taxes Affecting Real Estate § 4.08

§ 4.08 Payments on Sale or Cancellation of Leases and Subleases

[1] Payments to Cancel a Lease

An amount paid by a landlord to a tenant to induce it to cancel a lease is a capital expenditure and not a currently deductible expense. n400 The general rule is that a lease cancellation payment made by a landlord must be amortized over the remaining term of the old lease. This general rule applies when the purpose of cancelling the old lease is to enter into a new lease. n401 There are several exceptions to the general rule, however. The first exception arises when a landlord cancels the old lease in order to construct a new building or make extensive improvements to an existing building. In that case, the cost of cancellation is treated as a cost of acquiring a new asset and is amortizable over the recovery period of the new building n402 or the term of the new lease. n403 Similarly, where the landlord makes the lease cancellation payment in order to sell the property unencumbered by the lease, the amount of the payment is added to the landlord's basis for purposes of determining the amount of gain or loss on the sale. n404

Notwithstanding the general rule described above, in a case with an unusual fact pattern, the Ninth Circuit held that a lease cancellation payment was amortizable over the term of the new lease, even though the cancellation payment was made solely to obtain a new lease with a different party. n405 Due to its unusual facts, however, the *Wells Fargo* case appears to be of limited precedential value. A critical fact in that case was that the lease cancellation payments were to be paid only from rentals paid by the new tenant, and not otherwise. In effect, the result was a wash--the landlord was able to write off the cancellation payments over the new lease term as they were paid by the new tenant. Given the unusual facts, the court found that amortizing the cancellation payment over the new lease term (which was less than one year) provided a true reflection of the taxpayer's income. n406

The Ninth Circuit has distinguished *Wells Fargo* and recognized it as an exception to the general rule based on its unusual facts. n407 In the usual case, even the Ninth Circuit would amortize a lease cancellation payment over the unexpired term of the old lease, rather than the term of the new lease. That result will usually provide a truer reflection of income. n408

To the lessee, the transaction will be considered a sale of the lease. If the lease is on business or income-producing real property and has been held by the lessee for more than one year, any resulting gain or loss is considered to be from an asset used in a trade or business. n409 If the lease is on a personal residence, an amount received for cancellation is considered received from the sale of a capital asset.

When the lessee makes a payment to the lessor to induce the lessor to cancel a lease on business property, the payment will ordinarily be deductible as an ordinary and necessary business expense. Furthermore, the lessee will be entitled to deduct any unamortized leasehold improvement costs when the improvements are not physically recoverable. However, if the cancellation was made to enable the lessee to enter into a new lease on the same premises, the payment will be amortizable over the life of the new lease. In either case, the receipt of the payment by the lessor is generally treated as additional rental income. n410

When the lessee purchases outright ownership from the lessor, so that the leasehold and fee interests merge, no part of the purchase price can be allocated as the cost of canceling the lease. Thus, the entire amount paid is capitalized as part of the cost of the property.

[2] Sale of a Lease

When the lessee sells its entire leasehold interest to a third party, the transaction is treated as a sale or exchange, and it is subject to capital gain or *IRC Section 1231* treatment, except when the lessee is in the business of selling leases.

On the other hand, if only a portion of the full term of the leasehold is assigned, the transaction is considered to be a sublease and the payments are reportable as rental income.

A question arises as to whether there is a sale or a sublease when the lessee assigns a portion of the leased premises for the full term of the lease. If a sale classification is desired, the lessee should obtain the lessor's agreement to a release from the portion of that lease so assigned, with a corresponding reduction in rent, and have the assignee pay the rent directly to the lessor.

When the lessor sells its rights as landlord under a lease, but retains ownership of the leased property, the transaction probably will be viewed as an anticipatory assignment of income (i.e., the rental payments due from the tenant, the right to which was assigned by the lessor to the purchaser), and the payment received will be subject to tax treatment as ordinary income.

FOOTNOTES:

(n1)Footnote 400. *Miller v Commr*, 10 BTA 383 (1928) .

(n2)Footnote 401. *Trustee Corp v Commr*, 42 TC 482 (1984) , acq 1966-2 CB 7 ; *Handlery Hotels, Inc v US*, 663 F2d 892 (9th Cir 1981) ; but see *Wells Fargo Bank & Union Trust Co v Commr*, 163 F2d 521 (9th Cir 1947) and *Montgomery Co v Commr*, 54 TC 986 (1970) , acq 1970-2 CB XX.

(n3)Footnote 402. *Business Real Estate Trust of Boston v Commr*, 25 BTA 191 (1932) ; *Houston Chronicle Publishing Co v US*, 481 F2d 1240 (5th Cir 1973) ; see *American Spring and Wire Specialty Co v Commr*, TC Memo 1961-116, 20 TCM 116 .

(n4)Footnote 403. *Cosmopolitan Corp v Commr*, 18 TCM 542, TC Memo 1959-122 ; *Latter v Commr*, TC Memo 1961-67, 20 TCM 336 .

(n5)Footnote 404. *Shirley Hill Coal Co v Commr*, 6 BTA 935 (1927) .

(n6)Footnote 405. *Wells Fargo Bank & Union Trust Co v Commr*, 163 F2d 521 (9th Cir 1947) .

(n7)Footnote 406. *Id.*

(n8)Footnote 407. *Handlery Hotels, Inc v US*, 663 F2d 892 (9th Cir 1981) .

(n9)Footnote 408. *Id.*

(n10)Footnote 409. *Rev Rul 72-85, 1972-1 CB 234* .

(n11)Footnote 410. *Gurvey v US, 1986 US Dist LEXIS 29502 (ND Ill 1986)* . But see *1969 Corp et al v Commr, TC Memo 1986-387* , where payments made on notes given by lessee's guarantor to lessor in consideration of lease cancellation was capital, not ordinary gain.



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Federal Taxes Affecting Real Estate

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CHAPTER 5 Depreciation and Credits on Real Estate *

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.01

§ 5.01 Depreciation Rules: A Historical Background

The Economic Recovery Tax Act of 1981 (ERTA) completely revised the rules pursuant to which owners of depreciable assets could "recover" the cost of those assets for Federal income tax purposes. n1 Under ERTA, old depreciation rules were virtually discarded and replaced by a new "Accelerated Cost Recovery System" (ACRS) for property placed in service after December 31, 1980. The ACRS rules were, in turn, revised by two subsequent Congressional acts--the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984 n2--and essentially replaced by a third, the Tax Reform Act of 1986, which is discussed later in this chapter in Section 5.02. n3 The Revenue Reconciliation Act of 1993 and the Small Business Job Protection Act of 1996 introduced even more changes to cost recovery for depreciable assets. n4

ACRS applies only to property placed in service on or after January 1, 1981. Taxpayers owning depreciable property that they placed in service before January 1, 1981, will apply pre-ERTA depreciation methods to that property. As a result, taxpayers that were in business before 1981 may find that they need to deal with the old law, the new law, or both old and new laws. Furthermore, under an anti-churning rule, property placed in service before 1981 that is transferred thereafter to another taxpayer in certain carryover or nonrecognition transactions must continue to be depreciated by the transferee under the pre-ACRS rules. n4.1 For this reason, and because much of the conceptual framework of the old depreciation rules still apply, a discussion of the old depreciation rules precedes the explanation of ACRS.

From an economic perspective, depreciation is the periodic reduction in value of an asset over its useful life. The tax deduction allowed for depreciation is intended to recognize the exhaustion of the property due to wear and tear (including normal obsolescence) and to provide a method for matching the expense of this exhaustion with the income produced from the property. Under the pre-ERTA rules, the tax system generally attempted to match the tax deductions for depreciation with the actual economic exhaustion of the asset. This matching is no longer required in the post-ERTA world, and, accordingly, the tax benefit from the deduction for depreciation is a significant factor to consider in evaluating the economics of an investment in depreciable real estate. The tax provision that permits accelerated depreciation is one of the major factors to which many investors look when evaluating the tax and economic aspects of a potential real estate investment.

[1] Who May Deduct Depreciation

Depreciation is intended to provide an expense deduction that recognizes the "wasting of an asset." Therefore, the entity subject to the economic loss arising from the wasting process is the entity that is entitled to the deduction for depreciation. n5 Ordinarily, the person who owns or has capital invested in the property is entitled to the depreciation deduction. However, mere ownership or possession of bare legal title will not necessarily enable a holder to claim a depreciation deduction for tax purposes. n6 The converse is also true, and several methods exist for structuring a real estate venture so that someone other than the holder of legal title can claim a tax deduction for depreciation.

The first is to use a "straw" or "dummy" corporation to hold bare title to property for various non-tax reasons, such as limiting exposure to potential civil liability, or facilitating a financing of the property. Under limited circumstances, the Service recognizes the "straw" corporation for what it is and allows the true owner to claim the depreciation deduction. n7

The second method is to structure purchase and financing of real property as a capital lease. In a capital lease, the lease payments generally cover the cost of the property and interest costs, and the lessee has an option to purchase the property at the end of the lease at a nominal purchase price. The Service generally views a transaction of this type as a purchase of the property by the lessee, and a sale by the lessor rather than as a lease. n8 Thus, the *lessee* would be entitled to the depreciation deductions on the property. The present value of the aggregate minimum rental payments on the leased property becomes the depreciable basis of the property.

A third method involves leasehold improvements made by a lessee of real property. In most states, title to improvements to real property vests immediately in the lessor. However, when a lessee makes improvements to the property, it is entitled to tax deductions that recognize the loss of the value of the leasehold improvements over time. Leasehold improvements made by a lessee are recovered over the usual MACRS recovery period of the improvements, without regard to the term of the lease. n9-10

[2] What Property is Depreciable

A tax deduction for depreciation is allowed only for property "used in a trade or business" or "held for the production of income." n11 Depreciation is allowed on property, or a part thereof, that is subject to a decrease in value caused by physical wasting and wear and tear. Calculation of depreciation should begin at the point in time when the asset is placed in service. n12 Depreciable real property is usually considered to be placed in service when it has been completed and is ready for occupancy. n13 It is *not* necessary that the property actually be used or occupied. n14

In order to be depreciable, property must be used primarily for business purposes. For example, in one case, the Tax Court did not allow a depreciation deduction for capital improvements that were found to have been made primarily for the benefit of a shareholder, not the corporation. n15 In another case, the Service held that temporary business use of property held for sale is not enough to entitle the business to depreciation deductions on the property. n16 Thus, model homes that were used temporarily to assist sales, but were to eventually be sold, were not depreciable. The rationale behind the Service's ruling is that the taxpayer primarily held the property *for sale* to customers in the ordinary course of the taxpayer's business, rather than as property *used in* a trade or business.

Types of realty that can qualify for depreciation deductions include buildings and their structural components, towers, paved parking lots, certain leasehold improvements, certain landscaping, mobile homes, and any other real property that can be shown to have a bona fide business purpose and a limited useful life. However, land, by nature of its perpetuity, cannot be depreciated. n17 This is true even if the fertility of the land is deteriorating, or even if construction costs on an adjoining parcel are required to be allocated to the empty parcel. n18 Although golf course improvements have historically been held to constitute land and, as such, have not been subject to depreciation, n18.1 the IRS has issued a revenue ruling that allows depreciation of certain golf course greens land preparation costs. n18.2

The ruling distinguishes between traditional natural soil greens and "modern" greens. Push-up or natural soil greens are

essentially landscaping that involves some reshaping or regarding of the land. The IRS has ruled that the costs of land preparation undertaken in the original construction or reconstruction of push-up or natural soil golf course greens are not depreciable. Rather, these costs are inextricably associated with the land and must be added to the taxpayer's cost basis in the land. In contrast, "modern" greens make use of technological changes in green design and construction, and contain sophisticated integrated drainage systems. The greens are constructed with a network of subsurface drainage tiles or interconnected pipes, one or more layers of gravel and/or sand particles, a rootzone layer, and a variety of turfgrass. The IRS has ruled that the costs of land preparation undertaken in the original construction or reconstruction of modern golf course greens that is closely associated with depreciable assets are depreciable. This would include items such as a network of underground drainage tiles or pipes, so that the land preparation will be retired, abandoned, or replaced contemporaneously with those depreciable assets. n18.3

The recovery period of the land preparation costs is the same recovery period of the depreciable assets with which the land preparation is associated. For purposes of *IRC Section 168(a)*, the modern green improvements have a recovery period of 15 years, and for purposes of *IRC Section 168(g)* (the alternative depreciation system), they have a recovery period of 20 years. n18.4 The IRS noted, however, that not all improvement costs associated with modern greens are depreciable. The general earthmoving, grading, and initial shaping of the area surrounding and underneath the modern greens that occur before the construction are treated as general land preparation and must be added to the taxpayer's cost basis in the land. n18.5

Even for property other than golf courses, some costs associated with land are depreciable. The Tax Court has held that the air space above land used as a dump site is eligible for depreciation when it is "used up" as debris piles up on the property. n19 It has also been held that a leasehold interest in land for a fixed term of years may be amortized over that term. n20 Furthermore, because natural resources, such as oil wells and rock quarries, are subject to exhaustion in a way most land is not, they are eligible for tax deductions under special rules for depletion. n21

Certain land preparation costs are also depreciable if the land is used in a trade or business or for the production of income. In general, land preparation costs consisting of shrubbery and other elements of landscaping may be depreciable, depending on location. If the landscaping is immediately adjacent to a building, it is depreciable, but if it is situated around the perimeter of a tract of land, it must be capitalized as a part of the land costs and cannot be depreciated. n22 The cost of constructing roads, sewers, utility systems and other infrastructure items may be eligible for depreciation deductions, but only if they have a determinable useful life to the taxpayer. n23 If these improvements are transferred to a municipality or other local governmental body, after which the transferee became responsible for maintenance, repair and reconstruction of the improvements, the infrastructure items are usually considered to be intangible property to the taxpayer. In that case, the improvements are not depreciable. n23.1 Costs of obtaining a zoning variance that are allocable to a particular building and not to the land may be included in the depreciable basis of the underlying building. Costs of obtaining a zoning variance that provides benefits of an indefinite duration, however, cannot be depreciated. n23.2

Depreciation on machinery and equipment used by the taxpayer during the construction of its own building must be treated as an indirect cost, and capitalized as part of the cost of the building (i.e., no current depreciation deduction is allowed). n24

[3] Determination of Useful Life

Under prior law, the useful life over which depreciation was computed was generally determined based upon the reasonably expected use of an asset in the taxpayer's particular trade or business. Four factors were considered: n25

- (1) wear and tear and decay or decline from natural causes;
- (2) the normal progress of the art, economic changes, inventions, and current developments within the

industry and the taxpayer's trade or business;

(3) the climatic and other local conditions peculiar to the taxpayer's trade or business; n26 and

(4) the taxpayer's policy on repairs, renewals, and replacements.

In the past, many taxpayers attempted to use innovative approaches to support a useful life for realty as something shorter than its physical life. Generally, these efforts were not successful. n27 The Service vigorously contested any method that was not based on physical deterioration.

[4] Class Life Asset Depreciation Range ("CLADR")

This subsection briefly covers the depreciation rules that applied to property placed in service before 1981, when the new ERTA depreciation rules took effect. The depreciation rules before ERTA were designed to allocate depreciation deductions over the period the asset was used in business. This method was used so that deductions for the cost of an asset were matched with income produced by the asset. However, this method of depreciation often led to expensive and lengthy controversies between taxpayers and the Service over the proper useful life of an asset.

In an effort to minimize this controversy, the Class Life Asset Depreciation Range (CLADR) system was adopted. This system provided taxpayers with a relatively wide latitude in determining the useful lives of assets. It allowed taxpayers to select a life within a range of 20 percent above or below the CLADR "guiding life" for that asset. n28 If the election was made, it applied to all eligible property acquired during the taxable year to which the election related and for which a class life had been established. n29 The CLADR system applied to all additions of land improvements and personal property made during the year of election. n30 The CLADR asset categories and lives are specifically set forth in various revenue procedures, and are periodically revised. n31

[5] Salvage Value

Before depreciation could be calculated under the CLADR system, the asset's estimated residual value to the taxpayer at the end of the asset's useful life had to be determined. This value is referred to as the "salvage value." Under ACRS, it is no longer necessary to determine salvage value in calculating depreciation.

Salvage value is an estimate of the amount that will be realized from the sale or other disposition of an asset when it is no longer useful to the taxpayer and is to be retired from service. The salvage value may be a large percentage of the original cost if it is the taxpayer's practice to dispose of its depreciable assets while they are still in good operating condition. However, if it is the taxpayer's practice to retain its depreciable assets until their economic useful life is substantially exhausted, salvage value may represent no more than the estimated scrap value. n32 Also, the value was to be estimated at the time the property was acquired and could not be revised thereafter, unless there was a change in the asset's estimated life. n33

[6] Methods of Computing Depreciation Under CLADR

There are three basic methods of computing depreciation under CLADR, namely: straight line; double declining balance (at a rate not greater than twice the straight-line rate); and sum-of-the-years'-digits. n34 Also permitted, with certain restrictions, are any other consistent methods that will not result in accumulated depreciation during the first two-thirds of the asset's useful life that is greater than the amount that would have resulted from using the double declining balance method. n35

The following is a brief discussion of the five most common methods of depreciating real estate under the CLADR method:

1. *Straight-line.* Under this method, the basis of the property (less estimated salvage value) is written off ratably over the property's estimated useful life to the taxpayer. n36

Example:

An asset costs \$10,000 and has a useful life to the taxpayer of ten years. Assuming that the asset has no salvage value, the annual depreciation is equal to 10 percent of the cost, or \$1,000. This method may be applied to any new or used property, regardless of its useful life.

2. *Double declining balance.* Under this method, up to twice the straight-line rate could be applied to the unrecovered cost remaining at the end of each year, without regard to salvage value. This method could be applied only to certain new residential rental property or tangible personal property that has a useful life of three years or more. n37 Residential rental property was defined here as property from which 80 percent or more of the gross income is derived from dwelling units other than transient units (such as motels or nursing homes). n38

3. *150-percent declining balance.* Under this method, 150 percent of the straight-line rate could be applied to the unrecovered cost at the beginning of each year, without regard to salvage value. This method could be applied to any used personal property or new nonresidential real property with a life of three years or more. n39

Example:

An asset costs \$10,000 and has a useful life to the taxpayer of five years. The straight-line rate is 20 percent and the 150-percent declining balance rate is 30 percent. Depreciation under the 150-percent declining balance method is computed as follows:

	Unrecovered Cost	Current Depreciation Rate	Amount
.....			
1st year	\$10,000	30%	\$3,000
2nd year	7,000	30	2,100
3rd year	4,900	30	1,470
4th year	3,430	30	1,029
5th year	2,401	30	720
Total depreciation claimed			\$8,319
Unrecovered cost at end of estimated life			1,681
			\$10,000

4. *125-percent declining balance.* This is the maximum depreciation rate available for used real estate and was available only for used residential rental property with a useful life of 20 years or more. n40 All other used real estate was limited to straight-line depreciation. n41

5. *Sum-of-the-years'-digits.* Under this method, a decreasing fraction was applied to the original basis less the salvage value. The denominator of the fraction that is used remains constant and is represented by the sum of all the years' digits corresponding to the estimated useful life of the asset. The numerator of the fraction is the number of years of useful life remaining at the beginning of the year of computation. n42 For real estate, this method was available only for new residential housing having a useful life of three years or more. It is also available to certain personal property, such as rugs, furniture and similar items.

Example:

Assume that an asset has a four-year life.

Denominator-- $4 + 3 + 2 + 1 = 10$.

The denominator is $4 + 3 + 2 + 1 = 10$.

The depreciable fraction in:	the 1st year = $4/10$
	the 2nd year = $3/10$
	the 3rd year = $2/10$
	the 4th year = $1/10$

Partnership property may normally be depreciated using one of the accelerated methods. However, if the tax basis of partnership property is changed (increased) as a result of a change in ownership of a partnership interest, the additional tax basis in partnership property may only be depreciated using the straight-line method, even though the original basis in the property is still depreciated using an accelerated method. n43

It may be advantageous for the taxpayer to switch depreciation methods during the asset's useful life. The taxpayer may switch from any declining balance or sum-of-the-years'-digits method of depreciation to the straight-line method without prior approval from the Service. n44 It is necessary, however, that certain information be disclosed on the tax return for the year of the change. n45 In contrast, taxpayers may switch to accelerated methods only upon proper and timely application to the Commissioner of the Internal Revenue Service. Special rules apply if the CLADR system is used. n46

[7] Changing Method of Depreciation

In order to change a depreciation method that constitutes a change in method of accounting, a taxpayer must first obtain consent by the IRS to do so. n47 Consent may be obtained under one of two procedures. The first and cheapest (because it avoids user fees) is the automatic consent procedures set forth in *Revenue Procedure 2002-9*. n48 This automatic consent procedure allows a taxpayer who has claimed less than the depreciation allowable to change its method of accounting to claim allowable depreciation. The omitted depreciation from years prior to the year of change is taken into account through an *IRC § 481* adjustment. n49 A taxpayer that files and complies with an automatic change request procedure is granted consent to change its accounting method, subject to review by the IRS National Office and operating division director. Specified changes in depreciation that qualify for the automatic consent procedure are set forth in detail in the List of Automatic Accounting Method Changes in the Instructions to Form 3115. n49.1

The second procedure under which a taxpayer may request a change in accounting method is through the advance consent request procedure, as updated annually in the Internal Revenue Bulletin. n50 A user fee must be paid to request

a change in accounting method using the advance consent request procedure.

Regardless of which procedure is used, the taxpayer must file a Form 3115, Application for Change in Accounting Method in accordance with the instructions to that form. For changes in depreciation, a Schedule E of Form 3115 must also be completed.

[8] Change in Depreciation as Change in Accounting Method

[a] In General

Courts have not been consistent in resolving whether a change in depreciation method constitutes a change in method of accounting that requires consent of the IRS under *IRC Section 446(e)*. n50.1 As a result of the inconsistencies in treatment of the issue by courts, Treasury and the IRS issued regulations in an attempt to clarify the matter. n50.2

Note:

The regulations generally apply on or after December 30, 2003. n50.3 For prior periods, however, the IRS has announced a change in its litigating position as to whether a change in method of depreciation is a change in accounting method. The changed position reflects the Service's losses in the Brookshire and O'Shaughnessy cases, above. n50.4 Under its new position, the IRS will not assert that a change in computing depreciation or amortization under *IRC Sections 167, 168, 197, 1400I, 1400L(b), or 1400L(c)*, or former *IRC Section 168* (ACRS) is a change in method of accounting that requires the IRS consent under *IRC Section 446(e)*. This forbearance applies only for depreciable or amortizable property that is treated as a capital asset under the taxpayer's present and proposed methods of accounting. n50.5

[b] Changes in Depreciation That Are Changes in Method of Accounting

Regulations specify which changes in depreciation are and are not changes in a method of accounting. n50.6 In general, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. A change in the depreciation method, period of recovery, or convention of a depreciable or amortizable asset is also a change in method of accounting. n50.7 This change may be the result of, for example, a change in the classification of property under *IRC Section 168(e)* or a change in computing depreciation from the general depreciation system under *IRC Section 168(a)* to the alternative depreciation system of *IRC Section 168(g)*. Further, a change to or from claiming the additional first-year depreciation deduction provided by *IRC Section 168(k)* or *IRC Section 1400L(b)* is a change in method of accounting under certain circumstances. n50.8

Subject to a "useful life" exception, under which certain adjustments to useful lives that are not specified by the Code or other authority are not treated as a change in method of accounting, n50.9 a change to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code, n50.10 the regulations under the Code, or other guidance published in the Internal Revenue Bulletin is a change in method of accounting. n50.11

The regulations also provide that a change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Code, applicable regulations, or other guidance published in the Internal Revenue Bulletin, is treated as a change in method of accounting. Any other change in salvage value is not treated as a change in method of accounting. n50.12

[c] Changes in Depreciation That Are Not Changes in Method of Accounting

The regulations provide that a change in computing depreciation allowances in the taxable year in which the use of property changes in the hands of the same taxpayer is not a change in method of accounting. n50.13 In addition, the making of a late depreciation election or the revocation of a timely valid depreciation election generally is not a change in method of accounting. To make a late depreciation election or to revoke a timely valid depreciation election, a taxpayer must submit a request for a private letter ruling. n50.14 Finally, except as otherwise provided, any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. n50.15

Under a so-called "useful life" exception, an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under *IRC Section 167* (other than under *IRC Sections 168, 1400I, 1400L(c)*, the pre-1986 version of *IRC Section 168*, or an additional first-year depreciation deduction provision n50.16) is not a change in method of accounting. This exception is not available when the length of the useful life is specified by the Code, regulation, or other authority. n50.16.1

[d] Special Rules

The regulations provide special rules regarding the accounting method change treatment for the following items: n50.17

- a change from a declining balance method under *IRC Section 168(b)(1)* or (2) to the straight line method;
- changes in certain depreciation methods under *IRC Section 167* (other than under *IRC Sections 168, 1400I, 1400L(c)*, the pre-1986 version of *IRC Section 168*, or an additional first year depreciation deduction provision of the Internal Revenue Code; n50.17.1 or
- *IRC Section 481* adjustments.

These rules primarily affect non-real estate items, but *IRC Section 481* adjustments can come into play for real estate. The regulations give an example of a taxpayer that purchases a building and its components for use in manufacturing and initially depreciates it as 39-year nonresidential real property. If the taxpayer later completes a cost segregation study and reclassifies certain items as *IRC Section 1245* property, any change in the depreciation method, recovery period, and convention for those items will be a change in method of accounting that will result in an *IRC Section 481* adjustment. The useful life exception would not apply because the assets are depreciated under *IRC Section 168*. n50.18

[e] Application of the "Allowed or Allowable" Rule to Changes in Method of Accounting

IRC Section 1016(a)(2) provides that the basis of property is adjusted for amounts allowed as depreciation and amortization, but not less than the amount allowable. The regulations provide that *IRC Section 1016(a)(2)* does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation is a change in method of accounting under *IRC Section 446(e)* and the related regulations. n50.19 This change is consistent with *Revenue Procedure 2007-16*. Under *Revenue Procedure 2007-16*, a taxpayer may change its method of determining depreciation for a depreciable or amortizable asset after its disposition if the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable, for the asset in computing taxable income in the year of disposition or in prior taxable years. Because the taxpayer is permitted to claim the allowable depreciation not taken into account for this asset, the taxpayer's lifetime income is not permanently affected by the "allowed or allowable" rule. n50.20

The regulation regarding the application of the "allowed or allowable" rule to changes in method of accounting applies to changes in depreciation or amortization for property for tax years ending on or after December 30, 2003. n50.21

[9] Election to Expense Depreciable Business Assets

Taxpayers other than trusts, estates, and certain non-corporate lessors n51 may elect to expense the cost of *IRC Section 179* property that is used in the active conduct of a trade or business. n52 Section 179 property is new or used tangible depreciable property that is acquired by purchase and used in the active conduct of a trade or business, other than air conditioning or heating units. n53 Off-the-shelf computer software placed in service in taxable years beginning in 2003 and before 2011 is also *IRC Section 179* property. n53.1 The availability of *IRC Section 179* treatment with respect to real property is quite limited. The maximum amount that may be expensed in a taxable year varies according to the year the property is placed in service, as follows: n54

Tax Year Beginning	Maximum Amount
Before 1993	\$10,000
1993-1996	\$17,500
1997	\$18,000
1998	\$18,500
1999	\$19,000
2000	\$20,000
2001-2002	\$24,000
2003	\$100,000
2004	\$102,000 n54.1
2005	\$105,000 n54.2
2006	\$108,000 n54.3
2007	\$125,000
2008-2010	\$250,000
2011 and thereafter	\$25,000

NOTE:

If the maximum *IRC Section 179* deduction is reduced to \$25,000 after 2010, which will occur unless new legislation is enacted, n54.4 special rules will apply for the 2010/2011 taxable year for passthrough entities that have a taxable year other than a calendar year. A partnership (or LLC treated as one) or S corporation (passthrough entity) with a taxable year beginning in 2010 and ending in 2011 is subject to the \$250,000 limit for property it places in service during that taxable year. A partner, member, or shareholder of that entity that is a calendar year taxpayer is subject to the \$250,000 limit for (1) qualifying property placed in service by the partner, member, or shareholder apart from the passthrough entity during 2010, and (2) its allocable share of the *IRC Section 179* deduction from any passthrough entity with a taxable year ending in 2010. For 2011, that partner, member, or shareholder is subject to the \$25,000 maximum for (1) qualifying property placed in service by the partner, member, or shareholder apart from the entity during 2011, and (2) its allocable share of the *IRC Section 179* deduction from any passthrough entity with a taxable year ending in 2011. Thus, a single shareholder S corporation might elect to expense a \$250,000 cost under *IRC Section 179* for property placed in service during its April 1, 2010-March 31, 2011 fiscal year, but the S corporation shareholder would be subject to the 2011 \$25,000 limitation in claiming the items on his or her return. This is because the S corporation's 2010 taxable year ends within the shareholder 2011 taxable year. n54.5

The maximum amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds specified amounts. The phase-out thresholds are as follows: n55

Tax Year Beginning	Phase-out Threshold
1997-2002	\$200,000
2003	\$400,000
2004	\$410,000 n55.1
2005	\$420,000 n55.2
2006	\$430,000 n55.3-55.4
2007	\$500,000
2008-2010	\$800,000
2011 and thereafter	\$200,000

NOTE:

The amount that can be expensed under *IRC Section 179* is increased by \$100,000 for qualified section 179 disaster assistance property placed in service during a taxable year. n55.5 The phase-out threshold for reducing the amount that can be expensed with respect to qualified *IRC Section 179* disaster assistance property is increased by \$600,000. n55.6 Qualified *IRC Section 179* disaster assistance property is *IRC Section 179* property n55.7 that is also qualified disaster assistance property that is eligible for 50-percen additional first-year depreciation under *IRC Section 168(n)* . n55.8 Property for which this expensing is claimed cannot be treated as qualified zone property or qualified renewal property under *IRC Sections 1397A* and *1400J*. n55.9

A taxpayer who elects to expense under *IRC Section 179* must reduce the depreciable basis of the Section 179 property by the amount of the deduction. n56

Married individuals filing separately are treated as a single taxpayer for purposes of the dollar limitation and the reduction attributable to placing excess *IRC Section 179* property in service. n56.1

In addition, the amount treated as an expense cannot exceed the taxable income from the active trade or business of the taxpayer. n57 This limitation is applied *after* the limitations referred to in the previous paragraphs. A carryover is provided so that deductions disallowed under the taxable income limitation can be carried forward to the succeeding tax year. n58 When an amount is carried over to a succeeding year, the amount allowable as a deduction in the succeeding year is increased by the lesser of the following: n59

- (1) the aggregate amount disallowed by the taxable income limitation for all prior tax years (to the extent not previously allowed as a deduction in a carryover year), or
- (2) the amount of any unused Section 179 expense allowance for the taxable year.

The unused *IRC Section 179* expense allowance for a taxable year equals the excess (if any) of: (1) the maximum cost of Section 179 property that the taxpayer may deduct after applying the statutory limitations of *IRC Section 179(b)*, over (2) the amount of Section 179 property that the taxpayer actually elected to expense under *IRC Section 179*. n60

Example:

T, a calendar year taxpayer, has a \$30,000 carryover of a disallowed deduction for Section 179 property purchased in 2003. In 2004, T purchases and places in service Section 179 property costing \$125,000. T's taxable income from the trade or business in 2004 is \$110,000. T elects to expense \$90,000

of the Section 179 property purchased in 2004. T may deduct in 2004 \$10,000 of the \$30,000 carryover from 2003. This \$10,000 amount is the lesser of T's total outstanding carryover of disallowed deductions (\$30,000), or the amount of any unused Section 179 expense allowance for 2004 (\$100,000 limit less \$90,000 elected to be expensed, or \$10,000). For 2005, T has a \$20,000 carryover of disallowed deduction for the Section 179 property purchased in 2003. n61

Additional limits restrict the deduction under *Treas Reg § 1.446-1(e)(2)(ii)(b)*. The deductible cost of property that is only partially used in a trade or business is limited to the percentage that the property is used for trade or business purposes. Thus, for a \$10,000 item of Section 179 property that is used only 70 percent of the time in a trade or business, only \$7,000 could be expensed under *IRC Section 179*. For this partial business use rule to apply, however, more than 50 percent of the property's use must be for trade or business purposes. n62

If Section 179 property ceases to be used predominantly in the taxpayer's trade or business before the end of the property's recovery period, the taxpayer must generally recapture as ordinary income any amounts previously expensed to the extent the amount of those expenses exceeds the total amount that would have been allowable as depreciation deductions for prior tax years. n63

For partnerships, the limits of *IRC Section 179(b)* apply both at the partnership and partner level. A similar rule applies for S corporations and their shareholders. n64 The practical effect of this limitation is that in partnerships with any significant number of partners, *IRC Section 179* benefits are virtually unavailable to the partners with respect to property purchased by the partnership.

The election to expense under *IRC Section 179* is made on the tax return for the taxable year in which the eligible property is placed in service. The election must specify the items of property to which the election applies and the portion of the cost of those items that the taxpayer is electing to deduct. n64.1 The election may also be made on an amended return. n64.2 It cannot be made in any other manner, such as by a request for a change in accounting method. n64.3 The election generally may be revoked only with the consent of the Commissioner. n64.4 With respect to taxable years beginning after 2002 and before 2011, however, taxpayers may revoke expensing elections on amended returns without the consent of the Commissioner. Any revocation is irrevocable. n64.5

A revocation may be made for an entire election, for a specific item, or for a portion of the selected dollar amount of a specification. The amended return must include the adjustment to taxable income for the *IRC Section 179* revocation and any collateral adjustments to taxable income or to the tax liability (for example, allowable depreciation in that taxable year for the item of *IRC Section 179* property to which the revocation pertains). Those adjustments must also be made on amended tax returns for any affected succeeding taxable years. n64.6 Revocations cannot be made in any other manner, such as by a request for a change in accounting method. n64.7 Examples of the effect of a revocation are set forth in regulations. n64.8

FOOTNOTES:

(n1)Footnote 1. *IRC § 168*, added by Pub L No 97-34, 97th Cong, 1st Sess (Aug 13, 1981).

(n2)Footnote 2. TEFRA, Pub L No 97-248, 97th Cong, 2d Sess (Sept 3, 1982); TRA 1984, Pub L No 98-369, 98th Cong, 2d Sess (July 18, 1984).

(n3)Footnote 3. Pub L No 99-514, 99th Cong, 2d Sess (Oct 22, 1986).

(n4)Footnote 4. Pub L No 103-66, 103d Cong, 1st Sess (Aug 10, 1993); Pub L No 104-188, 104th Cong, 2d Sess (Aug 20, 1996).

(n5)Footnote 4.1. *IRC §§ 168(f)(5), 381(c)(6)*; Ltr Ruls 200339031 , 200339032 , 200339036 , 200339037 , 200339038 .

(n6)Footnote 5. *Weiss v Wiener*, 279 US 333 (1929) .

(n7)Footnote 6. *Barbour v Commr*, 44 BTA 1117 (1941) , *revd on other grounds* 136 F2d 486 (6th Cir 1943) , *cert denied* 320 US 778 (1943) .

(n8)Footnote 7. *Jacqueline, Inc. v Commr*, TC Memo 1978-218 , *gov'ts and taxpayer's appeals dismissed* (5th Cir 1979).

(n9)Footnote 8. *Rev Rul 55-541*, 1955-2 CB 19 .

(n10)Footnote 9-10. *IRC § 168(i)(8)*; *Nelson v Commr*, TC Memo 2000-212 ; see § 5.02[2][d].

(n11)Footnote 11. *IRC § 167(a)*.

(n12)Footnote 12. *Treas Reg § 1.167(a)-10(b)*.

(n13)Footnote 13. See, eg, *Satullo v Commr*, TC Memo 1993-614 , *affd per curiam in an unpublished opinion* 95-2 CCH USTC P 50,523 (11th Cir 1995) (denying depreciation deductions with respect to condominium rental units unavailable for rent due to major renovations).

(n14)Footnote 14. *Sears Oil Co Inc v Commr*, 359 F2d 191 (2d Cir 1966) ; *Rev Rul 76-238*, 1976-1 CB 55 .

(n15)Footnote 15. *Gill v Commr*, TC Memo 1994-92 , *affd on another issue* 96-1 CCH USTC P 50,138 (6th Cir 1996).

(n16)Footnote 16. *Rev Rul 89-25*, 1989-1 CB 79 (home-builder's temporary use of model homes).

(n17)Footnote 17. *Treas Reg 1.167(a)-5*; *Sleiman, Jr et al v Commr*, TC Memo 1997-530 (determining allocation of basis between nondepreciable land and depreciable improvements).

(n18)Footnote 18. *Urbanek v US*, 2 Cl Ct 574 (1983) , *affd* 731 F2d 870 (Fed Cir 1984) , *cert denied* 469 US 1034 (1984) .

(n19)Footnote 18.1. See *Rev Rul 55-290*, 1955-1 CB 32 ; *Edinboro Co v US*, 224 F Supp 30 (WD Pa 1963) .

(n20)Footnote 18.2. *Rev Rul 2001-60*, 2001-51 IRB 587 .

(n21)Footnote 18.3. *Id.*

(n22)Footnote 18.4. See *Rev Proc 87-56*, 1987-2 CB 676 .

(n23)Footnote 18.5. *Rev Rul 2001-60*, 2001-51 IRB 587 .

(n24)Footnote 19. *Sanders v Commr*, 75 TC 157 (1980) .

(n25)Footnote 20. *1220 Realty Co v Commr*, 322 F2d 495 (6th Cir 1963) .

(n26)Footnote 21. See *IRC § 611*.

(n27)Footnote 22. *Rev Rul 74-265*, 1974-1 CB 56 .

(n28)Footnote 23. *Rev Rul 88-99*, 1988-2 CB 33 ; TAM 200009004 .

(n29)Footnote 23.1. TAM 200017046 ; see *Rev Rul 68-607*, 1968-2 CB 115 ; *Treas Reg § 1.167(a)-3*; *Algernon*

Blair, Inc v Commr, 29 TC 1205 (1958) ; but see *Rev Rul 73-188*, 1973-1 CB 62 (taxpayers allowed to depreciate over 10 years the capital expenditures made to pay assessments for their share of converting a city street into an enclosed pedestrian mall where the mall was expected to provide a business advantage for 10 years).

(n30)Footnote 23.2. *Maguire/Thomas Ptnrs Fifth & Grand v Commr*, TC Memo 2005-34 .

(n31)Footnote 24. *Commr v Idaho Power*, 418 US 1 (1974) . TRA 1986 codified this rule with the passage of *IRC* § 263A.

(n32)Footnote 25. *Treas Reg* § 1.167(a)-1(b).

(n33)Footnote 26. Note that this factor includes the important consideration of the condition of the neighborhood in which the building is located.

(n34)Footnote 27. See, eg, *Honodel v Commr*, 76 TC 351 (1981) , *affd* 722 F2d 1462 (9th Cir 1984) .

(n35)Footnote 28. Former *IRC* § 167(m).

(n36)Footnote 29. *Treas Reg* § 1.167(a)-11(a).

(n37)Footnote 30. Former *IRC* §§ 167(m)(1), (2); *Treas Reg* § 1.167(a)-11(a).

(n38)Footnote 31. *Rev Proc* 83-35, 1983-1 CB 345 , supersedes *Rev Proc* 77-10, 1977-1 CB 548 , which previously set forth the CLADR asset categories and class lives. This revenue procedure has been superseded by *Rev Proc* 87-56, 1987-2 CB 674 , and *Rev Proc* 88-22, 1988-1 CB 785 , which apply to all property subject to *Treas Reg* § 1.446-(e)(2)(ii)(d)(3)(ii). *Rev Proc* 88-22 provides recovery periods and asset class lives and clarifies the definition of nonresidential real property and the applicable recovery period. CLADR is still relevant for determining MACRS lives.

(n39)Footnote 32. *Treas Reg* § 1.446-(e)(2)(ii)(d)(3)(iii).

(n40)Footnote 33. *Id.*

(n41)Footnote 34. Former *Treas Reg* § 1.446-(e)(2)(ii)(d)(3)(v).

(n42)Footnote 35. *Id.*

(n43)Footnote 36. *Treas Reg* § 1.167(b)-1(a).

(n44)Footnote 37. Former *IRC* §§ 167(c); (j)(2).

(n45)Footnote 38. Former *IRC* §§ 167(j)(2)(B); (k)(3)(C); see *Ltr Rul* 9825024 .

(n46)Footnote 39. Former *IRC* § 167(j)(1).

(n47)Footnote 40. Former *IRC* § 167(j)(5).

(n48)Footnote 41. Former *IRC* § 167(j)(4).

(n49)Footnote 42. *Treas Reg* § 1.167(a)-11(c)(1)(i)(C).

(n50)Footnote 43. *Treas Reg* § 1.167(c)-1(a)(6).

(n51)Footnote 44. *Treas Reg* § 1.167(e)-1(b)-(d); *Temp Treas Reg* § 1.167(e)-1T.

(n52)Footnote 45. *Treas Reg* §§ 1.167(e)-1, (d)(2).

(n53)Footnote 46. *Treas Reg* § 1.167(a)-11(c)(1)(iii).

(n54)Footnote 47. *Treas Reg* § 1.446-1(e)(2)(i); see § 5.01[8], below, for a discussion of what changes in depreciation constitute changes in an accounting method.

(n55)Footnote 48. *Rev Proc* 2002-9, 2002-3 IRB 327 ; this revenue procedure has frequently been modified, amplified, and clarified, and has also been superseded in certain parts.

(n56)Footnote 49. *Rev Proc* 2002-9, 2002-3 IRB 327 .

(n57)Footnote 49.1. See *Rev Proc* 2002-9, 2002-3 IRB 327 ; see Instructions to Form 3115.

(n58)Footnote 50. See *Rev Proc* 2008-1, 2008-1 IRB 1 .

(n59)Footnote 50.1. See *Kurzet v Commr*, 222 F3d 830 (10th Cir 2000) (holding that a change in recovery period resulting from a change in the classification of property from nonresidential real property to 15-year property was a change in method of accounting under *IRC* § 446(e)); *Brookshire Brothers Holding, Inc & Subsidiaries v Commr*, 320 F3d 507 (5th Cir 2003) , *affg TC Memo* 2001-150 , *reh'g en banc denied* 65 Fed Appx 511 (5th Cir 2003) (holding that a change in classification of property under *IRC* § 168 is not a change in method of accounting under *IRC* § 446(e) because the change is the functional equivalent of a change in useful life thereby resulting in the change falling under the useful life exception in former *Treas Reg* § 1.446-1(e)(2)(ii)(b)); *O'Shaughnessy v Commr*, 332 F3rd 1125 (8th Cir 2003) , *rev'g in part* 2002-1 USTC P 50,235 (D Minn 2001) (agreeing with the analysis in *Brookshire* and holding that a change in classification of property under *IRC* § 168 falls within the useful life exception and, thus, does not constitute a change in method of accounting under *IRC* § 446(e)); *Green Forest Manufacturing Inc v Commr*, *TC Memo* 2003-75 (holding that a change in computing depreciation from the general depreciation system in *IRC* § 168(a) to the alternative depreciation system in *IRC* § 168(g) is a change in classification that falls within the useful life exception and, therefore, is not a change in method of accounting).

(n60)Footnote 50.2. *TD* 9305 , adding *Treas Reg* §§ 1.167(e)-1(e), 1.446-1(e)(2)(ii), and 1.1016-3(h).

(n61)Footnote 50.3. *Treas Reg* §§ 1.167(e)-1(e), 1.446-1(e)(4), and 1.1016-3(j).

(n62)Footnote 50.4. See *Brookshire Brothers Holding, Inc & Subsidiaries v Commr*, 320 F3d 507 (5th Cir 2003) , *affg TC Memo* 2001-150 , *reh'g en banc denied* 65 Fed Appx 511 (5th Cir 2003) ; *O'Shaughnessy v Commr*, 332 F3rd 1125 (8th Cir 2003) , *rev'g in part* 2002-1 USTC P 50,235 (D Minn 2001).

(n63)Footnote 50.5. Chief Counsel Notice 2004-007.

(n64)Footnote 50.6. *Treas Reg* § 1.446-1(e)(2)(ii)(d).

(n65)Footnote 50.7. *Treas Reg* § 1.446-1(e)(2)(ii)(d)(2).

(n66)Footnote 50.8. *Treas Reg* § 1.446-1(e)(2)(ii)(d)(2)(ii), (iii), (iv). The regulation applies to the pre-2008 version of *IRC* § 168(k), but would also seem to apply to the accelerated depreciation allowance for property acquired during 2008. See § 5.02[10], below, for a discussion of this provision.

(n67)Footnote 50.9. See *Treas Reg* § 1.446-1(e)(2)(ii)(d)(3)(i), discussed in § 5.01[8][c], below.

(n68)Footnote 50.10. See, for example, *IRC* §§ 167(f)(1), 168(c), 168(g)(2), (3), 197.

(n69)Footnote 50.11. *Treas Reg* § 1.446-1(e)(2)(ii)(d), (3)(i).

(n70)Footnote 50.12. *Treas Reg* §§ 1.446-1(e)(2)(ii)(d)(2)(v), 1.446-1(e)(2)(ii)(d)(3)(iv).

(n71)Footnote 50.13. *Treas Reg* § 1.446-(e)(2)(ii)(d)(3)(ii).

(n72)Footnote 50.14. *Treas Reg* § 1.446-(e)(2)(ii)(d)(3)(iii).

(n73)Footnote 50.15. *Treas Reg* § 1.446-(e)(2)(ii)(d)(3)(v).

(n74)Footnote 50.16. See, for example, *IRC* §§ 168(k), 1400L(b), 1400N(d).

(n75)Footnote 50.16.1. *Treas Reg* § 1.446-1(e)(2)(ii)(d)(3)(i).

(n76)Footnote 50.17. *Treas Reg* § 1.446-(e)(2)(ii)(d)(5).

(n77)Footnote 50.17.1. See, for example, *IRC* §§ 168(k), 1400L(b), 1400N(d).

(n78)Footnote 50.18. *Treas Reg* § 1.446-1(e)(5)(iii), Ex 9.

(n79)Footnote 50.19. *Treas Reg* § 1.1016-3(h).

(n80)Footnote 50.20. *Rev Proc* 2007-16, 2007-4 *IRB* 358 .

(n81)Footnote 50.21. *Treas Reg* § 1.1016-3(j)(2).

(n82)Footnote 51. *IRC* § 179(d)(4), (5).

(n83)Footnote 52. *IRC* § 179(a).

(n84)Footnote 53. *IRC* § 179(d)(1); *Hart v Commr*, *TC Memo* 1999-236 (tobacco barn not Section 179 property).

(n85)Footnote 53.1. *IRC* § 179(d)(1).

(n86)Footnote 54. *IRC* §§ 179(b)(1); 179(d)(1); 1245(a)(3); *Tibbs v Commr*, *TC Memo* 1987-515 . A 2003 statutory base amount of \$100,000 was subject to inflation adjustments in 2003 through 2006 [*IRC* § 179(b)(1), (5)(A), *before amendment* by Pub Law 110-28]. Effective for taxable years beginning in 2007, the statutory base amount was \$125,000 [*IRC* § 179(b)(1), *before amendment* by Pub L No 111-147]. Temporary patches increased the base amount for 2008 and 2009, and legislation enacted in 2010 established a \$250,000 limit effective for tax years beginning after 2007 and before 2011. The legislation incorporated into the statute the inflation-adjusted amounts for 2008 and 2009.

(n87)Footnote 54.1. *Rev Proc* 2003-85, 2003-2 *CB* 1184.

(n88)Footnote 54.2. *Rev Proc* 2004-71, 2004-2 *CB* 974.

(n89)Footnote 54.3. *Rev Proc* 2005-70, 2005-2 *CB* 979.

(n90)Footnote 54.4. See *IRC* § 179(b)(1).

(n91)Footnote 54.5. See *Rev Proc* 2008-54, 2008-38 *IRB* 722 ; the revenue procedure was initially directed to 2008/2009 years, and became unnecessary because of continued extension of the \$250,000 maximum deduction. Its rationale applies, however for any consecutive years in which the maximum *IRC* § 179 deduction is changed. See also *IRC* § 179(d)(8).

(n92)Footnote 55. *IRC* § 179(b)(2). A 2003 statutory base amount of \$400,000 was subject to inflation adjustments in 2003 through 2006 [*IRC* § 179(b)(2), (5)(A), *before amendment* by Pub Law 110-28]. Effective for taxable years

beginning in 2007, the statutory base amount was \$500,000 [IRC § 179(b)(2), *before amendment by Pub L No 111-147*]. Temporary patches increased the phase-out threshold for 2008 and 2009. Legislation enacted in 2010 established an \$800,000 limit effective for tax years beginning after 2007 and before 2011. The legislation incorporated into the statute the inflation-adjusted amounts for 2008 and 2009.

(n93)Footnote 55.1. *Rev Proc 2003-85, 2003-2 CB 1184.*

(n94)Footnote 55.2. *Rev Proc 2004-71, 2004-2 CB 974.*

(n95)Footnote 55.3-55.4. *Rev Proc 2005-70, 2005-2 CB 979.*

(N96)Footnote 55.5. *IRC § 179(e)(1)(A).*

(n97)Footnote 55.6. *IRC § 179(e)(1)(B).*

(n98)Footnote 55.7. *See IRC § 179(d).*

(n99)Footnote 55.8. *IRC § 179(e)(2).* *See § 5.02[12], for a detailed discussion of IRC § 168(n).*

(n100)Footnote 55.9. *IRC § 179(e)(3).*

(n101)Footnote 56. *Treas Reg § 1.179-1(f)(1).*

(n102)Footnote 56.1. *IRC § 179(b)(4).*

(n103)Footnote 57. *IRC § 179(b)(3)(A).*

(n104)Footnote 58. *IRC § 179(b)(3)(B).*

(n105)Footnote 59. *IRC § 179(b)(3); Treas Reg § 1.179-3(b)(1).*

(n106)Footnote 60. *Treas Reg § 1.179-3(c).*

(n107)Footnote 61. *Treas Reg § 1.179-3(d).*

(n108)Footnote 62. *Treas Reg § 1.179-1(d)(1).*

(n109)Footnote 63. *IRC § 179(d)(10); Treas Reg § 1.179-1(e)(1).*

(n110)Footnote 64. *IRC § 179(d)(8); see Treas Reg §§ 1.179-1(f)(2), 1.179-2(b)(3), (4), (c)(2), (3), 1.179-3(g), (h).*

(n111)Footnote 64.1. *IRC § 179(c)(1).*

(n112)Footnote 64.2. *Treas Reg § 1.179-5(c)(1).* *See Rev Proc 2008-54 , § 7, 2008-38 IRB 722 (election by amended return may be made for any tax years beginning before 2011).*

(n113)Footnote 64.3. *Treas Reg § 1.179-5(d).*

(n114)Footnote 64.4. *IRC § 179(c).*

(n115)Footnote 64.5. *IRC § 179(c)(2); Treas Reg § 1.179-5(c)(1), (3)(ii).*

(n116)Footnote 64.6. *Treas Reg § 1.179-5(c)(3)(i).*

(n117)Footnote 64.7. *Treas Reg § 1.179-5(d).*

(n118)Footnote 64.8. *Treas Reg § 1.179-5(c)(4)*.

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Federal Taxes Affecting Real Estate

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.02

§ 5.02 Cost Recovery and Depreciation

[1] Depreciation and ACRS Deductions--Generally

The depreciation provisions discussed above have taken on diminishing importance because of the introduction of the accelerated cost recovery system (ACRS) by ERTA, and the modified accelerated cost recovery system (MACRS) introduced by the Tax Reform Act of 1986.

Under the ACRS, n65 the cost of "recovery property" placed in service after 1980 is deducted over a pre-established period of time, rather than during the taxpayer's actual estimated useful life of the property. "Recovery property" is placed into one of several general categories or classes, with the depreciable life of the property being determined under the guideline class to which the property is assigned by the Service. Deductions allowed for the property are taken in accordance with statutorily-prescribed methods and are written off each year. Salvage value is not considered, and thus at the completion of the specified period--e.g., 27.5 years for residential rental property and 39 years for nonresidential real property under a straight-line method--the deductions will have totaled the original basis of the depreciable property. n66

As under the pre-ACRS depreciation rules, a taxpayer must establish the cost or other basis of any property upon which cost recovery deductions are based. Failure to do so may result in a denial of the deduction or an estimate of the deduction under the *Cohan* rule. n67

[2] Modified Accelerated Cost Recovery of Real Property: 1987 and Thereafter

[a] Recovery Method and Periods

Under the MACRS, the cost recovery allowance for tangible property, including depreciable real estate, is determined by using the applicable depreciation method, the applicable recovery period and the applicable convention. n68 Most depreciable real property will fall within the categories of residential rental property or nonresidential real property. The applicable appreciation method for both of these types of property is the straight-line method, not an accelerated method. n69 The applicable recovery periods for these types of property are as follows: n70

Real Property	Recovery Period
Residential rental property	27.5 years

Nonresidential real property 39 years

The applicable convention for both residential rental property and nonresidential real property is the mid-month convention. Under the mid-month convention, the real property placed in service or disposed of by a taxpayer at any time during a month is treated as having been placed in service or disposed of in the middle of the month. ⁿ⁷¹ Under an alternative depreciation system, the taxpayer can elect, on a building-by-building basis, a longer 40-year straight-line recovery period for residential rental property or nonresidential real property. ⁿ⁷² The election to use the alternative depreciation system must be made in the year in which the building is placed in service. ^{n72.1} Once made, the election is irrevocable. ^{n72.2} This election is frequently made by a partnership that owns property eligible for the low income housing tax credit. Qualified nonresidential real property located on Indian reservations and placed in service before 2010 has a recovery period of 22 years. ^{n72.3}

[b] Real Property in Recovery Property Classes

A building or structure is residential rental property for the tax year if 80 percent or more of the gross rental income from the property for the year is rental income from dwelling units. A dwelling unit is a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment more than one half of the units in which are used on a transient basis. The rental value of the portion of the building or structure occupied by the taxpayer is included in the gross rental income to determine if the 80 percent test is met. ⁿ⁷³

Example (1):

Martin constructs a six-story building in Year 1. When it is placed in service in Year 2, the first floor is rented to a retail store at \$15,000 rent for the year. The dwelling units are rented and generate rental income of \$60,000 for the tax year. Since 80 percent ($\$60,000/\$75,000$) of the gross rental income is from the dwelling units, the building qualifies as residential rental property in Year 2.

Example (2):

Martin operates the retail store in the building in Example (1) in Year 3, and he also occupies one of the apartment units. If the fair rental value of the store and the apartment are the same as in Year 2, the building would qualify as residential rental property since the rental value of the store and the apartment occupied by Martin are treated as rental income from the building.

Example (3):

The building in Example (1) produces \$18,000 rent from the store in Year 3 and \$64,000 of gross rental income from the apartments. Since only 78.05 percent ($\$64,000/\$82,000$) of the gross rental income comes from the dwelling units, the building does not qualify as residential rental property in Year 3.

Nonresidential real property is *IRC Section 1250* property, i.e., depreciable real property which is not residential rental property or property with a class life of less than 27.5 years. ⁿ⁷⁴ Where two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting), they may be treated as a single building for purposes of determining whether the building or structure is residential rental property or nonresidential real property. ^{n74.1}

Property with an assigned class life of less than 27.5 years avoids classification as nonresidential property. For example, nonresidential real property would not include real property with a class life of less than 27.5 years, such as a theme or

amusement park (12.5-year class life), recreational facilities, including theaters, bowling alleys, and miniature golf courses (10-year class life), farm buildings (25-year class life), certain waste processing facilities (7-year class life), n75 certain gas utility grading costs (15-year property), n75.1 certain electric utility clearing and grading costs (20-year property), n75.2 motorsports entertainment complexes (7-year property), n75.3 or a certain Alaska natural gas pipeline (7-year property). n75.4 Retail motor fuel outlets may be depreciated over 15 years, whether or not food or other convenience items are sold at the outlet, n76 and whether or not the taxpayer-owner is the operator of the outlet. n77 Certain qualified leasehold improvement property placed in service after October 22, 2004 and before 2010 is treated as 15-year property, n77.1 as is certain qualified restaurant property placed in service after October 22, 2004 and before 2010. n77.2 Qualified retail improvement property placed in service after December 31, 2008, and before January 1, 2010 is also depreciable over 15 years. n77.3

[c] Depreciation of Improvements to Property and Component Depreciation

The cost recovery allowance for any addition to or improvement of property is computed in the same manner as the deduction for the underlying property would be computed if the underlying property were placed in service at the same time as the addition or improvement. n78

The recovery period of any addition or improvement to property begins on the later of: (1) the date on which the addition or improvement is placed in service; or (2) the date on which the property on which the addition or improvement was made is placed in service. n79

Notwithstanding the general statutory prohibition against component depreciation, n80 the Tax Court has held that, for purposes of assigning appropriate recovery periods to properties, tests developed under pre-ACRS law for purposes of the investment tax credit n81 may apply in determining whether properties are tangible personal property or structural components. n82 Thus, an improvement to property that qualifies as tangible personal property may be treated as tangible personal property for purposes of MACRS and may be depreciated over a shorter life. n83 Under this rule, a variety of electrical distribution or wiring systems, carpeting, n84 partitions, and other miscellaneous equipment and improvements have been permitted to be depreciated over a shorter period than the property to which they have been added. n85 A hotel's magnetic stripe keycard door locking system, however, has been treated as nonresidential real property with a recovery period of 39 years. n86 The IRS has taken the position that open-air parking structures are also nonresidential real property, and therefore have a recovery period of 39 years. n86.1

The IRS has issued a ruling that clarifies its examining approach with respect to depreciation of structural components. n87 The ruling reviews case authority and regulations n88 and notes that the focus in determining whether an item is a structural component is on the ultimate use of the item. This finding requires a facts and circumstances approach. The ruling states that pre-1981 case law and factors set forth in *Whiteco* n89 are relevant in making that determination. The factors used in *Whiteco* in determining whether property is inherently permanent and therefore not tangible personal property are the following: n90

- Is the property capable of being moved, and has it in fact been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that tend to show the expected or intended length of affixation, i.e., that the property may or will have to be moved?
- How substantial a job is removal of the property and how time consuming is it?
- How much damage will the property sustain upon removal?

● What is the manner of affixation of the property to the land?

The ruling states that no single factor set forth in *Whiteco* is the sole determinant of whether a particular item is tangible property, and, in view of the factual nature of the inquiry, no bright line test exists. The ruling makes special mention of the importance and use of cost segregation studies and further states that those studies must be specifically applied by the taxpayer and closely scrutinized by examiners. The ruling offers guidelines with respect to these studies. An accurate cost segregation study cannot be based on non-contemporaneous records, reconstructed data, or the taxpayer's estimates or assumptions that have no supporting records. n91

Several rulings have applied these factors in categorizing and analyzing raised floors that are installed to facilitate installation of various items. Although the term "structural component" can include parts of a building such as floors, n91.1 the IRS has ruled that a false raised floor that was built to permit wiring, air conditioning ducts, and other services for a computer to be installed was tangible personal property and not a structural component. n91.2

The IRS has indicated a similar result might hold with respect to a raised floor installed during the initial construction of a building in order to facilitate the installation of wiring, plumbing, and ventilation for computers and other equipment. The floor included removable panels providing access between the raised floor and the sub-floor. Removal of the raised floor, while possible, would necessitate a major renovation of the building's interior. The IRS hedged making an absolute position, however, and indicated that, depending on facts of any given case, a good argument could be made that the raised floor was a structural component and not tangible personal property with a recovery period of 5 years. n91.3

Another ruling details the IRS position regarding the recovery periods for various components of an elaborate hotel/casino complex. The ruling discusses the recovery periods for tangible personal property, which depend on the property's class life under *IRC Section 167(m)*, n91.4 and the recovery periods for exterior building facades, decorative ceilings, electrical outlets, door locks, wall coverings, millwork, decorative lighting fixtures, kitchen equipment, power generators, and a variety of other items. The ruling is instructive as the IRS analysis and approach to component depreciation. n91.5

In another ruling applying the *Whiteco* factors, n91.6 the IRS determined that gasoline pump canopies were tangible personal property for depreciation purposes with a 5-year recovery period, but that their supporting concrete footings were land improvements for depreciation purposes with a 15-year recovery period. n91.7 In a separate ruling dealing with the proper asset class for parking lots, the IRS determined that a parking lot connected to a steam production plant producing electricity was depreciable over a recovery period of 20 years, but a parking lot adjacent to the taxpayer's corporate headquarters was in a different class and was depreciable over a recovery period of 15 years. n91.8

In determining whether an item is a permanent land improvement or is depreciable as personal property over a shorter recovery period based on its class life, n91.9 courts first look to the asset guideline class into which the item is classified in *Revenue Procedure 87-56*. n91.10 If an item isn't clearly classified in that procedure, courts, like the IRS, apply the *Whiteco* factors to determine the proper characterization of the item. n91.11 In one case the court held that drip irrigation systems and wells used in connection with grapevines were permanent improvements, but trellising was properly classified as 10-year class life farm machinery or equipment. The trellising could therefore be depreciated over a 5-year recovery period. n91.12

Note:

Any change in the method of computing the depreciation allowances with respect to a particular account, or any change in depreciation method, is a change in method of accounting, for which IRS consent must be obtained. n92 Any reclassification of assets from Section 1250 property to Section 1245 property would, therefore, require prior IRS approval. A change in recovery period or convention in computing

depreciation is also a change of accounting method because it affects the timing of deductions, and IRS approval for the change must also be obtained. n93 A cost segregation study to properly categorize various assets should be undertaken with respect to rehabilitations, new construction, and acquisitions involving mixed assets. If a Form 3115 is filed to request a change in accounting method in order to claim larger depreciation allowances for prior years, any unclaimed depreciation for those years may be claimed in the year of the change as a *IRC Section 481* adjustment. n93.1

[d] Leasehold Improvements

In general, a lessee who makes improvements on property it leases may claim depreciation deductions on that property. n93.2 The cost of leasehold improvements made by a lessee, including the erection of a building on leased premises, is ordinarily recovered by the lessee under the cost recovery rules without regard to the lease term. The lessee is entitled to the deduction even if the lessor owns the constructed property. n93.3 On termination of the lease, a lessee who does not retain the improvement computes gain or loss by reference to the adjusted basis of the improvement at that time. n94 Although a lessee cannot generally deduct the cost of capital improvements to a lessor's property, n94.1 a current deduction is permitted if the capital expenditure is made in lieu of rent. n94.2 In order for a current deduction to be permitted, the lessor and lessee must intend that some or all of the lessee's capital expenditures are rent, and this intent must be plainly disclosed by the terms of the lease or the surrounding circumstances. n94.3

A separate depreciation rule comes into play for leasehold improvements that are made by the lessor. If the leasehold improvements made by the lessor are irrevocably disposed of or abandoned by the lessor at the end of the lease term, the lessor may treat the abandonment as a disposition of the improvements and use the adjusted basis of the improvements at that time to determine gain or loss. This provision allows lessors to write off the costs of abandoned improvements at the time the lease is terminated, rather than requiring the lessor to continue to write off the improvements over their remaining recovery period. n95

A lessee is also entitled to amortize its cost of acquiring its leasehold interest. In determining the amortization period for the lessee's cost of acquiring a lease (rather than leasehold improvements made by the lessee) the lease term is treated as including all renewal options, and any other period for which the parties reasonably expect the lease to be renewed, if less than 75 percent of the lease acquisition cost is attributable to the period of the term of the lease remaining on the date of its acquisition. In determining the period remaining on the term of the lease under this 75 percent test, periods of renewal, extension or continuation under an option exercisable by the lessee are not taken into account. n96

Qualified leasehold improvement property that is placed in service after October 22, 2004 and before 2010 is treated as 15-year recovery property, n96.1 and must be recovered using the straight-line method over that recovery period. n96.2 Qualified leasehold improvement property for this purpose includes any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. n96.3

If a lessor makes an improvement that qualifies as qualified leasehold improvement property, the improvement does not qualify as qualified leasehold improvement property to any subsequent owner of the improvement. n96.4 An exception to this rule applies in the case of death, mere changes in the form of business, and certain transfers of property that qualify for non-recognition treatment. n96.5

Under the alternative depreciation system, qualified leasehold improvement property has a class life of 39 years. n96.6

[e] Qualified Restaurant Property

Qualified restaurant property that is placed in service after October 22, 2004 and before 2010 is treated as 15-year recovery property, n96.7 and must be recovered using the straight-line method over that recovery period. n96.8 For property placed in service before January 1, 2009, qualified restaurant property means any improvement to a building if (1) that improvement is placed in service more than three years after the date the building was first placed in service; and (2) more than 50 percent of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. n96.9 Qualified restaurant property placed in service before January 1, 2009 also becomes eligible for the additional first-year depreciation deduction under *IRC Section 168(k)* by virtue of its assigned 15-year recovery period, provided it is placed in service within the required time period specified by that provision. n96.10 Under the alternative depreciation system, qualified restaurant property has a class life of 39 years. n96.11

For property placed in service after 2008, qualified restaurant property includes new construction of any building placed in service during calendar year 2009. It also includes improvements to a building (without regard to when the building was first placed in service). In either case, however, more than 50 percent of the building's square footage must be devoted to preparation of, and seating for on-premises consumption of, prepared meals. n96.11.1 Qualified property placed in service after 2008 is not eligible for bonus depreciation under *IRC Section 168(k)*. n96.11.2

Restaurant property that does not qualify as 15-year recovery property under the above provision is generally depreciated under the regular MACRS rules for nonresidential property-using the straight-line method of depreciation and a recovery period of 39 years. n96.12

[f] Qualified Retail Improvement Property

Qualified retail improvement property placed in service after December 31, 2008, and before January 1, 2010 is depreciable over 15 years using straight-line depreciation. n96.13 "Qualified retail improvement property" includes any improvement to an interior portion of a nonresidential building if the portion is open to the general public and is used in the retail trade or business of selling tangible personal property, and the improvement is placed in service more than three years after the building was first placed in service. n96.14 In the case of owner-owned improvements, the improvement is eligible for 15-year recovery only so long as the improvement is held by the owner that made the improvement. n96.15 The accelerated recovery is not available for enlargements of a building, an elevator or escalator, improvements to any structural component benefitting a common area, or improvements to the internal structural framework of a building. n96.16 Qualifying property is not eligible for bonus depreciation under *IRC Section 168(k)*. n96.17 Under the alternative depreciation method, qualified retail improvement property has a class life of 39 years. n96.18

[3] Accelerated Cost Recovery of Real Property: 1981-1986

The accelerated cost recovery system required the capital cost of qualified real (or personal) property, placed in service by the taxpayer during 1981 through 1986, to be recovered by an accelerated or straight-line method (without regard to salvage) over predetermined periods generally unrelated to, but shorter than, the property's useful life. n97 The ACRS applied to "recovery property," which was defined as depreciable tangible property used in a trade or business or held for the production of income. n98 Depreciation under *IRC Section 167* remains in effect for property placed in service before 1981. n99

[a] Recovery Property; Recovery Period

Several classes of recovery property were distinguished by the number of years over which cost recovery deductions could be taken with respect to the property in each class. n100 At the completion of the specified period, the deductions

should total the original basis of the property. Salvage value is not taken into account in determining the allowable deductions. n101

Most real property fell into a class which described its recovery period. This was initially "15-year real property," later extended to "18-year real property," and then "19-year real property." Other classes for which real property could qualify included "10-year property" and "low-income housing," the latter remaining with a 15-year recovery period. n102 The recovery periods and methods still apply to taxpayers who placed that property in service during the applicable periods.

A taxpayer could have elected to recover the cost of recovery property over a period longer than that described above, using the straight-line method. Thus, for ten-year property the electable recovery periods were ten, 25 or 35 years; for 15, 18 or 19-year real property, the electable periods were 15, 18, 19 (respectively), 35 or 45 years. n103 The election could be made on a property-by-property basis with respect to 15, 18 or 19-year real property or low-income housing. n104 Longer periods were required for property used predominantly outside the United States. n105

Under special "anti-churning rules," the ACRS provisions excluded (and still exclude) property obtained in certain transactions from qualifying as recovery property even if acquired by the taxpayer after 1980 (or 1986). These rules, which apply to both real and personal property, were (and are) designed to prevent taxpayers from turning their depreciable property placed in service before 1981 (or 1986) into ACRS property available for the newer writeoffs. n106

[b] Recovery Methods; Cost Recovery Deductions

The accelerated cost recovery allowance for 15, 18 or 19-year real property were based on the 15, 18 or 19-year recovery periods using a method similar to 175 percent declining balance (200 percent in the case of low-income housing property), and switching to a straight-line method in later years to maximize the allowable deduction. n107 Recovery of property, other than 19-year real property, was subject to a half-year convention. n108

The recovery allowance for 15, 18 or 19-year real property for the year it was placed in service or for the year of disposition was based on the number of months it was in service during the year, regardless of the duration of the taxpayer's taxable year, the property's recovery period or the recovery method used. n109

The recovery method for a building which is *IRC Section 1250* class property, generally real property, applies to any component of the building. The recovery period for a building component begins on the later of the date such component, or the building, is placed in service. n110 For practical purposes, this provision eliminates the former practice of "component depreciation," under which separate depreciation methods based on various useful lines were used for the building and individual components.

The cost of making a substantial improvement to a building, however, was eligible for a cost-recovery method other than the one used for the cost of the building being improved, i.e., the improvement is treated as a separate building. n111 The improvement was substantial only if:

- (1) it was made more than three years after the building was placed in service; and
- (2) it added to the capital account of the building within a 24-month period an amount equal to or in excess of 25 percent of the building's adjusted basis as of the first day of the 24-month period. n112

[c] Disposition of Recovery Property

If 1981-1986 ACRS property is sold or otherwise disposed of in a transaction where gain or loss is recognized, the gain

or loss is usually recognized on an asset-by-asset basis. An ACRS deduction may not be claimed for the property in the year of disposition unless it is transferred in a tax-free exchange where the transferee is treated as the transferor (and required to use the transferor's depreciation method and depreciation period) to the extent of carryover basis, n113 or it is 15, 18 or 19-year real property. n114 However, that to the extent ACRS deductions in excess of straight line have been claimed for the property, there may be ordinary income recapture under *IRC Sections 1245 and 1250*. (Rules governing recapture of cost recovery are discussed in the next chapter.) n115

[4] Additional 30-Percent First-Year Depreciation (for Property Acquired Before 2005)

An additional first-year depreciation deduction is available for qualified property acquired after September 10, 2001 and before January 1, 2005. n115.1 The additional deduction is equal to 30 percent of the property's adjusted basis. n115.2 The additional depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. n115.3 The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. n115.4 A taxpayer may elect not to have the additional first-year depreciation apply with respect to any class of property for any taxable year. n115.5 If a taxpayer elects not to deduct any additional first year depreciation for a class of property, the AMT depreciation adjustments n115.5.1 apply to that property for purposes of computing the taxpayer's alternative minimum taxable income. n115.5.2 Property for which the bonus 50-percent first-year depreciation deduction is claimed n115.5.3 is not eligible for the 30-percent additional first year depreciation deduction. n115.5.4

To qualify for the additional first-year depreciation deduction, several requirements (discussed in detail below) must be met:

- (1) the depreciable property must be of a specified type;
- (2) the original use of the depreciable property must commence with the taxpayer after a specified date;
- (3) the depreciable property must be acquired by the taxpayer within a specified time period; and
- (4) the depreciable property must be placed in service by a specified date. n115.5.5

To be eligible for the deduction, the property must meet all of these requirements in the first taxable year in which the property is subject to depreciation by the taxpayer, whether or not depreciation deductions are allowable. n115.5.6

Property otherwise depreciable under MACRS qualifies for the additional first-year depreciation deduction only if the property is one of the following: n115.6

- property with a recovery period of 20 years or less;
- water utility property; n115.6.1
- computer software other than computer software covered by *IRC Section 197*; or
- qualified leasehold improvement property.

Qualifying property also includes certain property that is subject to the capitalization rules n115.6.2 and is described in the provisions requiring an estimated production period exceeding 2 years or an estimated production period exceeding 1 year and a cost exceeding \$1 million. n115.7

Regulations provide that the following property is not eligible for the 30-percent additional first-year depreciation: n115.7.1

- certain property not subject to depreciation under *IRC Section 168*; n115.7.2
- property that is required to be depreciated under the alternative depreciation system (ADS) n115.7.3 or other provisions--this exception could apply to tax-exempt use property or tax-exempt bond financed property;
- certain property used in a farming business; n115.7.4
- qualified New York Liberty Zone leasehold improvement property; n115.7.5 or
- property for which the taxpayer elects not to deduct 30-percent additional first-year depreciation.

MACRS property for which the taxpayer makes an election to depreciate the property under the ADS system, in contrast, is eligible for the additional first year depreciation deduction (assuming all other requirements are met). n115.7.6

As a practical matter, except for qualified leasehold improvement property, the deduction comes into play primarily for personal property. n115.8

When qualified leasehold improvement property is involved, however, the additional first-year depreciation deduction can affect real estate. n115.9 Qualified leasehold improvement property includes an improvement to an interior portion of a building that is nonresidential real property if the following requirements are met: n115.10

- the improvement is made under or pursuant to a lease between unrelated persons by either the lessee or the lessor;
- that portion is to be occupied exclusively by the lessee (or sublessee) of that portion; and
- the improvement is placed in service more than 3 years after the date the building was first placed in service.

Certain improvements cannot qualify as qualified leasehold improvement property, including expenditures attributable to the enlargement of a building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building. n115.11 Regulations clarify what improvements constitute qualified leasehold property. n115.11.1

In order to be qualified property, the original use of the property generally must commence with the taxpayer on or after September 11, 2001 and before January 1, 2005. n115.12 An extension of the placed-in-service date (to January 1, 2006) is provided for certain property with a longer production period (i.e., property with a recovery period of at least 10 years, certain transportation property, and property that is subject to the uniform capitalization rules because it has an estimated production period exceeding 2 years, or an estimated production period exceeding 1 year and a cost exceeding \$1 million). n115.12.1 For certain property placed in service by taxpayers affected by Hurricanes Katrina, Rita, and Wilma the Secretary of the Treasury was authorized to extend the required date of the placement in service of that property by up to one year on an individual taxpayer basis, the Secretary of the Treasury. n115.12.2 but the IRS later announced an extended placed-in-service date to January 1, 2007 for all taxpayers, for property that is either placed in service by the taxpayer or manufactured by a person in the GO Zone, the Rita GO Zone, or the Wilma GO Zone. The extension applies only if the taxpayer was unable to meet the prior placed-in-service deadline for the property as a result

of Hurricane Katrina, Rita, or Wilma. n115.12.3 Original use generally means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Thus, new property initially used by a taxpayer for personal use and then subsequently converted by the taxpayer for use in its trade or business satisfies the original use requirement. However, new property acquired by a taxpayer for personal use and then subsequently acquired by a different taxpayer for use in its trade or business does not. n115.12.4

In addition, property qualifies for the additional deduction only if the taxpayer purchases (or begins construction of) the property (1) after September 10, 2001 and before January 1, 2005, and no binding written contract for the acquisition is in effect before September 11, 2001 or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before January 1, 2005. n115.13

A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to that person by the taxpayer within three months after the date that the property was placed in service, said property is treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. n115.13.1

Separate rules apply to the syndication of a lease by the lessor. If property is originally placed in service by a lessor (including by reason of self-construction of the property), n115.13.2 the property is sold within three months after the date that the property was placed in service, and the user of the property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of that sale.- n115.13.3 For multiple units of property subject to the same lease, property is treated as placed in service on the date of sale for purposes of qualifying for additional first-year depreciation if it is sold within three months after the final unit is placed in service, so long as the period between the time the first and last units are placed in service does not exceed 12 months. n115.13.4

Limitations apply regarding qualified property that was subject to prior contracts or was being constructed on or before September 10, 2001. Property qualifying for additional first-year depreciation does not include any property if the user or a related party to the user or owner of that property had a written binding contract in effect for the acquisition of the property at any time on or before September 10, 2001 (or, in the case of self-constructed property, the manufacture, construction, or production of the property began on or before September 10, 2001). For example, if a taxpayer sells to a related party property that was under construction on or prior to September 10, 2001, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract on or prior to September 10, 2001, the property does not qualify for the additional first year depreciation deduction. Furthermore, if a taxpayer sells property and leases the property back in a sale-leaseback arrangement, and the lessee had a binding written contract in effect for the acquisition of such property on or prior to September 10, 2001, then the lessor is not entitled to the additional first-year depreciation deduction. n115.14

[5] Additional Bonus 50-Percent First-Year Depreciation (for Property Acquired Before 2005)

An additional bonus first-year depreciation deduction may be taken equal to 50 percent of the adjusted basis of qualified property. n115.14.1 Qualified property is defined in the same manner as for purposes of the additional 30-percent first-year depreciation deduction, n115.14.2 except that the applicable time period for acquisition (or self construction) of the property is modified. n115.14.3 Property for which the bonus 50-percent first-year depreciation deduction is claimed is not eligible for the additional 30-percent first year depreciation deduction. n115.14.4 The bonus 50-percent first-year depreciation is allowed for both regular tax and alternative minimum tax purposes for the tax year in which the property is placed in service. n115.14.5 A taxpayer may elect not to have the bonus 50-percent depreciation apply to any class of property for any tax year. n115.14.6 If a taxpayer makes this election out, the AMT depreciation adjustments n115.14.7 apply to that property for purposes of computing the taxpayer's alternative minimum taxable income. n115.14.8 A taxpayer may request permission to revoke its election not to deduct the 50-percent depreciation through a private letter ruling. n115.14.9 An automatic 6-month extension from the due date of the taxpayer's federal tax return (excluding extensions) to revoke an election out is also available, provided the taxpayer filed a timely return

for the placed-in-service year of the class of property and, within this 6-month extension period, the taxpayer (and all taxpayers whose tax liability would be affected by the election) files an amended return for the placed-in-service year of the class of property in a manner that is consistent with the revocation of the election. n115.14.10

Two election options are available. First, for any class of 50-percent bonus depreciation property placed in service during the taxable year, a taxpayer may make an election to deduct the 30-percent, instead of the 50-percent, additional first-year depreciation. If this election is made, the allowable additional first-year depreciation deduction is determined as though the class of property is qualified property for purposes of 30-percent additional first-year depreciation. n115.14.11 Alternatively, the taxpayer may elect not to deduct both the 30-percent and the 50-percent additional first year depreciation. If this election is made, no additional first year depreciation deduction is allowable for the class of property. n115.14.12

In order to qualify for the bonus 50-percent depreciation deduction, the original use of the property must commence with the taxpayer after May 5, 2003. n115.14.13 The property must also be either (1) acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition was in effect before May 6, 2003; or (2) acquired by the taxpayer pursuant to a written binding contract which was entered into after May 5, 2003, and before January 1, 2005 n115.14.14 With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. n115.14.15

Property generally must be placed in service before January 1, 2005 to qualify for the bonus 50-percent depreciation deduction, but certain property with longer production periods (i.e., property with a recovery period of at least 10 years, certain transportation property, and property that is subject to the uniform capitalization rules because it has an estimated production period exceeding 2 years or an estimated production period exceeding 1 year and a cost exceeding \$1 million) will qualify if placed in service prior to January 1, 2006. n115.14.16 For property with a longer production period that is eligible for the extended placed-in-service date, however, only costs incurred before January 1, 2005 are eligible for the bonus 50-percent depreciation deduction. n115.14.17 The adjusted basis of qualified property acquired by a taxpayer in a like-kind exchange or an involuntary conversion is eligible for the bonus 50-percent bonus first-year depreciation deduction. n115.14.18

[6] Special Depreciation Allowance for Certain Property in New York Liberty Zone

[a] In General

Apart from the pre-2005 additional 30-percent first-year depreciation deduction n115.14.19 and the pre-2005 additional 50-percent bonus first-year depreciation deduction, n115.14.20 (which are allowed whether or not the property is located in the New York Liberty Zone), n115.15 an additional first-year depreciation deduction is allowed for certain property in the New York Liberty Zone. The amount of the deduction is 30 percent of the adjusted basis of qualified New York Liberty Zone property. n115.16 This additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. n115.17 The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. n115.18 In addition, no adjustment to the allowable amount of depreciation is made for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the additional depreciation deduction applies. n115.19 Property eligible for either the additional 30-percent first-year depreciation deduction or the additional 50-percent bonus first-year depreciation deduction under *IRC Section 168(k)* n115.20 is not eligible for the New York Liberty Zone additional first-year depreciation. n115.21 A taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year. n115.22 If a taxpayer makes this election out, the AMT depreciation adjustments n115.22.1 apply to that property for purposes of computing the taxpayer's alternative minimum taxable income. n115.22.2 A taxpayer may seek to revoke an election out by requesting a private letter ruling from the Commissioner. n115.22.3 An automatic 6-month extension from the

due date of the taxpayer's federal tax return (excluding extensions) to revoke an election out is also available, provided the taxpayer filed a timely return for the placed-in-service year of the class of property and, within this 6-month extension period, the taxpayer (and all taxpayers whose tax liability would be affected by the election) files an amended return for the placed-in-service year of the class of property in a manner that is consistent with the revocation of the election [Reg § 1.1400L(b)-1(e)(7)(ii)].

In order for property to qualify for the additional first-year New York Liberty Zone depreciation deduction, it generally must meet all of the following requirements. First, the property must be property to which the general rules of MACRS apply. The property must also be (1) property with an applicable recovery period of 20 years or less, (2) water utility property, (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by *IRC Section 197*. n115.23 A special rule precludes the additional first year depreciation under this provision for qualified New York Liberty Zone leasehold improvement property. n115.24

Second, substantially all of the use of the qualifying property must be in the New York Liberty Zone. n115.25 "New York Liberty Zone" means the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. n115.26

Third, the original use of the property in the New York Liberty Zone must commence with the taxpayer on or after September 11, 2001 (except for certain leased property). Finally, the property must be purchased by the taxpayer after September 10, 2001, and placed in service before January 1, 2007. For qualifying nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2009. Property will not qualify if a binding written contract for the acquisition of the property is in effect before September 11, 2001. n115.27

Nonresidential real property and residential rental property is eligible for the New York Liberty Zone additional first-year depreciation only to the extent that the property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed property if, as part of an integrated plan, it replaces real property which is included in a continuous area which includes real property destroyed or condemned. For purposes of the provision, it is intended that real property destroyed or condemned only include circumstances in which an entire building or structure was destroyed or condemned as a result of the terrorist attacks. Otherwise, the property is considered damaged real property. n115.28 Real property is a building or its structural components, or other tangible real property. n115.28.1

Special rules apply for New York Liberty Property that are similar to those regarding lease syndication and related user and party rules for additional 30-percent first-year depreciation provided under prior law. n115.28.2 Thus, property qualifying for the additional New York Liberty Zone depreciation does not include any property if the user or a related party to the user or owner of that property had a written binding contract in effect for the acquisition of the property at any time before September 11, 2001 (or in the case of self-constructed property the manufacture, construction, or production of the property began before September 11, 2001). n115.28.3 In addition, if (1) property is originally placed in service by a lessor (including by virtue of self-construction, n115.28.4 (2) the property is sold within three months after the date that the property was placed in service, and (3) the user of that property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of that sale. n115.28.5

[b] Qualified New York Liberty Zone Leasehold Improvement Property

For purposes of MACRS depreciation rules, 5-year property includes qualified New York Liberty Zone leasehold improvement property. n115.29 The term New York Liberty Zone leasehold improvement property means property defined in *IRC Section 168(k)(3)* that is placed in service after September 10, 2001 and before January 1, 2007 (and not subject to a binding contract on September 10, 2001) in the New York Liberty Zone. n115.30 Property described in *IRC Section 168(k)(3)* generally includes any improvement to an interior portion of a nonresidential building if the following

requirements are met: n115.31

- the improvement is made under or pursuant to a lease between unrelated persons by either the lessee or the lessor;
- that portion is to be occupied exclusively by the lessee (or sublessee) of that portion; and
- the improvement is placed in service more than 3 years after the date the building was first placed in service.

Certain improvements are not included in *IRC Section 168(k)(3)*, however, including expenditures attributable to the enlargement of a building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building. n115.32

The straight-line method must be used with respect to qualified New York Liberty Zone leasehold improvement property unless the taxpayer elects out of the 5-year recovery period for that property. n115.33 A 9-year period is specified as the class life of qualified New York Liberty Zone leasehold improvement property for purposes of the alternative depreciation system. n115.34

Taxpayers may elect not to have otherwise qualifying leasehold improvement property treated as 5-year property. If made, the election applies to all qualifying leasehold improvement property placed in service during the taxable year. n115.34.1

[7] Commercial Revitalization Deduction

[a] In General

A taxpayer may elect to recover the cost of a qualified revitalization building using a more accelerated method than is otherwise allowable under *IRC Section 168*. n115.35 A taxpayer may elect to do either of the following: n115.36

- deduct one-half of any qualified revitalization expenditures chargeable to a capital account with respect to any qualified revitalization building for the taxable year in which the building is placed in service; or
- amortize all qualified revitalization expenditures ratably over the 120-month period beginning with the month in which the building is placed in service.

If the taxpayer makes a commercial revitalization deduction election, n115.37 a depreciation deduction is not allowable for the amounts deducted or amortized under *IRC § 1400I(a)*. n115.38 The commercial revitalization deduction is allowed for both regular tax and alternative minimum tax purposes. n115.39

With respect to any qualified revitalization building, the aggregate amount that can be treated as qualified revitalization expenditures is the lesser of (1) \$10 million, or (2) the commercial revitalization expenditure amount allocated to the building by the state commercial revitalization agency where the building is located. n115.40

[b] Buildings and Expenditures Qualifying for the Deduction

Only buildings placed in service before 2010 n115.41 and located in a "renewal community" are eligible for the commercial revitalization deduction. n115.42 A "renewal community" is an area designated as such by the Secretary of HUD based on specified standards of poverty, unemployment, general distress, and other factors. n115.43 To qualify

for the deduction, either of the following placed in service requirements must be met: n115.44

- the building must be placed in service by the taxpayer and the original use of the building must begin with the taxpayer; or
- the building must be substantially rehabilitated n115.45 by the taxpayer and must be placed in service by the taxpayer after the rehabilitation.

An expenditure is eligible for the commercial revitalization deduction only if it is properly chargeable to capital account for depreciable property. n115.46 In addition, the property must be nonresidential real property n115.47 or must be Section 1250 property n115.48 that is functionally related and subordinate to nonresidential real property. n115.49

In the case of a building that is substantially rehabilitated by the taxpayer, n115.50 the acquisition cost of the building can be treated as a qualified revitalization expenditure only to the extent that it does not exceed 30 percent of the other qualified revitalization expenditures with respect to the building. n115.51 No expenditure that the taxpayer takes into account in computing any credit can be included as a qualified revitalization expenditure unless the taxpayer elects to take the expenditure into account only for purposes of the commercial revitalization deduction. n115.52

[c] State Agency Allocation of Commercial Revitalization Expenditure Amounts

The commercial revitalization agency for each state is permitted to allocate up to \$12 million of commercial revitalization expenditure amounts with respect to each renewal community located within the state for each calendar year after 2001 and before 2010. n115.53 The allocation must be made pursuant to a qualified allocation plan that is approved by the governmental unit of which the commercial revitalization agency is a part. n115.54 Further, the commercial revitalization agency for the state n115.55 must notify the chief executive officer (or its equivalent) of the local jurisdiction in which the qualified revitalization building is located of the allocation and provide that individual a reasonable opportunity to comment on the allocation. n115.56 Generally, the allocation under *IRC Section 1400I* is made at the same time and in the same manner as under the low-income housing credit provisions--ordinarily in the calendar year in which the building is placed in service. n115.57

The IRS has issued a detail revenue procedure which provides general rules under which commercial revitalization expenditures may be allocated and specifies the manner of making carryover allocations. n115.58 The procedure also details special rules for the 2002 or 2003 commercial revitalization expenditure ceiling, for certain carryover allocations made in 2002, and for allocation documents made in 2002. n115.59

[d] Manner of Making the Election

The manner of making the commercial revitalization deduction election is set forth in *Revenue Procedure 2003-38*. n115.60 The election is made by each person owning the qualified revitalization building (for example, by the member of a consolidated group, the partnership, or the S corporation that owns the building). The election must be made for the taxable year in which the building is placed in service. The election only applies to the extent that qualified commercial revitalization expenditure amounts are allocated to the building by the commercial revitalization agency of the state in which the building is located. n115.61 If the amount of that allocation exceeds the amount properly chargeable to a capital account for the building, the qualified revitalization expenditures eligible for the commercial revitalization deduction election are limited to the amount properly chargeable to a capital account for the building. n115.62

The election must be made by the due date (including extensions) of the federal tax return for the taxable year in which the qualified revitalization building is placed in service by the taxpayer. The election must be made in the manner prescribed in the instructions for Form 4562, *Depreciation and Amortization*. n115.63 An automatic extension of 6 months from the due date of the federal tax return (excluding extensions) for the placed-in-service year of the qualified

revitalization building is granted to make the election, provided the taxpayer timely filed its federal tax return for the placed-in-service year and the taxpayer satisfies the requirements in the regulations for receiving an extension. n115.64 A taxpayer that fails to make the commercial revitalization deduction election for the qualified revitalization building, but wants to do so, must file a request for an extension of time to make the election. n115.65

A taxpayer that places in service more than one qualified revitalization building during a taxable year may make the commercial revitalization deduction election for the placed-in-service year separately for each building. For example, a taxpayer that places in service in a single year three qualified revitalization buildings for which commercial revitalization expenditure amounts are allocated, may elect to deduct one-half of the qualified revitalization expenditures for one building and elect to amortize the qualified revitalization expenditures for the other two buildings ratably over a 120-month period. n115.66

The commercial revitalization deduction election is revocable only with the prior written consent of the Commissioner, which may be obtained by filing a request for a private letter ruling. n115.67

If a taxpayer does not properly make a timely commercial revitalization deduction election for a qualified revitalization building, the amount of depreciation allowable for that property must be determined under *Treas Reg* § 1.167(j)-3(b)(1)(ii) for the placed-in-service year and for all subsequent years. Thus, the commercial revitalization deduction election cannot be made by the taxpayer in any manner other than as set forth in the revenue procedures (for example, through a request under *IRC Section 446(e)* to change the taxpayer's method of accounting). n115.68

[8] AMT Depreciation of Real Property

For real property placed in service after 1998, AMT and regular tax depreciation deductions are the same, computed using the straight-line depreciation method over the property's MACRS recovery period. n115.69 For real property placed in service after 1986 and before 1999, the straight-line method of depreciation is used in computing the depreciation deduction for AMT purposes. n115.70 The recovery period for AMT purposes, however, is 40 years, n115.71 whereas the recovery period for regular tax purposes is 27.5 years (for residential rental property) or 39 years (for nonresidential real property). n115.72

[9] Special First-Year Depreciation Allowance for Cellulosic Biofuel

Taxpayers may take an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified cellulosic biomass biofuel, effective for property placed in service after October 3, 2008, in taxable years ending after that date. n115.72.01 For prior years, the additional depreciation was available only for qualified cellulosic biomass ethanol plant property. n115.72.1 "Cellulosic biofuel" is any liquid fuel which is produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis. n115.72.2 In order to qualify, the property generally must be placed in service before January 1, 2013. n115.72.3 The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. n115.72.4

The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under *IRC Section 162* or subject to capitalization under *IRC Section 263* or *IRC Section 263A*. n115.72.5 The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. n115.72.6 In addition, there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. n115.72.7 A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year. n115.72.8

In order for property to qualify for the additional first-year depreciation deduction, it must meet the following

requirements: n115.72.9

- The original use of the property must commence with the taxpayer on or after December 20, 2006.
- The property must be acquired by purchase (as defined under *IRC Section 179(d)*) by the taxpayer after December 20, 2006 and placed in service before January 1, 2013. Property does not qualify if a binding written contract for its acquisition was in effect on or before December 20, 2006.
- Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after December 20, 2006, and the property is placed in service before January 1, 2013 (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Property any portion of which is financed with the proceeds of a tax-exempt obligation under *IRC Section 103* is not eligible for the additional first-year depreciation deduction. n115.72.10 Recapture rules apply under the provision if the property ceases to be qualified cellulosic biofuel. n115.72.11 Property with respect to which the taxpayer has elected 50-percent expensing under *IRC Section 179C* is not eligible for the additional first-year depreciation deduction. n115.72.12

[10] Additional 50-Percent First-Year Depreciation for Property Acquired During 2008 or 2009

[a] In General

An additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property is allowed for qualifying property that is acquired during calendar year 2008 or 2009. n115.72.13 The additional first-year depreciation deduction is allowed for the taxable year in which the property is placed in service. n115.72.14 The deduction is allowed for both regular tax and alternative minimum tax purposes. n115.72.15 It is not, however, allowed for purposes of computing earnings and profits. n115.72.16

A taxpayer may elect out of additional first-year depreciation for any class of property. n115.72.17 Rules for making the election out with respect to the prior accelerated depreciation provisions. n115.72.18 and clarification of what constituted a "class of property" for purposes of those elections out are contained in regulations. n115.72.19 A six-month extension of time was also available to revoke an election out under the prior accelerated depreciation provisions if various conditions were met. n115.72.20 These matters have not yet addressed by the new legislation or IRS guidance, but the IRS has announced that until it provides further guidance, taxpayers may rely on those regulations with respect to the 2008 and 2009 additional first-year depreciation provision. n115.72.20.1

Qualified property eligible for the 50-percent depreciation deduction must meet several requirements. First, it must be one of the following: n115.72.21

- property to which MACRS applies with an applicable recovery period of 20 years or less;
- computer software other than computer software covered by *IRC Section 197*;
- water utility property; n115.72.22 or
- qualified leasehold improvement property. n115.72.23

NOTE:

Because of the above requirement, except for qualified leasehold improvement property, the deduction comes into play primarily for personal property and not real estate. n115.72.24

Second, the original use of the property must commence with the taxpayer after December 31, 2007. n115.72.25 The term "original use" means the first use to which the property is put, whether or not that use corresponds to the use of that property by the taxpayer. A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to that person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

n115.72.26 If property is originally placed in service by a lessor (including by reason of self construction of the property, n115.72.27 the property is sold within three months after the date that the property was placed in service, and the user of the property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of the sale. n115.72.28

Third, the taxpayer must purchase the property within the applicable time period. The applicable time period for acquired property is (1) after December 31, 2007, and before January 1, 2010, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2010. n115.72.29 (Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.)

With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2010. n115.72.30 Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to that property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2010 ("progress expenditures") is eligible for the additional first-year depreciation. n115.72.31

NOTE:

Committee reports state that for purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to *IRC Section 46(d)(3)* as in effect prior to the Tax Reform Act of 1986 apply. Under those rules, qualified progress expenditures for self-constructed property include amounts properly chargeable during the tax year to capital account with respect to property. For non-self constructed property, qualified progress expenditures include the lesser of (1) the amount paid during the tax year to another person for the construction of the property, or (2) the amount that represents that proportion of the overall cost to the taxpayer of the construction by the other person that is properly attributable to that portion of the construction that is completed during the tax year.

The fourth and final requirement for qualified property is that the property must be placed in service after December 31, 2007, and before January 1, 2010. n115.72.32 An extension of the placed in service date of one year (i.e., to January 1, 2011) is provided for certain property with a recovery period of ten years or longer, and for certain transportation property and aircraft. n115.72.33 In order for property to qualify for the extended placed-in-service date, the property is required to have an estimated production period exceeding one year and a cost exceeding \$1 million. n115.72.34

Property does not qualify for the additional first-year depreciation deduction when the user of that property (or a related

party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. n115.72.35 Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Thus, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction. n115.72.36

The additional first-year depreciation deduction is not allowed for any property that is required to be depreciated under the alternative depreciation system of MACRS in *IRC Section 168(g)*. n115.72.37

The basis of the property and the depreciation allowances in the year the property is placed in service and later years must be appropriately adjusted to reflect the additional 50-percent first-year depreciation deduction. n115.72.38

[b] Election to Accelerate AMT and Research Credits in Lieu of Bonus Depreciation

Corporations otherwise eligible for additional first-year depreciation under *IRC Section 168(k)* n115.72.39 may elect to claim additional research or minimum tax credits from past years in lieu of claiming that bonus depreciation. n115.72.40 A corporation making the election forgoes the additional first-year depreciation deductions and instead increases the limitation under *IRC Section 38(c)* on the use of research credits or *IRC Section 53(c)* on the use of minimum tax credits. n115.72.41 The increases in the allowable credits are treated as refundable. n115.72.42 The depreciation for qualified property for which the election is made is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election. n115.72.43

The research credit or minimum tax credit limitation is increased by an amount equal to 20 percent of the bonus depreciation amount for qualified property that would be claimed absent an election. n115.72.44 The AMT credit increase amount means the portion of the minimum tax credit under *IRC Section 53(b)* for the first taxable year ending after March 31, 2008, determined by taking into account only the adjusted net minimum tax for taxable years beginning before January 1, 2006. The minimum tax credits are treated as allowed on a first-in, first-out basis. n115.72.44.1

Generally, eligible qualified property included in the calculation is bonus depreciation property that meets the following requirements: (1) the original use of the property must commence with the taxpayer after March 31, 2008; (2) the taxpayer must purchase the property either (a) after March 31, 2008, and before January 1, 2010, but only if no binding written contract for the acquisition is in effect before April 1, 2008, or (b) pursuant to a binding written contract which was entered into after March 31, 2008, and before January 1, 2010; and (3) the property must be placed in service after March 31, 2008, and before January 1, 2010 (January 1, 2011 for certain longer-lived and transportation property). n115.72.45

In general, the amount by which the *IRC Section 168(k)(4)* election increases the business credit limitation n115.72.45.1 and the AMT credit limitation n115.72.45.2 is the bonus depreciation amount. n115.72.45.3 The bonus depreciation amount is limited to the lesser of: (1) \$30 million, or (2) six percent of the sum of research credit carryforwards from taxable years beginning before January 1, 2006 and minimum tax credits allocable to the adjusted minimum tax imposed for taxable years beginning before January 1, 2006. n115.72.46 For any taxable year, the bonus depreciation amount allocated to either the business credit limitation or AMT credit limitation cannot exceed the amount of unexpired and unused pre-2006 (1) business credit carryforwards allocable to the research credit or (2) AMT credit carryforwards, less bonus depreciation amounts allocated to each limitation, respectively, for all prior taxable years. n115.72.46.1 To the extent that the business credit or AMT credit allowable to a taxpayer is due to an increase in the business credit limitation or AMT credit limitation that results from the *IRC Section 168(k)(4)* election, those amount(s) are treated as overpayments that are refundable to the taxpayer. n115.72.46.2

All corporations treated as a single employer under *IRC Section 52(a)* (generally controlled corporations with more than 50 percent common ownership) are treated as one taxpayer for purposes of the limitation, as well as for making the election. n115.72.47

In several revenue procedures, the IRS has provided detailed guidance regarding the time and manner for making the *IRC Section 168(k)(4)* election both for eligible qualified property and for extension property. The particulars vary, depending on the identity of the taxpayer, the type of property involved, when the taxpayer's first taxable year ending after March 31, 2008 ends, and whether taxpayer's succeeding taxable year is a short taxable year. The procedures also explain the property eligible for the election, the time and manner of allocation of the credit limitation increases allowed by the election among members of a controlled group, the effect of the election on partnerships with corporate partners that make the election, and the application of the election to S corporations. n115.72.48

NOTE:

It must be noted that there are two elections under *IRC Section 168(k)*: the election not to claim the additional first year depreciation for all property in a particular class of property n115.72.49 and the election to apply *IRC Section 168(k)(4)* for all eligible qualified property or for extension property. A taxpayer who makes both elections applies the election not to claim the additional depreciation for a class of property first. Any class of property n115.72.49.1 for which the class-of-property election has been made is not qualified property, n115.72.49.2 eligible qualified property, or extension property. n115.72.49.3 For example, if a calendar-year taxpayer for its taxable year ending December 31, 2008, makes the election to accelerate the credits in lieu of depreciation and also elects not to claim the additional first year depreciation deduction for 7-year property, the taxpayer first applies the election not to claim the additional first-year depreciation to all of its 7-year property acquired and placed in service in 2008. All eligible qualified property (excluding the 7-year property) will then be included in the taxpayer's election to accelerate the credits in lieu of depreciation. n115.72.49.4

Any election may be revoked only with the consent of the IRS, which must be requested through a private letter ruling. n115.72.49.5 At the time the election is made, the taxpayer must also specify the portion of the additional first-year depreciation that is allocated to the *IRC Section 38(c)* or *IRC Section 53(c)* limitations. n115.72.49.6

Corporations may increase the research credit or minimum tax credit limitation by the bonus depreciation amount with respect to certain property placed in service in 2009 (2010 in the case of certain longer-lived and transportation property). n115.72.49.7 The increase is available only for "extension property," n115.72.49.8 which is property acquired in 2009 that is eligible for the additional 50-percent first year depreciation only because of legislation enacted in 2009 that extended that deduction for an additional year. n115.72.49.9

A taxpayer that has made an election to increase the research credit or minimum tax credit limitation for eligible qualified property for its first taxable year ending after March 31, 2008, may choose not to make this election for extension property. n115.72.49.10 Further, a taxpayer that has not made an election for eligible qualified property for its first taxable year ending after March 31, 2008 may make the election for extension property for its first taxable year ending after December 31, 2008, and for each subsequent year. n115.72.49.11

NOTE:

A taxpayer who elects to increase the research or minimum tax credit both for eligible qualified property and extension property must compute a separate bonus depreciation amount, maximum amount, and maximum increase amount, and apply those amounts to each group of property. In computing the maximum amount, the maximum increase amount for extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to extension property. n115.72.49.12

[11] Special Amortization Rules for Pollution Control Facilities

Taxpayers may elect to amortize certified pollution control facilities over 60 months, for facilities used in connection with plants first placed in service before 1976. n115.72.50 Certain atmospheric pollution control facilities placed in service after April 11, 2005 and used in connection with an electric generation plant or other property that is primarily coal fired may be amortized over 84 months, without regard to when the plant was first placed in service. n115.72.51

[12] 50-Percent First-Year Bonus Depreciation Allowed for Qualified Disaster Assistance Property

Additional 50-percent first-year bonus depreciation is allowed for qualified disaster assistance property in the year the property is placed in service. n115.72.52 The depreciation is available only for property that replaces or rehabilitates property that is destroyed or condemned in a disaster occurring in 2008 or 2009. n115.72.53 The deduction is allowed both for regular and AMT purposes. n115.72.54 The adjusted basis of the property is reduced by the amount of the deduction taken. n115.72.55

"Qualified disaster assistance property" includes the following property: n115.72.56

- property to which MACRS applies with an applicable recovery period of 20 years or less;
- computer software other than computer software covered by *IRC Section 197*;
- water utility property;
- qualified leasehold improvement property; n115.72.57
- nonresidential real property; and
- residential rental property.

Property qualifies for the bonus depreciation only if the following requirements are also met:

- substantially all of the property must be used in a trade or business in an disaster area with respect to a federally declared disaster occurring before January 1, 2010; n115.72.58
- the property must generally rehabilitate or replace property destroyed or condemned in the disaster (property is treated as replacing property destroyed or condemned if, as part of an integrated plan, it replaces property which is included in a continuous area which includes real property destroyed or condemned); n115.72.59
- the property must also be similar in nature to, and located in the same county as, the property being rehabilitated or replaced; n115.72.60
- the original use of the property in the disaster area must begin with an eligible taxpayer on or after the date of the disaster; n115.72.61
- the property must be purchased by the taxpayer after the date of the disaster (and no binding contract for its acquisition can have been in effect before that date); n115.72.62 and
- the property must be placed in service by the end of the third calendar year following the date of the disaster (fourth calendar year, in the case of nonresidential real property and residential rental property).

n115.72.63

The bonus depreciation is available for self-constructed property and also for sale-leasebacks and syndicated property.
n115.72.64

The following property is not eligible for the bonus depreciation:

- property for which bonus depreciation is taken under other provisions; n115.72.65
- property for which the alternative depreciation system n115.72.66 must be used; n115.72.67
- tax-exempt bond financed property; n115.72.68 and
- qualified revitalization building with respect to which the taxpayer has elected the commercial revitalization deduction. n115.72.69

A taxpayer may elect not to take the deduction with respect to any class of property placed in service during a taxable year. n115.72.70 Recapture can apply for any property that ceases to be qualified disaster assistance property.
n115.72.71

FOOTNOTES:

(n1)Footnote 65. *IRC § 168.*

(n2)Footnote 66. *IRC §§ 167, 168.*

(n3)Footnote 67. *Obot v Commr, TC Memo 2005-195; Witcher v Commr, TC Memo 2002-292 ; Han v Commr, TC Memo 2002-148 ; Vajda v Commr/TBP v Commr, TC Memo 2001-159* (Tax Court denied depreciation deduction claimed on buildings in excess of their basis to the taxpayer); *Zeidler v Commr, TC Memo 1996-157 , affd 98-1 USTC P 50,101 (7th Cir 1997); see Cohan v Commr, 39 F2d 540 (2nd Cir 1930) .*

(n4)Footnote 68. *IRC § 168(a), (b)--(d).* Land is not depreciable. *Treas Reg § 1.167(a)-2.*

(n5)Footnote 69. *IRC § 168(b)(3).*

(n6)Footnote 70. It should be noted that the recovery period for nonresidential real property placed in service by a taxpayer before May 13, 1993, is 31.5 years. *IRC § 168(c)(1), before amendment by P L No 101-66, 103rd Cong, 1st Sess § 13151(a)* (Aug 10, 1993).

(n7)Footnote 71. *IRC §§ 168(d)(2), (4).*

(n8)Footnote 72. *IRC §§ 168(g)(2), (7).*

(n9)Footnote 72.1. *IRC § 168(g)(7)(A); see Chief Counsel Advice 200327041.*

(n10)Footnote 72.2. *IRC § 168(g)(7)(B).*

(n11)Footnote 72.3. *IRC § 168(j)(2), (8).*

(n12)Footnote 73. *IRC § 168(e)(2)(A).*

(n13)Footnote 74. *IRC § 168(e)(2)(B).*

(n14)Footnote 74.1. See *IRC § 168(e)(2)*; see *Treas Reg § 1.1250-1(a)(2)(ii)*; see former *Treas Reg § 1.167(j)-3(b)(1)(ii)*. See *Ltr Ruls 200947004* and *200947005* for an analysis of treating a multi-purpose housing/commercial/garage project as a single building for purposes of classifying the entire project as residential rental property or nonresidential real property.

(n15)Footnote 75. *Rev Proc 87-56, 1987-2 CB 674*, as modified by *Rev Proc 88-22, 1988-1 CB 785*; see *Ltr Rul 200013038* (waste facility is 7-year property under *IRC § 168(e)*).

(n16)Footnote 75.1. *IRC § 168(e)(3)(E)(vi)*

(n17)Footnote 75.2. *IRC § 168(e)(3)(F)*.

(n18)Footnote 75.3. *IRC §§ 168(e)(3)(C)(ii), 168(i)(15)* effective for qualifying property placed in service through Dec 13, 2009 [*IRC § 168(i)(15)(D)*].

(n19)Footnote 75.4. *IRC §§ 168(e)(3)(C)(iii), 168(i)(16)*.

(n20)Footnote 76. *IRC § 168(e)(3)(E)(iii)*, in effect generally for property placed in service after Aug 20, 1996.

(n21)Footnote 77. *Rev Rul 97-29, 1997-2 CB 22*; see *Iowa 80 Group, Inc & Subs v US, 203 F Supp 2d 1058 (SD Iowa 2002)*, *affd in part, revd in part, and remanded 347 F3rd 1067 (8th Cir 2003)* for an excellent and detailed discussion of what constitutes a "retail motor fuels outlet." On remand, the district court found that a truck stop did not qualify as a retail motor fuels outlet, and the decision affirmed on appeal [see *Iowa 80 Group, Inc & Subs v IRS, 2005-1 USTC ¶ 50,342 (D Iowa, 2004), affd 406 F3rd 953 (8th Cir 2005)*].

(n22)Footnote 77.1. *IRC § 168(e)(3)(E)(iv)*; see *IRC § 168(e)(6)* and § 5.02[2][d], *below*, for further discussion.

(n23)Footnote 77.2. *IRC § 168(e)(3)(E)(v)*; see *IRC § 168(e)(7)* and § 5.02[2][e], *below*, for a discussion of qualified restaurant property.

(n24)Footnote 77.3. *IRC § 168(e)(3)(E)(ix)*; see § 5.02[2][f], *below*, for a discussion of qualified retail improvement property.

(n25)Footnote 78. *IRC § 168(i)(6)(A)*; S Rep No 99-313, 99th Cong, 2nd Sess 105 (1986).

(n26)Footnote 79. *IRC § 168(i)(6)(B)*.

(n27)Footnote 80. See *IRC § 168(i)(6)*.

(n28)Footnote 81. See *Scott Paper Co v Commr, 74 TC 137 (1980)*; *Morrison, Inc v Commr, TC Memo 1986-129*; *Treas Reg § 1.48-1*.

(n29)Footnote 82. *Hospital Corp of Am and Subs v Commr, 109 TC 21 (1997)*.

(n30)Footnote 83. *Hospital Corp of Am and Subs v Commr, 109 TC 21 (1997)*.

(n31)Footnote 84. See *Rev Rul 67-349, 1967-2 CB 48*.

(n32)Footnote 85. *Hospital Corp of Am and Subs v Commr, 109 TC 21 (1997)*.

(n33)Footnote 86. *Ltr Rul 9924044*; see *IRC § 168(c)*.

(n34)Footnote 86.1. See Coordinated IRS issue paper LMSB4-0709-029 (July 31, 2009).

(n35)Footnote 87. Chief Counsel Memorandum 199921045.

(n36)Footnote 88. See *Scott Paper Co v Commr*, 74 TC 137 (1980) ; *Hospital Corp of Am and Subs v Commr*, 109 TC 21 (1997) ; *Treas Reg § 1.48-1(e)(2)*.

(n37)Footnote 89. See *Whiteco Indus, Inc v Commr*, 65 TC 664 (1975) .

(n38)Footnote 90. See *Whiteco Indus, Inc v Commr*, 65 TC 663 (1975) .

(n39)Footnote 91. Chief Counsel Memorandum 199921045; see *Noell Enterprises, Inc v US*, 36 Fed Cl 722 (1996) , *affd without publ opin* 132 F3d 54 (Fed Cir 1997) .

(n40)Footnote 91.1. See *Treas Reg § 1.48-1(e)(1)*.

(n41)Footnote 91.2. *Rev Rul 74-391*, 1974-2 CB 9 .

(n42)Footnote 91.3. *FSA 200033002* ; *FSA 200110001* .

(n43)Footnote 91.4. See *Rev Proc 87-56*, 1987-2 CB 674 for class lives.

(n44)Footnote 91.5. *FSA 200203009* .

(n45)Footnote 91.6. See *Whiteco Indus, Inc v Commr*, 65 TC 664 (1975) .

(n46)Footnote 91.7. *Rev Rul 2003-54*, 2003-1 CB 982 .

(n47)Footnote 91.8. *Rev Rul 2003-81*, 2003-2 CB 126 .

(n48)Footnote 91.9. See *IRC § 168(e)(1)*.

(n49)Footnote 91.10. See *Rev Proc 87-56*, 1987-2 CB 674 .

(n50)Footnote 91.11. See *Whiteco Indus, Inc v Commr*, 65 TC 664 (1975) .

(n51)Footnote 91.12. *Trentadue v Commr*, 128 TC 91 (2007) .

(n52)Footnote 92. Chief Counsel Memorandum 199921045; see *IRC § 446(e)*.

(n53)Footnote 93. Chief Counsel Memorandum 199921045; see *Standard Oil Co v Commr*, 77 TC 349 (1981) ; see § 5.01[7], for a discussion of change in depreciation method.

(n54)Footnote 93.1. *IRC § 481(a)*.

(n55)Footnote 93.2. *Treas Reg § 1.162-11(b)*; *Hopkins Partners, Cleveland Airport Hotel Limited Partnership v Commr*, TC Memo 2009-107 .

(n56)Footnote 93.3. *McGrath v Commr*, TC Memo 2002-231 , *affd per curiam* 2003-2 USTC P 50,663 (5th Cir 2003); *Currier v Commr*, 51 TC 488 (1968) .

(n57)Footnote 94. *IRC § 168(i)(8)(A)*; S Rep No 99-313, 99th Cong 2d Sess 105 (1986); *Nelson v Commr*, TC Memo 2000-212 .

(n58)Footnote 94.1. See *Treas Reg § 1.162-11(b)(1)*; *IRC § 168(i)(8)*; *Nelson v Commr*, TC Memo 2000-212 .

(n59)Footnote 94.2. *Your Health Club, Inc v Commr*, 4 TC 385 (1944) ; *McGrath v Commr*, TC Memo 2002-231 ,

affd per curiam 2003-2 USTC P 50,663 (5th Cir 2003); Hopkins Partners, Cleveland Airport Hotel Limited Partnership v Commr, TC Memo 2009-107.

(n60)Footnote 94.3. *McGrath v Commr, TC Memo 2002-231, affd per curiam 2003-2 USTC P 50,663 (5th Cir 2003); Cunningham v Commr, 28 TC 670 (1957), affd 258 F2d 231 (9th Cir 1958); see ME Blatt Co v US, 305 US 267 (1938); see Treas Reg § 1.61-8(c) (inclusion of lessee capital expenditures in lessor's gross income).*

(n61)Footnote 95. *IRC § 168(i)(8)(B).*

(n62)Footnote 96. *IRC § 178; S Rep No 99-313, 99th Cong, 2nd Sess 105 (1986).*

(n63)Footnote 96.1. *IRC § 168(e)(3)(E)(iv).*

(n64)Footnote 96.2. *IRC § 168(b)(3)(G).*

(n65)Footnote 96.3. *IRC § 168(3)(6), (k)(3).*

(n66)Footnote 96.4. *IRC § 168(e)(6)(A).*

(n67)Footnote 96.5. *IRC § 168(e)(6)(B); see IRC §§ 332, 351, 361, 721, 731, 1031, 1033, 1038.*

(n68)Footnote 96.6. *IRC § 168(g)(3)(B).*

(n69)Footnote 96.7. *IRC § 168(e)(3)(E)(v).*

(n70)Footnote 96.8. *IRC § 168(b)(3)(H).*

(n71)Footnote 96.9. *IRC § 168(e)(7), before amendment by Pub Law No 110-343.*

(n72)Footnote 96.10. *See IRC § 168(k)(2)(A)(i)(1).*

(n73)Footnote 96.11. *IRC § 168(g)(3)(B).*

(n74)Footnote 96.11.1. *IRC § 168(e)(7)(A).*

(n75)Footnote 96.11.2. *IRC § 168(e)(7)(B).*

(n76)Footnote 96.12. *IRC § 168(c).*

(n77)Footnote 96.13. *IRC § 168(e)(3)(E)(ix); IRC § 168(b)(3)(l).*

(n78)Footnote 96.14. *IRC § 168(e)(8)(A).*

(n79)Footnote 96.15. *IRC § 168(e)(8)(B).*

(n80)Footnote 96.16. *IRC § 168(e)(8)(C).*

(n81)Footnote 96.17. *IRC § 168(e)(8)(D).*

(n82)Footnote 96.18. *IRC § 168(g)(3)(B).*

(n83)Footnote 97. *Former IRC § 168.*

(n84)Footnote 98. *Former IRC § 168(c)(1).*

(n85)Footnote 99. *IRC § 167*. Former *IRC § 168(e)*.

(n86)Footnote 100. Former *IRC § 168(c)(2)*.

(n87)Footnote 101. Former *IRC § 168(f)(9)*.

(n88)Footnote 102. Former *IRC § 168(c)(2)(C)-(F)*.

(n89)Footnote 103. Former *IRC § 168(b)(3)(A)*.

(n90)Footnote 104. Former *IRC § 168(b)(3)(B)(ii)*.

(n91)Footnote 105. Former *IRC § 168(f)(2)*.

(n92)Footnote 106. Former *IRC § 168(e)(4)*.

(n93)Footnote 107. Former *IRC § 168(b)(2)(A)*.

(n94)Footnote 108. Former *IRC § 168(b)(3)(B)(iii)*.

(n95)Footnote 109. Former *IRC § 168(f)(5)*.

(n96)Footnote 110. Former *IRC § 168(f)(1)(A)*.

(n97)Footnote 111. Former *IRC § 168(f)(1)(C)(i)*.

(n98)Footnote 112. Former *IRC §§ 168(f)(1)(C)(ii), (iii)*.

(n99)Footnote 113. Former *IRC § 168(f)(10); IRC § 168(i)(7)*.

(n100)Footnote 114. Former *IRC § 168(b)(2)(B); IRC § 168(d)(2), (4)*.

(n101)Footnote 115. See Ch 6 for a discussion of depreciation recapture.

(n102)Footnote 115.1. *IRC § 168(k)(1), (2)(A)(iii), before amendment by Pub Law No 110-185*.

(n103)Footnote 115.2. *IRC § 168(k)(1)(A), before amendment by Pub Law No 110-185*. See *Treas Reg § 1.168(k)-1(d)* for the manner of computing the additional 30-percent depreciation deduction.

(n104)Footnote 115.3. *IRC § 168(k)(1)(A), (2)(G), before amendment by Pub Law No 110-185*. See *Treas Reg § 1.168(k)-1(d)(1)(iii), (e)(6), (f)(5)(iii)(D)* (AMT rules).

(n105)Footnote 115.4. *IRC § 168(k)(1)(B), before amendment by Pub Law No 110-185*.

(n106)Footnote 115.5. *IRC § 168(k)(2)(D)(iii), before amendment by Pub Law No 110-185*; see *Treas Reg § 1.168(k)-1(e)* for rules for making the election not to take the 30-percent additional first-year depreciation and clarification for what constitutes a class of property for purposes of making the election. An automatic 6-month extension from the due date of the taxpayer's federal tax return (excluding extensions) to revoke an election out is available, provided the taxpayer filed a timely return for the placed-in-service year of the class of property and, within this 6-month extension period, the taxpayer (and all taxpayers whose tax liability would be affected by the election) files an amended return for the placed-in-service year of the class of property in a manner that is consistent with the revocation of the election [*Reg § 1.168(k)-1(e)(7)(ii)*]. A taxpayer may also request permission to revoke its election not to deduct the 30-percent additional first-year depreciation through a private letter ruling [*Reg § 1.168(k)-1(e)(7)(i)*]. See *Ltr Rul 200625020* ; *Ltr Rul 200626038* (permission to revoke granted, based on tax return preparer's failure to account

for AMT in making the initial election). For 2000 and 2001 returns, see *Rev Proc 2002-33*, 2002-2 CB 963 , as modified by *Rev Proc 2003-50*, 2003-2 CB 119 for guidance in making the election not to claim the additional first-year depreciation [see *Treas Reg § 1.168(k)-1(e)(4)*].

(n107)Footnote 115.5.1. See *IRC § 56*.

(n108)Footnote 115.5.2. *Treas Reg § 1.168(k)-1(e)(6)*.

(n109)Footnote 115.5.3. See *IRC § 168(k)(4)*, before repeal by Pub Law No 110-185; see § 5.02[5], below, for a discussion.

(n110)Footnote 115.5.4. *IRC § 168(k)(4)(E)*, before repeal by Pub Law No 110-185.

(n111)Footnote 115.5.5. *IRC § 168(k)(2)*, before amendment by Pub Law No 110-185.

(n112)Footnote 115.5.6. *Treas Reg § 1.168(k)-1(b)(1)*.

(n113)Footnote 115.6. *IRC § 168(k)(2)(A)*, before amendment by Pub Law No 110-185.

(n114)Footnote 115.6.1. See *IRC § 168(e)(5)*.

(n115)Footnote 115.6.2. See *IRC § 263A*.

(n116)Footnote 115.7. *IRC §§ 168(k)(2)(B)(i)(IV)*, before amendment by Pub Law No 110-185, 263A(f)(1)(B)(ii), (iii).

(n117)Footnote 115.7.1. *Treas Reg § 1.168(k)-1(b)(2)(ii)(A)*.

(n118)Footnote 115.7.2. See *IRC § 168(f)*.

(n119)Footnote 115.7.3. See *Treas Reg § 1.168(e)(1)(ii)(B)*.

(n120)Footnote 115.7.4. See *IRC § 263A(e)(2)(A)*.

(n121)Footnote 115.7.5. See *IRC § 1400L(c)(2)*.

(n122)Footnote 115.7.6. See *Treas Reg § 1.168(k)-1(b)(2)(i)*.

(n123)Footnote 115.8. *IRC § 168(k)(2)(A)*, before amendment by Pub Law No 110-185.

(n124)Footnote 115.9. See *IRC § 168(k)(3)*.

(n125)Footnote 115.10. *IRC § 168(k)(2)(A)(i)(IV)*, before amendment by Pub Law No 110-185, (3)(A).

(n126)Footnote 115.11. *IRC § 168(k)(3)(B)*.

(n127)Footnote 115.11.1. *Treas Reg § 1.168(k)-1(c)*.

(n128)Footnote 115.12. *IRC § 168(k)(2)(A)(ii)*, before amendment by Pub Law No 110-185.

(n129)Footnote 115.12.1. *IRC § 168(k)(2)(A)(iv)*, (B), before amendment by Pub Law No 110-185.

(n130)Footnote 115.12.2. Pub Law No 109-135, § 105.

(n131)Footnote 115.12.3. *Announcement 2006-29*, 2006-1 CB 879 .

(n132)Footnote 115.12.4. *Treas Reg § 1.168(k)-1(b)(3)(i), (ii).*

(n133)Footnote 115.13. *IRC § 168(k)(2)(A)(iii), before amendment by Pub Law No 110-185.*

(n134)Footnote 115.13.1. *IRC § 168(k)(2)(E)(ii), before amendment by Pub Law No 110-185.*

(n135)Footnote 115.13.2. *See IRC § 168(k)(2)(E)(i), before amendment by Pub Law No 110-185.*

(n136)Footnote 115.13.3. *IRC § 168(k)(2)(E)(iii), before amendment by Pub Law No 110-185.*

(n137)Footnote 115.13.4. *IRC § 168(k)(2)(E)(iii), before amendment by Pub Law No 110-185, effective for property sold after June 4, 2004. See Treas Reg § 1.168(k)-1(b)(3)(iii) (sale-leaseback, syndication, and related transactions).*

(n138)Footnote 115.14. *IRC § 168(k)(2)(E)(iv), before amendment by Pub Law No 110-185.*

(n139)Footnote 115.14.1. *IRC § 168(k)(4), before repeal by Pub Law No 110-185, effective for tax years ending after May 5, 2003; see IRC § 168(k)(1). See Treas Reg § 1.168(k)-1(d) for the manner of computing the 50-percent bonus depreciation deduction.*

(n140)Footnote 115.14.2. *IRC § 168(k)(2), before amendment by Pub Law No 110-185, discussed in § 5.02[4], above.*

(n141)Footnote 115.14.3. *IRC § 168(k)(4)(B), (C), before repeal by Pub Law No 110-185.*

(n142)Footnote 115.14.4. *IRC § 168(k)(4)(E), before repeal by Pub Law No 110-185.*

(n143)Footnote 115.14.5. *IRC § 168(k)(4)(A), before repeal by Pub Law No 110-185; see IRC § 168(k)(1)(A), (k)(2)(F), before amendment by Pub Law No 110-185. See Treas Reg § 1.168(k)-1(d)(1)(iii), (e)(6), (f)(5)(iii)(D) (AMT rules).*

(n144)Footnote 115.14.6. *IRC § 168(k)(2)(D)(iii); see Treas Reg § 1.168(k)-1(e) for rules for making the election.*

(n145)Footnote 115.14.7. *See IRC § 56.*

(n146)Footnote 115.14.8. *Treas Reg § 1.168(k)-1(e)(6).*

(n147)Footnote 115.14.9. *Treas Reg § 1.168(k)-1(e)(7)(i).* See Ltr Rul 200625020 ; *Ltr Rul 200626038* (permission to revoke granted, based on tax return preparer's failure to account for AMT in making the initial election not to claim the bonus 50-percent depreciation).

(n148)Footnote 115.14.10. *Treas Reg § 1.168(k)-1(e)(7)(ii).*

(n149)Footnote 115.14.11. *Treas Reg § 1.168(k)-1(e)(1)(ii)(A); see IRC § 168(k)(2), before amendment by Pub Law No 110-185.*

(n150)Footnote 115.14.12. *Treas Reg § 1.168(e)(1)(ii)(B).*

(n151)Footnote 115.14.13. *IRC § 168(k)(4)(B)(i), before repeal by Pub Law No 110-185; see Treas Reg § 1.168(k)-1(b)(3) (original use requirement).*

(n152)Footnote 115.14.14. *IRC § 168(k)(4)(B)(ii), before repeal by Pub Law No 110-185.*

(n153)Footnote 115.14.15. *IRC § 168(k)(4)(C), before repeal by Pub Law No 110-185; see IRC § 168(k)(2)(D),*

before amendment by Pub Law No 110-185. See *Treas Reg* § 1.168(k)-1(b)(4)(iii)(B) (when construction begins).

(n154)Footnote 115.14.16. *IRC* § 168(k)(4)(B)(iii), before repeal by Pub Law No 110-185; see *IRC* § 168(k)(2)(B), before amendment by Pub Law No 110-185.

(n155)Footnote 115.14.17. *IRC* § 168(k)(4)(C), before repeal by Pub Law No 110-185; see *IRC* § 168(k)(2)(B)(ii), before amendment by Pub Law No 110-185.

(n156)Footnote 115.14.18. *Treas Reg* § 1.168(k)-1(f)(5).

(n157)Footnote 115.14.19. See *IRC* § 168(k)(1)-(3), before amendment by Pub Law No 110-185, discussed in § 5.02[4], above.

(n158)Footnote 115.14.20. *IRC* § 168(k)(4), before repeal by Pub Law No 110-185, discussed in § 5.02[5], above.

(n159)Footnote 115.15. *IRC* § 168(k), before amendment by Pub Law No 110-185.

(n160)Footnote 115.16. *IRC* § 1400L(b); see *Treas Reg* § 1.1400L(b)-1 (rules for determining special depreciation for New York Liberty Zone property).

(n161)Footnote 115.17. *IRC* § 1400L(b)(1)(A), (2)(E).

(n162)Footnote 115.18. *IRC* § 1400L(b)(1)(B).

(n163)Footnote 115.19. *IRC* § 1400L(b)(2)(E).

(n164)Footnote 115.20. See [4] and [5], above.

(n165)Footnote 115.21. *IRC* § 1400L(b)(2)(C)(i).

(n166)Footnote 115.22. *IRC* § 1400L(b)(2)(C)(iv); see *Treas Reg* § 1.1400L(b)-1(e) for rules for making the election not to take the special depreciation allowance for New York Liberty Zone property. For 2000 and 2001 returns, see *Rev Proc* 2002-33, 2002-1 CB 963, as modified by *Rev Proc* 2003-50, 2003-2 CB 119 for guidance in making the election not to claim the special depreciation allowance for New York Liberty Zone property [see *Treas Reg* § 1.1400L(b)-1(e)(4)].

(n167)Footnote 115.22.1. See *IRC* § 56.

(n168)Footnote 115.22.2. *Treas Reg* § 1.1400L(b)-1(e)(6).

(n169)Footnote 115.22.3. *Treas Reg* § 1.1400L(b)-1(e)(7)(i).

(n170)Footnote 115.23. *IRC* § 1400L(b)(2)(A).

(n171)Footnote 115.24. *IRC* § 1400L(b)(2), (c); see [b], below, for a discussion.

(n172)Footnote 115.25. *IRC* § 1400L(b)(2)(A)(ii).

(n173)Footnote 115.26. *IRC* § 1400L(h).

(n174)Footnote 115.27. *IRC* § 1400L(b)(2)(A).

(n175)Footnote 115.28. *IRC* § 1400L(b)(2)(B).

(n176)Footnote 115.28.1. *Treas Reg § 1.1400L(b)-1(b)(4)*.

(n177)Footnote 115.28.2. *IRC § 1400L(b)(2)(D)*; see *IRC § 168(k)(2)(E)*, before amendment by Pub Law No 110-185.

(n178)Footnote 115.28.3. *IRC § 168(k)(2)(E)(iv)*, *1400L(b)(2)(D)*.

(n179)Footnote 115.28.4. See *IRC § 168(k)(2)(E)(i)*, before amendment by Pub Law No 110-185.

(n180)Footnote 115.28.5. *IRC §§ 168(k)(2)(E)(iii)*, before amendment by Pub Law No 110-185, *1400L(b)(2)(D)*.

(n181)Footnote 115.29. *IRC § 1400L(c)(1)*.

(n182)Footnote 115.30. *IRC § 1400L(c)(2)*.

(n183)Footnote 115.31. *IRC § 168(k)(3)*.

(n184)Footnote 115.32. *IRC § 168(k)(3)(B)*.

(n185)Footnote 115.33. *IRC § 1400L(c)(3)*, (5).

(n186)Footnote 115.34. *IRC § 1400L(c)(4)*.

(n187)Footnote 115.34.1. *IRC § 168(k)(2)(D)(iii)*, before amendment by Pub Law No 110-185, *1400L(c)(5)*. The manner of electing out is specified in *Rev Proc 2005-43*, 2005-2 CB 107 .

(n188)Footnote 115.35. *IRC § 1400I*.

(n189)Footnote 115.36. *IRC § 1400I(a)*.

(n190)Footnote 115.37. See [d], below, for the manner of making the election.

(n191)Footnote 115.38. *IRC § 1400I(f)(1)*.

(n192)Footnote 115.39. *IRC § 1400I(f)(4)*.

(n193)Footnote 115.40. *IRC § 1400I(c)*; see [c], below, for a discussion of state agency allocation.

(n194)Footnote 115.41. *IRC § 1400I(g)*.

(n195)Footnote 115.42. *IRC § 1400I(b)(1)*; see *IRC § 1400E*.

(n196)Footnote 115.43. *IRC § 1400E(a)(1)*, (c).

(n197)Footnote 115.44. *IRC § 1400I(b)(1)*.

(n198)Footnote 115.45. See *IRC § 47(c)(1)(C)*.

(n199)Footnote 115.46. *IRC § 1400I(b)(2)(A)*.

(n200)Footnote 115.47. See *IRC § 168(e)* for a definition.

(n201)Footnote 115.48. See *IRC § 1250(c)* for a definition.

(n202)Footnote 115.49. *IRC § 1400I(b)(2)(A)*.

- (n203)Footnote 115.50. See *IRC § 1400I(b)(1)(B)*.
- (n204)Footnote 115.51. *IRC § 1400I(b)(2)(B)(i)*.
- (n205)Footnote 115.52. *IRC § 1400I(b)(2)(B)(ii)*.
- (n206)Footnote 115.53. *IRC § 1400I(d)*.
- (n207)Footnote 115.54. *IRC § 1400I(e)*.
- (n208)Footnote 115.55. *IRC § 1400I(d)(3)*.
- (n209)Footnote 115.56. *IRC § 1400I(e)(1)*.
- (n210)Footnote 115.57. *IRC § 1400I(d)(4)*; see *IRC § 42(h)(1), (7)*.
- (n211)Footnote 115.58. *Rev Proc 2003-38*, §§ 3-6, 2003-1 CB 1017 .
- (n212)Footnote 115.59. *Rev Proc 2003-38*, § 8, 2003-1 CB 1017 .
- (n213)Footnote 115.60. *Rev Proc 2003-38*, § 7, 2003-1 CB 1017 .
- (n214)Footnote 115.61. See [c], above, for a discussion of allocation.
- (n215)Footnote 115.62. *Rev Proc 2003-38*, § 7.01, 2003-1 CB 1017 .
- (n216)Footnote 115.63. *Rev Proc 2003-38*, § 7.02(1), 2003-1 CB 1017 .
- (n217)Footnote 115.64. *Rev Proc 2003-38*, § 7.02(2)(a), 2003-1 CB 1017 .
- (n218)Footnote 115.65. *Rev Proc 2003-38*, § 7.02(2)(b), 2003-1 CB 1017 ; see *Treas Reg § 301.9100-3*.
- (n219)Footnote 115.66. *Rev Proc 2003-38*, § 7.03, 2003-1 CB 1017 ; see *IRC § 1400I(a)*.
- (n220)Footnote 115.67. *Rev Proc 2003-38*, § 7.04, 2003-1 CB 1017 .
- (n221)Footnote 115.68. *Rev Proc 2003-38*, § 7.05, 2003-1 CB 1017 .
- (n222)Footnote 115.69. *IRC §§ 56(a)(1)(A), 168(a), (b)(3), (c)*.
- (n223)Footnote 115.70. *IRC §§ 56(a)(1)(A), 168(g)*.
- (n224)Footnote 115.71. *IRC §§ 56(a)(1)(A), 168(g)(2)*.
- (n225)Footnote 115.72. *IRC § 168(c)*.
- (n226)Footnote 115.72.01. *IRC § 168(l)(1)(A)*; Pub Law 110-343, § 201(c). For prior years, the additional depreciation was available only for qualified cellulosic biomass ethanol plant property.
- (n227)Footnote 115.72.1. *IRC § 168(l)(1)(A)*, before amendment by Pub Law No 110-343; the deduction is allowed for property placed in service after Dec 20, 2006 in taxable years ending after that date [Pub Law No 109-432, § 209(b)].
- (n228)Footnote 115.72.2. *IRC § 168(l)(3)*.

(n229)Footnote 115.72.3. *IRC § 168(l)(2)(D)*.

(n230)Footnote 115.72.4. *IRC § 168(l)(1)(A), (6); see IRC § 168(k)(2)(G)*.

(n231)Footnote 115.72.5. *See IRC § 168(l)(1)(A)*.

(n232)Footnote 115.72.6. *IRC § 168(l)(1)(B)*.

(n233)Footnote 115.72.7. *IRC § 168(l)(6); see IRC § 168(k)(2)(G)*.

(n234)Footnote 115.72.8. *IRC § 168(l)(4)(C)*.

(n235)Footnote 115.72.9. *IRC § 168(l)(2)*.

(n236)Footnote 115.72.10. *IRC § 168(l)(4)(B)*.

(n237)Footnote 115.72.11. *IRC § 168(l)(7); see IRC § 179(d)(10)*.

(n238)Footnote 115.72.12. *IRC § 168(l)(8)*.

(n239)Footnote 115.72.13. *IRC § 168(k)(1)(A), (2)(A)(iii)*.

(n240)Footnote 115.72.14. *IRC § 168(k)(1)(A), 168(k)(2)(A)*.

(n241)Footnote 115.72.15. *IRC § 168(k)(2)(G)*.

(n242)Footnote 115.72.16. *IRC § 312(k)(3)(A)*.

(n243)Footnote 115.72.17. *IRC § 168(k)(2)(D)(iii)*.

(n244)Footnote 115.72.18. *See §§ 5.02[4] and 5.02[5], above, for a discussion of these provisions.*

(n245)Footnote 115.72.19. *See Treas Reg § 1.168(k)-1(e)*.

(n246)Footnote 115.72.20. *Treas Reg § 1.168(k)-1(e)(7)(ii)*.

(n247)Footnote 115.72.20.1. *See Treas Reg § 1.168(k)-1*.

(n248)Footnote 115.72.21. *IRC § 168(k)(2)(A)(1)*.

(n249)Footnote 115.72.22. *See IRC § 168(e)(5) for a definition.*

(n250)Footnote 115.72.23. *See IRC § 168(k)(3) for a definition.*

(n251)Footnote 115.72.24. *See IRC § 168(k)(2)(A)(1)*.

(n252)Footnote 115.72.25. *IRC § 168(k)(2)(A)(ii)*.

(n253)Footnote 115.72.26. *IRC § 168(k)(2)(E)(ii)*.

(n254)Footnote 115.72.27. *See IRC § 168(k)(2)(E)(i)*.

(n255)Footnote 115.72.28. *IRC § 168(k)(2)(E)(iii)*.

(n256)Footnote 115.72.29. *IRC § 168(k)(2)(A)(iii)*.

- (n257)Footnote 115.72.30. *IRC § 168(k)(2)(E)(i).*
- (n258)Footnote 115.72.31. *IRC § 168(k)(2)(B)(ii).*
- (n259)Footnote 115.72.32. *IRC § 168(k)(2)(A)(iv).*
- (n260)Footnote 115.72.33. *IRC § 168(k)(2)(A)(iv), 168(k)(2)(B), 168(k)(2)(C).*
- (n261)Footnote 115.72.34. *IRC §§ 168(k)(2)(B)(i)(IV), 263A(f)(1)(B)(iii).*
- (n262)Footnote 115.72.35. *IRC § 168(k)(2)(E)(iv)(II).*
- (n263)Footnote 115.72.36. *IRC § 168(k)(2)(E)(iv)(I).*
- (n264)Footnote 115.72.37. *IRC § 168(k)(2)(D).*
- (n265)Footnote 115.72.38. *IRC § 168(k)(1)(B).*
- (n266)Footnote 115.72.39. See [a], above, for a discussion.
- (n267)Footnote 115.72.40. *IRC § 168(k)(4)*, effective for tax years ending after March 31, 2008 [Pub Law 110-289, § 3081(d)].
- (n268)Footnote 115.72.41. *IRC § 168(k)(4)(A)(iii), (B).*
- (n269)Footnote 115.72.42. *IRC § 168(k)(4)(F).*
- (n270)Footnote 115.72.43. *IRC § 168(k)(4)(A)(ii).*
- (n271)Footnote 115.72.44. *IRC § 168(k)(4)(C)(i).*
- (n272)Footnote 115.72.44.1. *IRC § 168(k)(4)(E)(iv). Rev Proc 2008-65 , § 5.06, 2008-44 IRB 1082 , as modified by Rev Proc 2009-33 , § 7.03, 2009-29 IRB 150 .*
- (n273)Footnote 115.72.45. *IRC § 168(k)(4)(D); see IRC § 168(k)(2)(A)(iv), (B), (C).*
- (n274)Footnote 115.72.45.1. See *IRC § 38(c).*
- (n275)Footnote 115.72.45.2. See *IRC § 53(c).*
- (n276)Footnote 115.72.45.3. See *IRC § 168(k)(4)(A)(iii).*
- (n277)Footnote 115.72.46. *IRC § 168(k)(4)(C)(iii), (E)(iii), (iv).*
- (n278)Footnote 115.72.46.1. *IRC § 168(k)(4)(E)(ii).* See Rev Proc 2009-33 , § 5, 2009-29 IRB 150 ; Rev Proc 2008-65 , § 5, 2008-44 IRB 1082 , and Rev Proc 2009-16 , §§ 4, 5, 6, 2009-6 IRB 449 , for additional guidance regarding the computation of the bonus depreciation amount and the allocation of the bonus depreciation amount between the business credit and AMT credit limitations under *IRC §§ 38(c)* and *53(c)*.
- (n279)Footnote 115.72.46.2. *IRC § 168(k)(4)(F).*
- (n280)Footnote 115.72.47. *IRC § 168(k)(4)(c)(iv).*
- (n281)Footnote 115.72.48. *Rev Proc 2009-33, 2009-29 IRB 150 , modifying and superseding Rev Proc 2009-16 and Rev Proc 2008-65 ; see Rev Proc 2009-16, 2009-6 IRB 449 , amplifying and supplementing Rev Proc 2008-65, 2008-44*

IRB 1082 .

(n282)Footnote 115.72.49. See *IRC § 168(k)(2)(D)(iii)*.

(n283)Footnote 115.72.49.1. See *Treas Reg § 1.168(k)-1(e)(2)*.

(n284)Footnote 115.72.49.2. See *IRC § 168(k)(2)*.

(n285)Footnote 115.72.49.3. See *IRC § 168(k)(4)*.

(n286)Footnote 115.72.49.4. *Rev Proc 2008-65* , § 4.01, *2008-44 IRB 1082* .

(n287)Footnote 115.72.49.5. *IRC § 168(k)(4)(G)(i)*; *Rev Proc 2008-65* , § 4.01, *2008-44 IRB 1082* .

(n288)Footnote 115.72.49.6. *IRC § 168(k)(4)(E)(i)*.

(n289)Footnote 115.72.49.7. *IRC § 168(k)(4)(H)*.

(n290)Footnote 115.72.49.8. *IRC § 168(k)(4)(H)(i), (ii)*.

(n291)Footnote 115.72.49.9. *IRC § 168(k)(4)(H)(iii)*; see Pub Law No 111-5, § 1201.

(n292)Footnote 115.72.49.10. *IRC § 168(k)(4)(H)(i)*. The manner of excluding extension property from the election is set forth in *Rev Proc 2009-33* , § 4, *2009-29 IRB 150* .

(n293)Footnote 115.72.49.11. *IRC § 168(k)(4)(H)(ii)*. The manner of making the election for extension property is set forth in *Rev Proc 2009-33* , § 6, *2009-29 IRB 150* .

(n294)Footnote 115.72.49.12. See *IRC § 168(k)(4)(A), (C), (H)*. See *Rev Proc 2009-33* , §§ 5.01, 7.02, *2009-29 IRB 150* , modifying *Rev Proc 2008-65* , § 5, *2008-44 IRB 1082* .

(n295)Footnote 115.72.50. *IRC § 169(a), (c)(1)*.

(n296)Footnote 115.72.51. *IRC § 169(a), (d)(5)*.

(n297)Footnote 115.72.52. *IRC 168(n)(1)(A)*, effective for property placed in service after Dec 31, 2007, with respect to disasters declared after that date.

(n298)Footnote 115.72.53. *IRC § 168(n)(2)(A)(ii)(I)*.

(n299)Footnote 115.72.54. *IRC § 168(n)(2)(D)*; see *IRC § 168(k)(2)(G)*.

(n300)Footnote 115.72.55. *IRC § 168(n)(1)(B)*.

(n301)Footnote 115.72.56. *IRC § 168(n)(2)(A)(i)*.

(n302)Footnote 115.72.57. See *IRC § 168(k)(3)* for a definition.

(n303)Footnote 115.72.58. *IRC § 168(n)(2)(A)(ii)*.

(n304)Footnote 115.72.59. *IRC § 168(n)(2)(A)(iii)(I)*.

(n305)Footnote 115.72.60. *IRC § 168(n)(2)(A)(iii)(II)*.

(n306)Footnote 115.72.61. *IRC § 168(n)(2)(A)(iv)*.

(n307)Footnote 115.72.62. *IRC § 168(n)(2)(A)(v).*

(n308)Footnote 115.72.63. *IRC § 168(n)(2)(A)(iv), (v), (vi).*

(n309)Footnote 115.72.64. *IRC § 168(n)(2)(C); see IRC § 168(k)(2)(E).*

(n310)Footnote 115.72.65. *IRC § 168(n)(2)(B)(i).* See *IRC §§ 168(k)* (certain bonus depreciation for property placed in service in 2008), *168(l)* (cellulosic biofuel property), *168(m)* (qualified reuse and recycling property), *1400N(d), (p)(3)* (certain GO Zone property), *1400N(p)(3).*

(n311)Footnote 115.72.66. See *IRC § 168(g).*

(n312)Footnote 115.72.67. *IRC § 168(n)(2)(B)(ii).*

(n313)Footnote 115.72.68. *IRC § 168(n)(2)(B)(iii).*

(n314)Footnote 115.72.69. *IRC § 168(n)(2)(B)(iv); see IRC § 1400I(a).*

(n315)Footnote 115.72.70. *IRC § 168(n)(2)(B)(v).*

(n316)Footnote 115.72.71. *IRC § 168(n)(4).* See *IRC § 179(d)(10).*

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Federal Taxes Affecting Real Estate

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.03

§ 5.03 Rehabilitation Tax Credit

[1] Introduction

A 20-percent tax credit is allowed for qualified rehabilitation expenditures with respect to any certified historic structure and a 10 percent tax credit for qualified rehabilitation expenditures with respect to any qualified rehabilitation buildings other than certified historic structures. n116

[2] Qualified Rehabilitation Expenditures

[a] In General

The term "qualified rehabilitation expenditure" includes any amount properly charged to a capital account for which depreciation is allowed and which is:

- nonresidential real property;
- residential rental property; or
- real property with a class life of more than 12.5 years.

Only expenditures made in connection with the rehabilitation of a qualified rehabilitated building will be considered a qualified rehabilitation expenditure. n117 An expenditure made in connection with other buildings, such as a taxpayer's personal residence, is not eligible for the credit. n118 For purposes of the rehabilitation tax credit, the date that qualified rehabilitation expenditures are considered incurred by the taxpayer is determined under an accrual method of accounting. The date is determined in this way regardless of the accounting method used by the taxpayer with respect to other items of income or expense. n119 Conditional or contingent costs are therefore not eligible for the credit. n120 A taxpayer may claim the rehabilitation credit for expenditures made by a prior owner, to the extent the prior owner does not place in service the portion of the building to which the expenditures are allocable. n120.1

The term "rehabilitation" includes renovation, restoration, or reconstruction of a building, but does not include enlargement or new construction. n121 An "enlargement" is defined as an increase in the total volume of a building. However, an increase in floor space resulting solely from interior remodeling is not considered an enlargement. n122

The same is not true of a remodeling that increases exterior dimensions. In one ruling, the IRS refused to allow a rehabilitation credit for amounts spent to replace an exterior stairway with a stairway tower that slightly expanded the volume of the building. That the larger stairway was necessary in order to comply with the local building code did not change the fact that the volume of the building was enlarged. Therefore, the new stairway tower could not qualify as a "rehabilitation" eligible for the credit. n122.1

If a rehabilitation includes an enlargement, the costs of the project must be apportioned between the eligible rehabilitation and the ineligible enlargement. n123 Amounts spent on such rehabilitation are chargeable to a capital account only if they are properly includable in computing the basis of real property. Accordingly, amounts treated as expenses and deducted in the year they are paid or incurred do not qualify for the rehabilitation tax credit. n124

Architectural and engineering fees, site survey fees, legal expenses, insurance premiums, development fees, and other construction fees qualify as rehabilitation expenditures. n125 Any fees that are conditional or contingent, however, do not. Therefore, a developer's fee that was payable only if there was available cash was found to be ineligible for the credit. n126 Construction period interest and taxes do not qualify as rehabilitation expenditures unless they are capitalized under *IRC Section 263A*. n127

In addition, qualified rehabilitation expenditures do not include the following: n128

- (1) any expenditure with respect to which the taxpayer does not use the straight line recovery method, unless the property is tax-exempt bond-financed property or certain imported property; n129
- (2) cost of acquisition;
- (3) expenditures attributable to certified historic structures (unless the rehabilitation is a certified rehabilitation); n130
- (4) tax-exempt use property;

NOTE:

Tax-exempt use property for purposes of the rehabilitation credit is generally defined by cross reference to the definition in *IRC Section 168(h)*. n130.1 Under that definition, in the case of nonresidential real property, tax-exempt use property generally means the portion of the property leased in a disqualified lease to tax-exempt entities. n130.2 A safe harbor provides, however, that in the case of nonresidential real property, the property is treated as tax-exempt use property only if the portion of the property leased to tax-exempt entities in disqualified leases is more than 35 percent of the property. n130.3 For determining rehabilitation expenditures eligible for the rehabilitation credit, however, nonresidential real property is treated as tax-exempt use property only if the portion of the property leased to tax-exempt entities in disqualified leases is more than 50 percent (rather than 35 percent) of the property. n130.4

- (5) expenditures by lessees, if upon completion of rehabilitation, the remaining term of the lease is less than the recovery period as determined under *IRC Section 168(c)*. n131

NOTE:

Property that qualifies for additional 30-percent first year depreciation n131.1 or 50-percent bonus depreciation under prior law, n131.2 special Liberty Zone depreciation, n131.3 or the 50-percent additional depreciation for qualifying property acquired during 2008 n131.3.1 may also qualify for the rehabilitation credit under *IRC Section 47*. A taxpayer may claim the additional first year depreciation

deduction for the unadjusted depreciable basis of the qualified rehabilitation expenditures and may claim the rehabilitation credit (provided the requirements of *IRC Section 47* are met) for the remaining basis of the qualified rehabilitation expenditures (unadjusted depreciable basis less the additional first year depreciation deduction allowed or allowable, whichever is greater). In order to claim the credit, the taxpayer must depreciate the remaining adjusted depreciable basis of those expenditures using the straight line method over the regular MACRS or alternative depreciation system recovery period. n131.4 A taxpayer may also claim the rehabilitation credit for the portion of the basis of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures if the taxpayer elects not to deduct the additional first year depreciation for the class of property that includes the qualified rehabilitated expenditures. n131.5

[b] At-Risk Rules Apply

At-risk rules may apply to reduce the credit base eligible for the rehabilitation credit if non-recourse financing is used. n131.6 The amount of the qualified rehabilitation expenditures eligible for the rehabilitation credit is reduced by the nonqualified nonrecourse financing with respect to them. n131.7 This restriction applies only for property placed in service by (1) an individual, or (2) a C corporation if at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. n131.8 It also applies only if the property is used in connection with an activity with respect to which any loss is subject to the statutory at-risk limitations. n131.9 This includes, among other things, any trade or business activity or activity engaged in for the production of income. n131.10

"Nonqualified nonrecourse financing" for this purpose is any nonrecourse financing that is not qualified commercial financing. n131.11 "Qualified commercial financing" is any financing with respect to property (other than convertible debt) if the following requirements are met: n131.12

- the property is acquired from an unrelated person; n131.13
- the amount of nonrecourse financing with respect to the property does not exceed 80 percent of the property's credit base; and
- the financing is from a qualified person, or is from or guaranteed by certain governmental entities.

"Nonrecourse financing" for this purpose includes any amount with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or similar arrangements, and (except as provided by regulations) any amount borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used, or from a related person to a person (other than the taxpayer) having such an interest. n131.14 Decreases in the nonqualified nonrecourse financing after the year the property is placed in service can increase the credit base in the taxable year of the decrease. n131.15 Similarly, increases in nonqualified nonrecourse financing can increase the tax in an amount that takes into effect the resulting decrease in the credit base for all prior years. n131.16

[3] Qualified Rehabilitated Building

[a] In General

The term "qualified rehabilitated building" means any building (and its structural components) that:

- (1) has been substantially rehabilitated;
- (2) was placed in service before the beginning of the rehabilitation period;

(3) meets the external wall and internal structural framework retention test; and

(4) is depreciable. n132

The credit is not available, however, for improvements to property used outside the U.S., n133 for property used for lodging, n134 for property used by certain tax-exempt organizations, n135 or for property used by government units for foreign persons or entities. n136

The prohibition of the credit with respect to property that is used predominantly to furnish lodging or in connection with the furnishing of lodging n137 does not apply to the following: n138

(1) nonlodging commercial facilities that are available to persons not using the lodging facilities on the same basis as they are available to persons using the lodging facilities (such as restaurants, drug stores, and grocery stores); n139

(2) a hotel or motel where more than half of the accommodation is used on a transient basis (generally, rental periods of less than 30 days). n140

Residential homes that are rented on a long-term basis are deemed to be lodging and, therefore, will not qualify for the credit unless they are certified historic structures. n141

[b] Placed in Service

A building other than a certified historic structure will not be treated as a qualified rehabilitated building unless it was originally placed in service before 1936. n142 Further, such a building is not considered a qualified rehabilitated building unless it has been in the same location since before 1936. n143 A certified historic structure may be placed in service at any time before the beginning of rehabilitation. n143.1

[c] Substantial Rehabilitation

A building is treated as having been substantially rehabilitated only if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer and ending with or within the taxable year exceed the greater of: (1) the adjusted basis of the building and its structural components; or (2) \$5,000. n144 A 60-month, rather than 24-month, measuring period may be elected in some cases. n145 An extension of time is also available for rehabilitations affected by Hurricane Katrina, Wilma, or Rita. n145.1

In determining the adjusted basis of the building for this purpose, the basis of all parties having an interest in the building must be taken into account. n146 In the case of rental property, the basis to both the landlord and tenant are taken into account. n147

Rehabilitation expenditures occurring outside the 24-month period selected by the taxpayer may still qualify as part of a qualified rehabilitation expenditure and, thus, may be taken into account in determining the amount of the credit. Qualified rehabilitation expenditures occurring prior to the measuring period in the taxable year in which the measuring period begins, and expenditures occurring after the measuring period during the year in which the measuring period ends, qualify. n148

Example:

In Year 1, a calendar year taxpayer purchases a building for \$200,000. The taxpayer begins the rehabilitation of the building in March of Year 1. From March 1 through June 30 of Year 1, the taxpayer

incurs \$12,000 of qualified rehabilitation expenditures. From July 1 of Year 1 through June 30 of Year 3, the taxpayer incurs an additional \$220,000 in expenses. From July 1 of Year 3 through October 1 of Year 3, the taxpayer incurs an additional \$20,000 of expenditures.

The taxpayer selects the period of July 1 of Year 1 through June 30 of Year 3 as the 24-month period for determining whether the rehabilitation is substantial. Under the facts given here, the building will be deemed substantially rehabilitated. In addition, the \$12,000 of expenses incurred from March 1 through June 30 of Year 1 and the \$20,000 of expenses incurred from July 1 of Year 3 through October 1 of Year 3 also qualify as qualified rehabilitation expenditures. The adjusted basis of the building is determined as of July 1 of Year 1. n149

[d] Determination of Basis

The adjusted basis of the building is determined as of the first day of the 24-month period selected by the taxpayer or the beginning of the holding period, whichever is later. Determination of the beginning of the holding period is made without regard to any reconstruction done by the taxpayer in connection with the rehabilitation. n150

The increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by 100 percent of the amount of the rehabilitation credit allowed. n151

[e] Wall Retention Test

[i] In General

To be considered a "qualified rehabilitated building," the building must meet the internal structural framework and external wall retention test. In the case of a building other than a certified historic structure, the internal and external wall retention test is met if, in the rehabilitation process:

- (1) 50 percent or more of the existing external walls of such building are retained in place as external walls;
- (2) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls; and
- (3) 75 percent or more of the existing internal structural framework of such building is retained in place. n152

The area used in the above computations is based upon the area of the external walls or internal structural framework that is retained in place after the rehabilitation is completed, as compared to the total wall area prior to the rehabilitation. The pre-rehabilitation area shall be determined before any destruction, modification or construction of any external walls or internal structural framework is undertaken by any party in anticipation of the rehabilitation. n153

[ii] External Wall

An external wall includes any wall that has one face exposed to the weather, earth, or abutting wall of an adjacent building. n154 In general, the term "external wall" includes only those walls that form the outline or perimeter of the building or that surround an uncovered courtyard. Therefore, the walls of an internal shaft designed solely to bring light or air into the center of the building which enclose space not designed for occupancy or other use by people, any walls surrounded by external walls of the building, and any walls enclosing any other space not designed for occupancy by people are not considered external walls. n155

[iii] Internal Framework

Internal structural framework includes all load-bearing internal walls and any other internal structural supports, including columns, girders, beams, trusses, spandrels, and all other components that are essential to the stability of the building. n156

[iv] Retained in Place

An existing external wall is retained in place if its supporting elements are retained in place. The supporting elements may be reinforced, but not replaced, in the rehabilitation process and still be considered retained in place for the purposes of the test. n157

An external wall is considered retained in place even if the existing doors and windows are modified, eliminated or replaced. An external wall may even be disassembled and reassembled, provided that the original supporting elements are used when the wall is reassembled. n158

[f] Phased Rehabilitation

For any rehabilitation which is reasonably expected to be completed in phases set forth in architectural plans and specifications before the rehabilitation begins, the rehabilitation period is increased from 24 months to 60 months. n159

[g] Time for Claiming Credit

In general, rehabilitation expenditures are taken into account for purposes of the rehabilitation credit in the year in which the rehabilitated building is placed in service. n160 Property to which qualified rehabilitation expenditures are attributed is not treated as being placed in service until the building meets the definition of a qualified rehabilitated building for the taxable year. n161 Accordingly, the property's first taxable year as a qualified rehabilitated building is also the year it is considered to be placed in service. n162

Under certain circumstances, however, a taxpayer will be entitled to elect to claim rehabilitation tax credits for qualified rehabilitation expenditures made with respect to a building that is in the process of undergoing rehabilitation and has not been fully placed in service. A limited exception exists that allows taxpayers to claim credits on "progress expenditure property." Progress expenditure property is property being constructed by or for the taxpayer if, based on facts known at the close of the taxable year in which construction begins, the property is reasonably expected to have a construction period of two years or more. n163

[4] Certified Historic Structure

A certified historic structure is any building that is:

- (1) listed in the National Register, or
- (2) is located in a registered historic district and is certified by the Secretary of the Interior as being of historic significance to the district. n164

A building is considered to be a certified historic structure at the time it is placed in service if: n164.1

- the taxpayer reasonably believes on that date the building will be determined to be a certified historic structure;

- the taxpayer has requested on or before that date a determination from the Department of Interior that the building is a certified historic structure; and
- the Department of Interior later determines that the building is a certified historic structure.

The IRS may, however, waive the requirement that the application for certification of historic status be filed with the US Department of Interior before the property is placed in service. It normally does so by granting an extension of time for an application for certification of historic status with the US Department of the Interior. n164.2

[a] Registered Historic District

The term "registered historic district" means any district listed in the National Register. It also means a district which is designated under a statute of the appropriate state or local government, if such statute is certified by the Secretary of the Interior as containing criteria which will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, and the Secretary of the Interior certifies that the district substantially meets all of the requirements for listing districts in the National Register. n165

[b] Certified Rehabilitation

A certified rehabilitation is any rehabilitation of a certified historic structure which the Secretary of the Interior has certified as being consistent with the historic character of such property or of the district in which such property is located. n166 It is important to note that the procedures that must be followed to ensure that the rehabilitation of a certified historic structure will qualify as a certified rehabilitation are significantly different (and more complicated) than those that must be followed with respect to a rehabilitation of a building other than a certified historic structure.

The rehabilitation of a building other than a certified historic structure must simply be performed in accordance with the standards established in the Code and the Treasury Regulations thereunder. In contrast, the certified rehabilitation of a certified historic structure must be done not only in accordance with the standards established in the Code and Treasury Regulations, but also in accordance with the standards established by the Department of the Interior. In general, the rehabilitation standards established by the Department of Interior are significantly more restrictive than those contained in the Code. n167

The standards established by the Department of the Interior require, at a minimum, consideration of the following:

- (1) Storefront alterations must be justified.
- (2) If the rehabilitation process requires removal of windows or portions of walls, the taxpayer must show why the process selected was preferable to alternative processes.
- (3) Owners are strongly encouraged to retain and repair original windows.
- (4) Installation of new windows (especially tinted windows) must be justified by supporting documentation.
- (5) Replacement sash should match the original in size, pane configuration, color, trim details and reflective qualities.
- (6) Cleaning of masonry surfaces is generally permitted only to halt deterioration or to remove graffiti and stains. Even then, the cleaning method selected must be of the gentlest means possible. n168

Owners planning to undertake a certified rehabilitation of a certified historic building are strongly encouraged to work closely with an architect that has considerable experience in the rehabilitation of historic structures. Additionally, owners should contact the relevant state preservation office as early as possible in the planning process. The state offices can be very helpful in providing guidance in planning and carrying out the rehabilitation. The standards are very strict, and failure to perform the rehabilitation in accordance with these standards, even in what may seem to be a very minor matter, can result in the denial of certification of the rehabilitation. n169 Without certification of the rehabilitation, a taxpayer will not be entitled to claim rehabilitation tax credits for the rehabilitation expenditures. n170

[5] National Register

As discussed in *Section 5.03 [4]* above, a certified historic structure includes any building listed in the National Register. In order to have a building listed in the National Register, the taxpayer must file a "Historic Preservation Certification Application" with its state office of historic preservation. The application contains three separate sections:

- (1) evaluation of significance;
- (2) description of rehabilitation; and
- (3) certification of rehabilitation.

After all three sections have been completed and certified by the state office, the building, in general, is listed on the National Register. The sections of the application are described below. n171

[a] Evaluation of Significance

The evaluation of significance step is required for those buildings that are not already listed on the National Register or situated in a registered historic district. The evaluation will indicate whether or not the building is significant enough to be listed in the National Register. This step is completed by submitting Part 1 of the Historic Preservation Certification Application to the state office. The state office then has 30 days to review the application and recommend to the National Park Service whether or not the building is eligible for the National Register. A building that meets the requirements with respect to Part 1 of the application is not automatically listed on the National Register; at that point, the building has only a preliminary determination that it is eligible for listing. n172

[b] Description of Rehabilitation

The second step is known as the "description of rehabilitation." This step requires the taxpayer to submit a detailed description of the rehabilitation to the state office. The application breaks down the rehabilitation into components that deal with the significant architectural features of the building.

In general, it is strongly recommended that building owners obtain approval prior to the initiation of any rehabilitation work. However, although there is no statutory requirement that approval be obtained prior to initiation of any rehabilitation work, it is essential that a sufficient number of clear color photographs are taken to document interior and exterior conditions, including site and environment, before and after any rehabilitation is done. Elevation features, interior features, and spaces should be shown. Failure to provide photographs of "before" conditions may result in a denial of the requested certification. n173

[c] Certification

Finally, once the rehabilitation has been completed, the "after" photographs of the building are submitted to the state

office in request for certification of the rehabilitation. The state office passes this request on to the National Park Service for certification. Once the National Park Service has certified the rehabilitation, the building is listed in the National Register. Completion of this final step results in the rehabilitation being treated as a certified rehabilitation of a certified historic structure. n174

[6] Tax Credit Recapture

In general, if a rehabilitated building is disposed of or ceases to be investment credit property within five years of being placed in service, the taxpayer is subject to tax credit recapture. The taxpayer's tax liability for the year of the disposition (or the year the building otherwise ceases to be investment credit property) is increased by the recapture percentage multiplied by the total credits taken. The recapture percentage depends upon the year in which the property ceases being investment credit property:

- (1) 100 percent recapture if disposed of within 1 year after being placed in service;
- (2) 80 percent recapture if disposed of within 2 years after being placed in service;
- (3) 60 percent recapture if disposed of within 3 years after being placed in service;
- (4) 40 percent recapture if disposed of within 4 years after being placed in service; and
- (5) 20 percent recapture if disposed of within 5 years after being placed in service.

There is no recapture after five years. n175

If, during any taxable year, there is a recapture of the rehabilitation tax credit with respect to any building the basis of which was reduced by the amount of the rehabilitation tax credit, the basis of such building (immediately before the recapture) is increased by the amount of the recapture. n176 The additional basis is apparently recovered over the remaining depreciable life of the property.

[7] Partnerships

In the case of a partnership, each partner shall take into account, separately, for its taxable year within which the partnership's taxable year ends, its share of the basis of partnership rehabilitation property. n177

Each partner shall be treated as a separate taxpayer with respect to its share of the basis of partnership rehabilitation property. The class life of the property in the hands of each partner shall be the same as the class life of the property in the hands of the partnership. n178

Each partner's share of the basis of any rehabilitated property is generally determined in accordance with the ratio by which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in *IRC Section 702(a)(9)*), regardless of whether the partnership has a profit or loss for the taxable year. n179 Thus, if the partners agree to share losses in one ratio and to share profits in another ratio, the rehabilitation credits are allocated in accordance with the profit sharing ratio even in a year in which the partnership has an overall loss.

If the partnership profit ratio changes during the taxable year of the partnership, the ratio effective on the date on which the property was placed in service applies for purposes of basis and credit allocation. In addition, if the partnership specially allocates all items of income, gain, loss or deduction with respect to any item of property eligible for rehabilitation credits, such special allocation will be respected for rehabilitation property, provided the special allocations are recognized under *IRC Section 704(a)* and the regulations thereunder. n180

Example:

A qualified rehabilitated building with a basis of \$100,000 is placed in service June 1, 19X2. There are five partners in the partnership on January 1, 19X2, and five additional partners are admitted on December 1, 19X2. Allocations are made in accordance with profits interests.

The five partners in the partnership on January 1, 19X2, would each be allocated 20% of the property's basis: \$20,000. The original five would be eligible to claim the related rehabilitation tax credits with respect to their allocated share of the property's qualified rehabilitation expenditures. The five partners admitted after the property was placed in service would not be allocated any of the property's basis and would not be eligible to claim any associated rehabilitation tax credits. n181

[8] Rehabilitation Tax Credit of Lessees**[a] Lessee Rehabilitation Expenditures**

A lessee may claim a credit for qualified rehabilitation expenditures it makes with respect to a qualified rehabilitated building. A lessee's qualified rehabilitation expenditures are eligible for the credit if, as of the time the rehabilitation is completed, the remaining term of the lease is equal to or exceeds the lessee's recovery period for the property (27.5 years for residential property and 39 years for commercial property). n182

In determining whether a lessee's expenditures qualify as a substantial rehabilitation, the building's basis equals the adjusted basis of the lessor plus the adjusted basis of the lessee in the leasehold, and any leasehold improvements that are structural components of the building. n183 If the building is sold before the lessee completes the rehabilitation, however, the new lessor's basis must be taken into account. n184

Example:

A lessee with 50 years remaining on a lease begins a rehabilitation of a building on February 1. At that time, the lessor's adjusted basis in the building is \$200,000. The lessee enters into a qualified rehabilitation plan under which it will incur \$500,000 in expenditures during the next 24-month period. From February to August, the lessee incurs \$150,000 of expenditures on the rehabilitation. On September 1, the lessor sells the building to a third party for \$750,000. The lessee's rehabilitation expenditures will not be deemed to be substantial because the total rehabilitation expenditures will not exceed the new lessor's basis in the building. n185

Planning Tip:

A lessee wishing to preserve the credit for its rehabilitation expenditures should enter into a contract or covenant with the lessor in which the lessor agrees not to sell or otherwise transfer the property until the rehabilitation is completed. n186

[b] Pass-Through of Credit from Lessor to Lessee

A lessor may elect to pass through the rehabilitation tax credit to the lessee. n187 To do so, the lessor must deliver a written statement to the lessee setting forth specified information on or before the filing of the lessee's income tax return. n188 The IRS has also ruled that a trust which is a lessor may elect to pass through the credit to its lessee. n189

[9] Allowance of Credit Against Alternative Minimum Tax

Effective for rehabilitation credits determined attributable to qualified rehabilitation expenses properly taken into account for periods after December 31, 2007 (including any carryback of the credits), the tentative minimum tax is

treated as being zero for purposes of determining the tax liability limitation with respect to the rehabilitation credit. Therefore, these rehabilitation credits may offset AMT liability. n189.1 For prior expenditures, the rehabilitation credit could reduce regular income tax, but could not reduce the AMT. n189.2

FOOTNOTES:

(n1)Footnote 116. *IRC § 47(a)*.

(n2)Footnote 117. *IRC § 47(c)(2)(A)*.

(n3)Footnote 118. *Dennis v Commr, TC Memo 1993-345*.

(n4)Footnote 119. *Treas Reg § 1.48-12(c)(3)(i)*.

(n5)Footnote 120. *Brassard v US, 99-2 USTC P 50,752 (8th Cir 1999)*.

(n6)Footnote 120.1. *Treas Reg § 1.48-12(c)(3)(ii); Ltr Rul, 20004 032*.

(n7)Footnote 121. *Treas Reg § 1.48-12(b)(2)(iv)*.

(n8)Footnote 122. *Treas Reg § 1.48-12(c)(10)*.

(n9)Footnote 122.1. *Ltr Rul 200518016*.

(n10)Footnote 123. *Treas Reg § 1.48-12(c)(10)(ii)*.

(n11)Footnote 124. *Treas Reg § 1.48-12(c)(2)*.

(n12)Footnote 125. *Id.*

(n13)Footnote 126. *Brassard v US, 99-2 USTC P 50,752 (8th Cir 1999)*.

(n14)Footnote 127. *Id.*

(n15)Footnote 128. *IRC § 47(c)(2)(B)*.

(n16)Footnote 129. See *IRC § 168(c), (g)(1)(B), (C)*.

(n17)Footnote 130. See [4], below, for a discussion of rehabilitation of certified historic structures.

(n18)Footnote 130.1. *IRC § 47(c)(2)(B)(v)*.

(n19)Footnote 130.2. *IRC § 168(h)(1)(B)(i)*.

(n20)Footnote 130.3. *IRC § 168(h)(1)(B)(iii)*.

(n21)Footnote 130.4. *IRC § 47(c)(2)(B)(v)*, effective for expenditures properly taken into account for periods after Dec 31, 2007 [Pub Law 110-289, 3025(b)]. For prior periods, the rehabilitation credit also used the 35-percent threshold [*IRC § 47(c)(2)(B)(v), before amendment by Pub Law No 110-289*].

(n22)Footnote 131. *IRC § 47(c)(2)(B)*; see [8], below, for a discussion of rehabilitation tax credits of lessees.

(n23)Footnote 131.1. See *IRC § 168(k)(2), before amendment by Pub Law No 110-185*; see § 5.02[4], above, for a discussion.

(n24)Footnote 131.2. See *IRC § 168(k)(4)*, before repeal by Pub Law No 110-185; see § 5.02[5], above, for a discussion.

(n25)Footnote 131.3. See *IRC § 1400L(b)* see § 5.02[6], above, for a discussion.

(n26)Footnote 131.3.1. See *IRC § 168(k)*; see § 5.02[10], above, for a discussion.

(n27)Footnote 131.4. See *IRC § 168(c), (g)*.

(n28)Footnote 131.5. *Treas Reg §§ 1.48-12(c)(8)(i), 1.168(k)-1(f)(10), 1.1400L(b)-1(f)(9)*.

(n29)Footnote 131.6. *IRC § 49(a)(1)(C)(i)*.

(n30)Footnote 131.7. *IRC § 49(A)(1)(A)*.

(n31)Footnote 131.8. *IRC §§ 49(a)(1)(B)(i), 454(a)(1), 542(a)(2)*.

(n32)Footnote 131.9. *IRC §§ 49(a)(1)(B)(ii), 465*.

(n33)Footnote 131.10. *IRC § 465(c)(3)(A)*.

(n34)Footnote 131.11. *IRC § 49(a)(1)(D)(i)*.

(n35)Footnote 131.12. *IRC § 49(a)(1)(D)(ii)*.

(n36)Footnote 131.13. See *IRC §§ 49(a)(1)(D)(v), 465(b)(3)(C)* (related person).

(n37)Footnote 131.14. *IRC § 49(a)(1)(D)(iii)*.

(n38)Footnote 131.15. *IRC § 49(a)(1)(D)(2)(A), (C)(ii)*.

(n39)Footnote 131.16. *IRC § 49(b)(1)*.

(n40)Footnote 132. *IRC § 47(c)(1)(A)*.

(n41)Footnote 133. *IRC § 50(b)(1)*.

(n42)Footnote 134. *IRC § 50(b)(2)*.

(n43)Footnote 135. *IRC §§ 47(c)(2)(B)(v), 50(b)(3)*.

(n44)Footnote 136. *IRC § 50(b)(4)*.

(n45)Footnote 137. See *IRC § 50(b)(2)*.

(n46)Footnote 138. *IRC § 50(b)(2)*.

(n47)Footnote 139. *Treas Reg § 1.48-1(h)(2)(i)*.

(n48)Footnote 140. *Treas Reg § 1.48-1(h)(2)(ii)*.

(n49)Footnote 141. *Johnston v Commr, 114 F3d 145 (10th Cir 1997) ; Treas Reg § 1.48-1(h)(2)(iv)*.

(n50)Footnote 142. *IRC § 47(c)(1)(B)*.

(n51)Footnote 143. *Treas Reg § 1.48-12(b)(5)*.

(n52)Footnote 143.1. See *IRC § 47(c)(1)(A)*.

(n53)Footnote 144. *IRC § 47(c)(1)(C)(i)*.

(n54)Footnote 145. *IRC § 47(c)(1)(C)(ii)*; see [f], below for a discussion.

(n55)Footnote 145.1. *Notice 2006-38, 2006-1 CB 777* . See Chapter 1 for a discussion.

(n56)Footnote 146. *Treas Reg § 1.48-12(b)(2)(iii)(A)*.

(n57)Footnote 147. *Treas Reg § 1.48-12(b)(2)(iii)(B)*.

(n58)Footnote 148. *Treas Reg § 1.48-12(b)(2)(x)*, Examples (1) and (2).

(n59)Footnote 149. *Treas Reg § 1.48-12(b)(2)(x)*, Examples (1) and (2); see *IRC § 47(c)(1)(C)*.

(n60)Footnote 150. *Id.*

(n61)Footnote 151. *IRC § 50(c)(1)*.

(n62)Footnote 152. *Treas Reg § 1.48-12(b)(3)(i)(C)*.

(n63)Footnote 153. *Treas Reg § 1.48-12(b)(3)(i)(D)*.

(n64)Footnote 154. *Treas Reg § 1.48-12(b)(3)(ii)*.

(n65)Footnote 155. *Id.*

(n66)Footnote 156. *Treas Reg § 1.48-12(b)(3)(iii)*.

(n67)Footnote 157. *Treas Reg § 1.48-12(b)(3)(iv)*.

(n68)Footnote 158. *Id.*

(n69)Footnote 159. *IRC § 47(c)(1)(C)(ii)*; *Ltr Rul 199934014* .

(n70)Footnote 160. *IRC § 47(b)(1)*.

(n71)Footnote 161. *Treas Reg § 1.48-12(f)(2)(i)*.

(n72)Footnote 162. *Id.*

(n73)Footnote 163. *IRC § 47(d)*.

(n74)Footnote 164. *IRC § 47(c)(3)(A)*.

(n75)Footnote 164.1. *Treas Reg § 1.48-12(d)(1)*.

(n76)Footnote 164.2. *Ltr Ruls 201008020* (consultant failed to file application with the Dept. of Interior, and the taxpayer failed to file Part I of the Historic Preservation Certification application with the Dept. of Interior prior to placing property in service), *200937001* (initial application not timely filed before property was placed in service because of incorrect advice from attorney), *200416003*, *200416001* , *200414008* , *200414006* , *200414005* , *200408003* , *200339005* , *200333016* , *200314001* ; see *Treas Reg §§ 1.48-12(d)(l)*, *301-9100-2*, *301.9100-3*.

- (n77)Footnote 165. *IRC § 47(c)(3)(B)*.
- (n78)Footnote 166. *IRC § 47(c)(2)(C)*.
- (n79)Footnote 167. See *16 USC § 470a*.
- (n80)Footnote 168. See *36 CFR § 67.7*
- (n81)Footnote 169. *Schneider Partnership v Dept of Interior*, 693 F Supp 223 (DNJ 1989) .
- (n82)Footnote 170. *BT Washington Broadcasting Service Inc v US*, 92-2 CCH USTC P 50,545 (ND Ala 1992).
- (n83)Footnote 171. See generally the Instructions to the Historic Preservation Certification Application provided by the United States Department of the Interior through the National Park Service.
- (n84)Footnote 172. See *36 CFR § 67.4*.
- (n85)Footnote 173. *Id* at § 67.6.
- (n86)Footnote 174. *Id*.
- (n87)Footnote 175. *IRC § 50(a)*.
- (n88)Footnote 176. *Treas Reg § 1.48-12(e)(3)*.
- (n89)Footnote 177. *Treas Reg § 1.46-3(f)(1)*.
- (n90)Footnote 178. *Id*.
- (n91)Footnote 179. *Treas Reg § 1.46-3(f)(2)(i)*.
- (n92)Footnote 180. *Treas Reg § 1.46-3(f)(2)(ii)*.
- (n93)Footnote 181. *Treas Reg § 1.46-3(f)(2)(i)*.
- (n94)Footnote 182. *IRC § 47(c)(1)(C)(iii), (2)(B)(vi)*; see *IRC § 168(c)*.
- (n95)Footnote 183. *Treas Reg § 1.48-12(b)(2)(iii)(B)*.
- (n96)Footnote 184. *Treas Reg § 1.48-12(b)(2)(ii)(B)*.
- (n97)Footnote 185. *IRC § 47(c)(1)(C)(i)*; *Treas Reg § 1.48-12(b)(2)(ii)(B)*.
- (n98)Footnote 186. See *IRC § 47(c)(1)(C)(i)*; *Treas Reg § 1.48-12(b)(2)(ii)(B)*.
- (n99)Footnote 187. *IRC § 50(d)(5)*; see *IRC § 48(d)*, before amendment by Pub L 101-508; *Treas Reg § 1.48-12(f)(1)*.
- (n100)Footnote 188. *Treas Reg § 1.48-4(f)*.
- (n101)Footnote 189. *Ltr Rul 9506027* .
- (n102)Footnote 189.1. *IRC § 38(c)(4)(B)(v)*. See Pub Law 110-289, § 3022(d)(3) (effective dates).
- (n103)Footnote 189.2. *IRC § 38(c)(1)(A)*; *IRC § 38(c)(4)(B)*, before amendment by Pub Law No 110-289.

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Federal Taxes Affecting Real Estate

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.04

§ 5.04 Low-Income Housing Tax Credits

[1] Introduction

The Low-Income Housing Tax Credit (LIHC) is a federal income tax credit claimed by owners of residential rental properties that are rented to low-income tenants. n190 The credit is claimed as part of the general business credit. n190.1 A taxpayer claiming the credit must file a completed Form 8586, "Low-Income Housing Credit," for each year in which the credit is claimed. A completed Form 8609, "Low-Income Housing Credit Allocation and Certification," must also be filed one time with the IRS in order to claim the credit. n190.2

The LIHC is claimed over ten years, n191 and begins with the taxable year in which the building is placed in service or, at the election of the taxpayer, in the following taxable year. n191.1 The credit can be used in connection with both new and existing buildings. n192 Rehabilitation expenditures by a taxpayer with respect to an existing building are treated as a separate new building for purposes of the LIHC. n192.1 A taxpayer who purchases a building before a prior owner places in service rehabilitation expenditures made may treat the expenditures of the prior owner as a separate new building, and may also incur its own rehabilitation expenditures for purposes of qualifying them as a separate new building for purposes of the LIHC. n192.2 Allocation of the credit is administered by the states. Because Congress expected demand for the LIHC to be exceptionally high, it chose to limit the amount of the credit that would be available in each state. n193 The limitation is generally referred to as LIHC "volume cap." Each state has agencies responsible for allocating the limited quantity of credits to low-income housing projects, and taxpayers must apply to the appropriate agency to receive an LIHC allocation.

A state's LIHC volume cap (or "state housing credit ceiling") for any calendar year after 2000 is an amount equal to the sum of--

(1) the unused state housing credit ceiling (if any) of the state for the preceding calendar year;

(2) the greater of (a) \$1.75 (\$1.50 for 2001) multiplied by the state population, or (b) \$2 million; both the \$1.75 and \$2 million amounts are subject to cost-of-living adjustments after 2002; n193.1 For 2004, the amount is the greater of \$1.80 multiplied by the state population, or \$2,075,000. n193.2 For 2005, the amount is the greater of \$1.85 multiplied by the state population, or \$2,125,000. n193.3 For 2006, the amount is the greater of \$1.90 multiplied by the state population, or \$2,190,000. n193.4 For 2007, the

amount is the greater of \$1.95 multiplied by the state population, or \$2,275,000. n193.5 Legislation enacted in 2008 increases from \$2.00 per resident to \$2.20 per resident the allocation authority provided annually to each State for calendar years 2008 and 2009. n193.6 It also increases the minimum annual cap for certain small population States by ten percent of the otherwise available amounts in 2008 and 2009, respectively. n193.7 Therefore, for 2008, the amount is the greater of \$2.20 multiplied by the state population, or \$2,555,000. n193.8 For 2009, the amount is \$2.30 multiplied by the state population, or \$2,665,000. n193.9 For 2010, the amount is the greater of \$2.10 multiplied by the State population, or \$2,430,000. n193.10

(3) the amount of any state housing credit ceiling returned to the state during the calendar year (e.g., by developers whose projects did not go forward); and

(4) the amount, if any, of the national unused housing credit ceiling allocated to the state by the Secretary of the Treasury. n194

No state housing credit volume cap allocation is required with respect to the portion of any credit attributable to eligible basis financed by tax-exempt bonds that utilized tax exempt bond volume cap. If the principal payments on that financing are applied within a reasonable period to redeem obligations the proceeds of which were used to provide that financing or that financing is refunded. n194.1 And where 50 percent or more of the aggregate basis of any building and the land on which the building is located is financed by such a bond, no state housing credit volume cap is required with respect to the entire building. n195 Costs of acquisition and rehabilitation costs must be aggregated in applying the 50 percent test. Taxpayers cannot separately meet the 50 percent test for an acquisition and a later rehabilitation of a project. n195.1 Such a project would, of course, be eligible only for the "30 percent" credit for federally subsidized projects. n195.2

The Code requires state housing credit agencies to submit annual reports to the Secretary of the Treasury concerning their housing credit allocation activities, and requires those agencies to have in place plans for the allocation of credits among projects that are intended to limit the aggregate of all subsidies allocated to a particular project to the amount necessary for the financing of the project. n196

A low-income housing project will generally be eligible for credits every year for ten years after it has been placed in service. The actual credit period will usually extend over 11 calendar years, because only a *pro rata* portion of a full year's credit is available in the first year, with the remainder being available in the 11th year. n197 The LIHC will not be available (or will be recaptured) unless an LIHC building satisfies specific low-income housing compliance rules for a full 15-year period. n198

Analysis of the LIHC and its eligibility requirements can be divided into two major parts: initial year calculation and succeeding year calculations. The initial year calculation has four components:

- (1) the qualified low-income building; n198.1
- (2) the low-income occupancy percentage; n198.2
- (3) the amount of eligible basis; n198.3 and
- (4) the credit percentage. n198.4

Each of these four factors must be analyzed to determine whether a project is eligible to receive low-income housing credits, and to determine the amount of credits available. To be eligible for any credits, a project must first meet the requirements for a qualified low-income building. (These requirements are discussed in *Section 5.04 [3]* below.) Once a

building is deemed to be a qualified low-income building, its owner must determine the building's "qualified basis" in order to determine the amount of LIHC a project may claim in the initial year. n199 A building's qualified basis is the product of the "low-income occupancy percentage" and the "eligible basis." n200 The amount of LIHC that a building owner may claim in the initial year is the building's qualified basis multiplied by the credit percentage. n201

After the initial year, the first three items listed above continue to affect the amount of LIHC that may be claimed and the determination of whether a tax credit recapture event has occurred. n201.1

The credit percentage is fixed in the initial year and therefore is not affected by subsequent year calculations. However, the other three items can change in the subsequent years and thus decrease (or increase) the amount of credit to which a taxpayer is entitled. These three factors must be redetermined each year. n201.2

The LIHC is an extremely technical income tax area. Because the LIHC is a relatively new income tax provision, it is not supported by a large body of administrative or judicial interpretation. This lack of guidance is exacerbated by the many nuances contained in LIHC law as well as by the changes that have occurred since LIHC legislation was first enacted. The IRS frequently issues private letter rulings responding to requests about application of various LIHC requirements. It has also issued general guidance about various aspects of the credit, n201.3 and has issued revenue procedure under which affected taxpayers in major disaster areas may obtain relief from certain statutory requirements pertaining to the credit. n201.4 Certain rehabilitation costs are also eligible for a 70-percent credit. n201.5

[2] Economic Factors

The LIHC is generally designed to subsidize either 30 percent or 70 percent of the costs of the low-income units in a project. n202 The 30-percent subsidy is for new construction that is already federally subsidized and for the acquisition costs of existing buildings. n203 "Federally subsidized" buildings include buildings financed with tax exempt bonds. n203.1 The 70-percent subsidy is for new construction that is not already receiving federal subsidies. n204

The 30-percent or 70-percent subsidy is realized by claiming federal income tax credits every year for ten years. n205 The actual amount of the annual credit is calculated to yield a present value of either 30 percent or 70 percent of certain building costs. n205.1

In exchange for receiving this credit, the project owner must agree to rent units to low-income individuals at reduced rental rates. n205.2 Theoretically, the credit is designed to provide the additional rent that is necessary to compensate low-income building owners for the reduced rental income.

Even though the low income housing tax credit starts out as a stream of tax benefits over a ten-year period, in practice low income housing developers use low-income housing tax credits as an inducement to raise equity dollars from investors. The amount of capital that a developer can raise based on any specific amount of credits will vary based on such factors as prevailing interest rates, the perceived stability and viability of the project, and the demand for and supply of credits available. For example, every \$1.40 to \$1.70 in tax credits might generate \$1.00 in equity contributions in a transaction in which the investors receive essentially all of the tax credits, one-half of any operating cash flow, and all cash from the sale or refinancing of the property until they receive a return of 100 percent of their capital, with the remainder of cash (if any) being split 50 percent by the investors and 50 percent by the general partner/sponsor.

General economic principles influence where developers choose to build tax credit subsidized low-income housing. Such housing is generally built where the land costs are low and the LIHC allowable rents are close to market-rate rents.

Economic forces generally make it more difficult to build low-income tax credit housing in major cities because land costs are higher and low-income rents are substantially below market-rate rents. However, some additional federal and

state programs make development in these cities more feasible. n206 For this reason, the basis of a building constructed in a high cost area (or the rehabilitation expenditures taken into account in a rehabilitation in such an area) are increased by 30 percent. n207

When deciding whether to apply for an allocation, building owners should consider four major criteria:

- (1) the economic value of the credit;
- (2) the economic value of additional government subsidies;
- (3) the economic cost of the reduced rents; and
- (4) the administrative burden of complying with the LIHC program.

[3] Qualified Low-Income Building

[a] Overview

To qualify for the LIHC, a project must satisfy the requirements for a "qualified low-income building." First, the building must be part of a qualified low-income housing project at all times during the 15-year compliance period. n208 In addition, to be a qualified low-income building, a building must be subject to the depreciation rules of *IRC Section 168*. n209

[b] Qualified Low-Income Housing Project

[i] Set-Aside Test

A qualified low-income housing project is generally any residential rental property that satisfies one of two minimum set-aside tests. n210 These tests are referred to as the minimum set-aside tests because they require a minimum number of units to be set aside for occupancy by low-income tenants. The two tests are known as the 20-50 test and the 40-60 test. n211 A third test for so-called "deep rent skewed" projects is satisfied if 15 percent or more of the low income units in the building or project are occupied by tenants whose gross income is 40 percent or less of the area median gross income. n212

The building owner must identify and elect the minimum set-aside test that the building will attempt to satisfy when the project is placed in service. n213 The applicable set-aside test must be satisfied by the end of the first year of the credit period for the building (or substantial rehabilitation project). n214 The applicable minimum set-aside test must then be complied with continuously thereafter for the entire extended compliance period. n215 The minimum set aside test will not be violated if the income of a low income tenant rises above the specified ceiling, and the unit will continue to be considered to be a low income unit; provided that if the income of the occupants of the unit rises above 140 percent of the income limitation (170 percent, in the case of a deep rent skewed project), the next available unit of a comparable size or smaller (the next available low income unit of any size, in the case of a deep rent skewed project) is rented to a tenant who satisfies the applicable income limitation. n216

Regulations define various terms and detail the workings of this "available unit rule." n217 In determining whether a unit is an over-income unit, the aggregate income of all the occupants of the unit is taken into account. n218 A unit ceases to be treated as a low-income unit under the available unit rule if it becomes an over-income unit and a nonqualified resident occupies any comparable unit that is available or that later becomes available in the same building of a low-income housing project. n219 When a current resident moves to a different unit within the same low-income building, the units exchange status. Thus, the newly-occupied unit adopts the status of the vacated unit, and the vacated unit assumes the status the newly-occupied unit had immediately prior to its occupancy by the qualifying residents.

n220 A unit is not available for purposes of the available unit rule when it is no longer available for rent due to a reservation that is binding under local law. n221

The IRS has established procedures pursuant to which buildings occupied solely by low income tenants may obtain a waiver of the annual income certification requirements, and has informed housing agencies and project owners as to how to obtain income certifications in other circumstances. n222

[A] 20-50 Test

To satisfy the 20-50 test, at least 20 percent of the residential units in the project must be both rent-restricted and occupied by tenants whose gross income is 50 percent or less of the area's median gross income. n223

[B] 40-60 Test

The 40-60 test requires that at least 40 percent of the residential units in the project be both rent-restricted and occupied by tenants whose gross income is 60 percent or less of the area's median gross income. n224

[ii] Rent-Restricted Test

A residential unit is rent-restricted only if the "gross rent" with respect to such unit does not exceed 30 percent of the income limitation applicable under the minimum set-aside test. n225 Therefore, if the 20-50 minimum set-aside test is elected, then gross rent is limited to 30 percent of the 50 percent, i.e., 15 percent, of "area median gross income." Likewise, if the 40-60 minimum set-aside test is elected, then gross rent is limited to 30 percent of 60 percent, i.e., 18 percent, of area median gross income. n226 If the deep rent skewed set aside test is elected, then gross rent is limited to 30 percent of the 40 percent; i.e., 12 percent of the area median gross income.

[A] Gross Rent

The term "gross rent" is defined as a periodic charge for the right to occupy or use someone else's property. It includes an allowance, specified in the Treasury Regulations, for the cost of any utilities that are paid by the tenant, except for the cost of a telephone. n227 Gross rent also includes the cost imposed on the tenant for any non-optional services (i.e., services other than housing services) provided by the landlord to the tenant. A service is optional only if payment for the service is not required as a condition of occupancy. n228 Gross rent does not include rental assistance payments made on behalf of a tenant, such as through Section 8 of the *United States Housing Act of 1937* or any comparable federal or state low-income housing assistance program. n229 In addition, an applicant may not be denied admission to a LIHC project because the applicant holds a voucher or certificate of eligibility under the Section 8 program. n230

[B] Area Median Gross Income

The LIHC rules generally use a definition of Area Median Gross Income that is based upon the HUD methodology used for Section 8 of the *United States Housing Act of 1937*. n231 Under Section 8, median family income estimates are based on decennial census data, updated by Bureau of the Census P-60 income data and Department of Commerce County Business Patterns employment and earnings data. These definitions of income do not make reference to an individual's income for purposes of the federal income tax.

The measurement of area median gross income applied for residential rental property located in certain rural areas is modified in the case of projects subject to the low-income housing credit volume limits. In the case of properties located in rural areas (as defined in section 520 of the Housing Act of 1949), the income targeting rules of the low-income housing credit are applied by reference to the greater of the otherwise applicable area median gross income standard, or the national nonmetropolitan median gross income. This new income targeting rule applies to all such buildings if the building receives a low-income housing credit allocation under the otherwise applicable low-income housing credit

volume limit. It does not apply in the case of buildings which do not require a low-income housing credit allocation because they are substantially bond-financed. n231.1 The area median gross income rules are not changed for buildings in metropolitan areas.

[4] Qualified Basis

The credit amount that an owner may claim with respect to a building is based on the percentage of the building that is occupied by low-income tenants. Specifically, the available credit equals the product of the building's qualified basis multiplied by the "applicable [credit] percentage." n232 The qualified basis of any qualified low-income building for any taxable year is equal to the "applicable fraction (i.e., the low-income occupancy percentage) of the eligible basis of the building. n233

[a] Low-Income Occupancy Percentage

The low-income occupancy percentage is determined as of the close of the taxable year and is the smaller of the unit fraction or the floor space fraction. n234 The term "unit fraction" refers to the ratio of low-income units in the building to the total number of residential units in such building. n235 The number of residential units in the building includes units that are not occupied. n236

The term "floor space fraction" refers to the ratio of total floor space of the low-income units in such building to the total floor space of all residential rental units in such building. n237 The floor space of the residential rental units includes that of units that are not currently occupied. n238

A low-income unit is defined as a unit that is both rent-restricted and occupied by a tenant who satisfies the income limitations under the elected minimum set-aside test. n238.1 In addition to these two general requirements, there are several other specific requirements. A low-income unit: n238.2

- (1) must not be used for transient occupancy (but under certain circumstances may be used to provide transitional housing for the homeless);
- (2) must be suitable for occupancy;
- (3) generally cannot be owner-occupied (or occupied by a person related to the owner) if there are four or fewer units in the project; n239
- (4) must be located in a building (i.e., a trailer park is not eligible);
- (5) must be available to the general public (i.e., occupancy may not be limited to members of a specific social organization or to employees of neither they nor their children are dependents of another individual, or if the full-time students are married and file a joint return a specific employer); n239.1 and
- (6) may not be a manager's unit (but the cost of the Manager's unit is included in eligible basis, and the unit is excluded from both the numerator and the denominator of the "applicable fraction"). n240

In general, student housing does not qualify for the low-income housing credit. There are three exceptions with respect to units occupied by an individual: (1) who is a student and receiving assistance under title IV of the Social Security Act (Temporary Assistance for Needy Families); (2) who is enrolled in a job training program receiving assistance under the Job Training Partnership Act or under other similar Federal, State, or local laws, or (3) who is student who previously foster care assistance (under part B or E of title IV of the Social Security Act). n240.1 A housing unit occupied entirely by full-time students may qualify for the LIHC if the full-time students are single parents and neither they nor their

children are dependents of another individual, or if the full time students are married and file a joint return. n241

In the first year of the credit period, the unit and floor space fractions are calculated on a monthly basis. n242 The calculation begins with the first full month in which the property is placed in service. The occupancy of the unit is determined as of the last day of the month. n243 A credit that may be disallowed in the first year due to this monthly calculation may be claimed in the eleventh year. n244

The Treasury Department is authorized to provide a waiver of penalties for *de minimis* errors in the application of the low-income tenant occupancy requirements. n245 The Treasury Department has adopted procedures for the grant of a waiver of the annual recertification of tenant income for tenants in buildings that are occupied entirely by low-income tenants. n246 Third-party verification of a tenant's or prospective tenant's income from his or her combined assets is not necessary if: (1) the combined assets do not exceed \$5,000; and (2) the tenant or prospective tenant provides a signed, sworn statement to this effect to the building owner. n247

[b] Eligible Basis

In general, "eligible basis" is the acquisition cost of the property, plus the cost of any improvements to the property. n248 Only the adjusted basis of the building may be included in eligible basis. The adjusted basis is determined by taking into account the non-depreciation adjustments described in *IRC Section 1016*. The cost of land is not included in adjusted basis. n248.1 Nonrecourse debt may constitute part of a taxpayer's basis in property as long as the fair market value of the property securing the debt reasonably approximates the principal amount of the debt, n248.2 and the debt is genuine and likely to be paid by the taxpayer. n248.3

Eligible basis also includes facilities for the use of the tenants, other facilities reasonably required by the project, and amenities (e.g., stoves, refrigerators, and air conditioning units) to the extent that the cost of such facilities and amenities in the low-income units are comparable to the cost of the items in any unsubsidized (i.e., "market rate") residential units in the building. n249 The determination of eligible basis is similar to the determination of cost basis used elsewhere in tax law. n250

An existing building can have an eligible basis only if it meets the following requirements:

- It must be acquired by purchase. n250.1
 - Effective for buildings placed in service after July 30, 2008, at least 10 years must have elapsed since the date the building was last placed in service. n250.2 There are two exceptions to this requirement. n250.3 First, the ten-year rule is waived in the case of any Federally-assisted or State-assisted building. n250.4 A Federally-assisted building includes any building which is substantially assisted, financed, or operated under section 8 of the United States Housing Act of 1937, section 221(d)(3), 221(d)(4) or 236 of the National Housing Act, section 515 of the Housing Act of 1949, or any other housing program administered by the Department of Housing and Urban Development or the Rural Housing Service of the Department of Agriculture. n250.5 A State-assisted building is any building which is substantially assisted, financed, or operated under any State law similar in purposes to those of the Federal laws used in the definition of a Federally-assisted building. n250.6 Second, upon application by the taxpayer, the IRS may waive the 10-year requirement if the building is acquired from an insured depository institution in default, or from a receiver or conservator of that institution. n250.7 For buildings placed in service before July 31, 2008, at least 10 years must have elapsed since the later of the date the building was last placed in service or the date of the most recent nonqualified substantial improvement. n250.8 The IRS may waive the 10-year requirement: (1) if the building is acquired from an insured depository institution in default, or from a receiver or conservator of that institution; n250.9 or (2) for federally assisted buildings, if the waiver of the ten-year holding period is necessary to avert an assignment of the

mortgage secured by property in the project to HUD, or the Rural Housing Service (RHS), or (formerly) the FmHA. n250.10 Letter rulings frequently waive the 10-year holding period requirement. n250.11

- The building was not previously placed in service by the taxpayer or a person related to the taxpayer as of the time previously placed in service.

- A credit is allowed for rehabilitation expenditures made to the building. n251

Under the general rule, the eligible basis for the entire compliance period is determined as of the close of the first year of the credit period. n251.1 This rule enables developers to include in eligible basis capitalized costs incurred after the date the building was placed in service, but before the end of the first taxable year of the credit period.

Generally, the amounts included in the adjusted basis account for costs associated with all property that comes under the definition of residential rental property. n251.2 Also included in the adjusted basis are the costs for common areas associated with apartment buildings. n252 The adjusted basis of a building located in a qualified census tract n252.1 can also include depreciable property that is used throughout the taxable year in providing any community service facility used by non-tenants of the low-income building. n252.2 The community service facility, however, may not exceed the sum of: (1) 25 percent of so much of the eligible basis of the qualified low-income housing credit project of which it is a part as does not exceed \$15,000,000; and (2) 10 percent of any excess over \$15,000,000 of the eligible basis of the qualified low-income housing credit project of which it is a part. n252.3 For buildings placed in service before 7/31/08, the facility cannot exceed 10 percent of the eligible basis of the qualified low-income housing credit project of which it is a part. n252.4 Eligible basis can also include community buildings that are used for tenant meetings, various classes, providing social services to project residents, and cooperative child care. n253 Streets, drainage and other utility infrastructure improvements constructed in connection with low-income housing buildings can also be included in eligible basis. n253.1 However, property must be depreciable under *IRC Section 168* if its costs are to be included in the eligible basis. n254 This rule prevents taxpayers from claiming the LIHC with respect to land costs. n254.1

Buildings located in three types of high-cost areas (i.e., qualified census tracts, difficult development areas, and buildings designated by a state housing credit agency as requiring an increase in the credit in order for the building to be financially feasible) are eligible for an enhanced credit. n254.1.1 Under the enhanced credit, the 70-percent and 30-percent credits are increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. n254.1.2 A further requirement for the enhanced credit for qualified census tracts and difficult development areas is that the portions of each metropolitan statistical area or nonmetropolitan statistical area designated as difficult to develop areas cannot exceed an aggregate area having 20 percent of the population of that statistical area. n254.1.3 This requirement does not apply to buildings eligible for the enhanced credit by virtue of being designated by a State housing credit agency as requiring an increase in the credit in order for the building to be financially feasible. n254.1.4

Private letter rulings sometimes address whether certain costs can be included in eligible basis and, although not citable as precedent, the rulings can provide useful guidance on likely IRS positions with respect to certain costs. For example, the IRS has ruled that for a land preparation cost to be includable in eligible basis, the cost must be for depreciable property. The cost of land preparation is depreciable property only if the preparation is so closely associated with a particular depreciable asset that the preparation would be retired, abandoned, or replaced contemporaneously with that depreciable asset. Whether this would occur in a given case is a question of fact. n254.2

The IRS has ruled that costs associated with the issuance of tax-exempt bonds are generally not includable in a project's eligible basis because they do not qualify as either depreciable property that is residential rental property under *IRC Section 103* or as depreciable property used in a common area or provided as a comparable amenity to all residential units in a building. This is because bond issuance costs are amortizable as an intangible under *IRC Section 167*, but are

not depreciable under *IRC Section 168*. n254.3

The IRS has made several points in its rulings regarding eligible basis generally. First, it has made clear that it is not bound by any State Agency determination that a cost is includable in eligible basis when determining the financial feasibility of the project under *IRC Section 42(m)(2)(A)*. Thus, a state agency's verification and acceptance of a cost will not guarantee its inclusion in eligible basis for purposes of the low-income housing credit. n254.4

Reversing its prior position, n254.5 the IRS has ruled that for the purpose of the low-income housing tax credit, impact fees are includable in the eligible basis of a qualified low-income building. n254.6 Impact fees are one-time charges that are imposed by state or local governments against new development or expansion of existing developments to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. In general, impact fees are refundable (in full or in part) if the new or expanded development ultimately is not constructed as planned. Impact fees can be imposed on a variety of items, including water capital, wastewater capital, roads, educational facilities, law enforcement, and fire/rescue facilities. The fees are often based on the type and size of the development. Once construction began, the fees are usually not transferable and remained with the land. n254.7 A change in method of accounting for impact fees to conform to *Revenue Ruling 2002-9* does not affect the amount of credit that has been allocated under *IRC Section 42(h)(1)* or allowed for buildings financed with tax-exempt bonds subject to the volume cap. n254.8

The IRS has also ruled regarding third-party costs and fees incurred by the taxpayer in obtaining a construction loan. In one ruling, the items were amortized over the life of the loan. The IRS ruled that the construction loan intangible was not subject to *IRC Section 168* and was therefore not includable in eligible basis. The IRS noted, however, that *IRC Section 263A* required the amortization deductions relating to the construction loan intangible to be capitalized to the produced property during the construction period. The deductions had to be reasonably allocated to all property produced. Therefore IRS ruled that to the extent the deductions were allocable to the adjusted bases of *IRC Section 168* property that qualified as residential rental property under *IRC Section 103* or to *IRC Section 168* property used in a common area or provided as a comparable amenity to all residential units in the building, the amortization deductions were includable in the project's eligible basis. n254.9 In one ruling, the IRS allowed a partnership to use the substitute cost method n254.9.1 to determine its eligible basis for purposes of the low-income housing credit. n254.9.2 Under the substitute cost method, the taxpayer had to include direct and indirect costs that had to be capitalized under *IRC Section 263A* in the project's eligible basis for purposes of determining amount of the low-income housing credit for which the project was eligible. Certain interest costs required to be capitalized under *IRC Section 263A(f)* were among the indirect costs that could be included in eligible basis. With respect to a partnership (such as the taxpayer in the ruling) or other flow-through entities, rules for assigning to any property the amount of capitalized interest had to first be applied at the entity level and then at the beneficiary level. n254.9.3 The ruling detailed the capitalization requirements and other steps the taxpayer had to take in order to use the substitute cost method. n254.9.4

The IRS has also ruled that fees paid to a developer to engaged in partnership organizational and syndication activities on behalf of the taxpayer are not includable in eligible basis. n254.10 Costs incurred to secure tenants for unit vacancies are also not includable in eligible basis because the costs are not related to the building construction, and therefore cannot establish or add to the basis of depreciable property under *IRC Section 168*. n254.11

Costs included in eligible basis must be reasonable in amount. In reviewing a project's application for the LIHC, each housing credit agency is required to consider the reasonableness of the developmental and operation costs of a project as an additional factor in making its determination as to the proper amount of credits to allocate. n255 Administrative errors and omissions that occur in this process, often relating to misidentified buildings and carryover allocations, are frequently corrected by private letter ruling requests. n256

The eligible basis of a building cannot include any costs financed with the proceeds of a federally funded grant. n257 Certain rental assistance payments made to the owner of a building on behalf of low-income tenants are not federal

grants with respect to the building for this purpose. These payments include the following: n258

- rental assistance payments made under Section 8 of the US Housing Act of 1937 (the "Act"); n259
- payments made under a qualifying program of rental assistance administered under Section 9 of the Act; n260
- payments made to a building owner on behalf of or in respect of a tenant under the *Section 8 Assistance for Single-Room Occupancy Dwellings Program* n261 or under the *Shelter Plus Care Program*; n262
- payments made under such other programs or methods of rental assistance as may be designated in the Federal Register or the Internal Revenue Bulletin;
- payments made on behalf or in respect of a tenant under the *Housing Opportunities for Persons With AIDS* (HOPWA) program; n263
- rental assistance payments made to a building owner on behalf or in respect of a tenant under the *Rent Supplement Payment* program; n263.1 and
- rental assistance payments made to a building owner on behalf or in respect of a tenant under the *Rental Assistance Payments* program. n263.2

Certain rental assistance payments under the Indian Housing Block Grant Program are also not treated as grants. n263.3

[c] Rehabilitation Expenditures

For purposes of the LIHC, qualified rehabilitation expenditures to an existing building are treated as a new building n263.4 and are therefore eligible for the 70-percent credit. n263.5 Rehabilitation expenditures generally include amounts chargeable to capital account that are depreciable, but do not include the costs of acquisition. n263.6 To qualify for the credit, the rehabilitation expenditures must equal the greater of an amount that is (1) at least 20 percent of the adjusted basis of the building being rehabbed, as determined at the beginning of the 24-month rehabilitation period; or (2) at least \$6,000 per low-income unit in the building being rehabbed. n263.7 The \$6,000 amount is indexed for inflation after 2009. n263.8 The above minimum expenditures apply for buildings that receive credit allocations after July 30, 2008 and to substantially tax-exempt bond financed buildings (which satisfy the requirements of *IRC Section 42(h)(4)* and therefore do not require a credit allocation) that receive a tax-exempt bond allocation after July 30, 2008. n263.9 For buildings placed in service before July 31, 2008, the rehabilitation expenditures must equal the greater of an amount that is (1) at least 10 percent of the adjusted basis of the building being rehabbed; or (2) at least \$3,000 per low-income unit in the building being rehabbed. n263.10

For purposes of applying the LIHC, the rehabilitation expenditures are treated as placed in service at the close of the 24-month rehabilitation period. n263.11

Planning Guide:

Taxpayers have discretion in selecting the 24-month rehabilitation period for purposes of determining the placed-in-service date for the rehabilitation expenditures. They may request a private ruling that their selected dates will be accepted by the IRS. n263.12

At the election of the taxpayer, a special rule applies allowing the 30-percent credit to both existing buildings and rehabilitation expenditures if the second prong (i.e., at least \$6,000 of rehabilitation expenditures per low-income unit)

of the rehabilitation expenditures test is satisfied. This election is available only in the case where the taxpayer acquired the building and immediately prior to that acquisition the building was owned by or on behalf of a government unit. n263.13

[5] Credit Percentage

The calculation of the credit percentage depends on whether the project involves new or existing buildings, whether any federal subsidies are used, and when the project was placed in service. New buildings are generally allowed a higher credit percentage than existing buildings. n264

The calculation of the applicable percentage is generally designed to produce a credit equal to: (1) 70 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not federally subsidized (the "70-percent credit"); or (2) 30 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is federally subsidized and existing housing that is substantially rehabilitated (the "30-percent credit"). n265 Where existing housing is substantially rehabilitated, the existing housing is eligible for the 30-percent credit and the qualified rehabilitation expenses (if not federally subsidized) are eligible for the 70-percent credit. n266

The credit percentage for a low-income building is set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to the building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued. n267

Planning Guide:

Taxpayers making the election must ensure that they have a binding credit allocation commitment and that they make a valid credit percentage election in accordance with regulations. n268 The election must be signed and notarized by the fifth day following the end of the month in which the binding agreement was made. n269 An election to use the credit percentage in effect when the binding credit allocation commitment is made should be given careful consideration due to the significant impact of changing interest rates.

The credit percentages used for the 70-percent credit and 30-percent credit are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the Applicable Federal Rates for mid-term and long-term obligations for the month the building is placed in service. The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building. n270 An applicable percentage of 9 percent applies, however, for newly constructed non-Federally subsidized buildings placed in service after July 30, 2008 and before December 31, 2013. n270.1 The 9 percent floor applies notwithstanding a prior irrevocable election by the taxpayer to apply to those buildings a lower applicable percentage. n270.1.1

If any portion of the eligible basis of a building is federally subsidized, then the building is ineligible for the 70-percent credit. Effective for buildings placed in service after July 30, 2008, a Federal subsidy includes only obligations the interest on which is exempt from tax under *IRC Section 103*. This restriction on what constitutes a federal subsidy allows additional buildings to become eligible for the 70-percent credit. n270.2 A tax-exempt obligation used to provide construction financing for any building is not treated as a subsidy if it (when issued) identified the building for which the proceeds of the obligation would be used and it is redeemed before that building is placed in service. n270.3

For buildings placed in service before July 31, 2008, federal subsidies include: (1) any obligation the interest of which is tax exempt from tax under *IRC Section 103*; (2) a direct or indirect federal loan if the interest rate is less than the

applicable federal rate; n271 or (3) assistance provided under the HOME Investments Partnership Act or the Native American Housing Assistance and Self Determination Act of 1996 if certain requirements are not met. n272

Planning Guide:

A developer whose project includes only a small amount of funding from tax-exempt obligations may find it profitable to elect to exclude from the eligible basis of the building the proceeds of those obligations. Doing so may allow the entire project to be eligible for the 70-percent credit on the reduced basis. n273

For buildings placed in service before July 31, 2008, a 70-percent credit is allowed for certain "HOME" (HOME Investment Partnership) or Native American Housing Assistance projects. Projects with HOME or Native American Housing assistance will not be treated as federally subsidized if 40 percent or more of the aggregate residential rental units in the project are occupied by individuals whose gross incomes are 50 percent or less of the area's median gross income. HOME or Native American Housing Assistance projects are not eligible to receive the 30 percent bonus that would be available for an LIHC project in a qualified census tract or difficult development area, but they are eligible for the special rule applicable to certain high cost housing areas (i.e., New York City), pursuant to which only 25 percent of the residential units in the building need be occupied by individuals with gross income of 50 percent or less of the area's median gross income. n274

[6] At-Risk Rules

At-risk rules apply in the determination of the available amount of LIHC, but the at-risk rules adopted for the LIHC differ substantially from the at-risk rules that apply to the allowance of losses under *IRC Section 465*. The LIHC at-risk rules generally follow the at-risk rules applicable to the former investment tax credit, which are set forth in *IRC Section 49(a)(1)*, with certain modifications. n275

The LIHC at-risk rules apply to individuals, including beneficiaries of estates and trusts and shareholders of "S" corporations, and to closely held "C" corporations. n276 These rules do not apply to widely-held "C" corporations. n277 A "closely-held corporation" is a corporation which, at any time during the last half of the taxable year, had more than 50 percent of the value of its outstanding common stock owned, directly or indirectly, by or for not more than five individuals. n278

[a] Nonrecourse Financing

The general at-risk rule is that any non-qualified nonrecourse financing will not be included in the credit base, and expenditures attributable to this financing will therefore generally not qualify for the LIHC. n279 Operationally, the credit base of LIHC property that would otherwise be eligible for the credit is reduced by the amount of the nonrecourse financing. n280 The one exception to this reduction rule is for nonrecourse financing that satisfies the definition of "qualified commercial financing." n281

[b] Qualified Commercial Financing

The term "qualified commercial financing" refers to any debt with respect to an LIHC property if: n282

- (1) the property was acquired by the taxpayer from a person who is not a related person;
- (2) either--(a) the creditor is a qualified person, or (b) the loan is from, or guaranteed by, any federal, state or local government or instrumentality of such government; and
- (3) such financing is not convertible debt.

A "qualified person" is generally any person who is actively and regularly engaged in the trade or business of lending money. n283 However, the term does not include:

- (1) a person from whom the property was acquired (or a person related to that person); n284
- (2) a person who receives a fee with respect to the taxpayer's investment in the property (or a person related to that person). n285

[7] Restriction on Use

In addition to the rules previously described, there are other limitations on the LIHC that are more general in nature. Three of these limitations are the passive loss rules, the general business credit limitations and the alternative minimum tax. Each of these restrictions is discussed below.

[a] Passive Loss Rules

The use of passive activity losses and credits is limited. n286 The limitation applies to individuals (including shareholders of "S" corporations), estates, trusts, closely-held "C" corporations and personal service corporations. Passive activity losses and credits are losses and credits from a passive activity. n287 They can generally be used only against income or tax attributable to a passive activity. n288 A rental activity (e.g., a low-income housing project) is specifically defined as a passive activity. n289 Special rules limiting the application of the passive activity loss rules apply to persons who are active participants in the real estate business. n290

An individual who is not eligible for the special rule for persons active in a real estate business can still claim up to \$25,000 of losses (or credit equivalent) from a rental real estate activity. n291 Two general requirements must be satisfied to qualify for this provision. First, in general, the taxpayer must satisfy a different active participation requirement. n292 Second, in general, the taxpayer must have an adjusted gross income (AGI) of less than \$100,000. If the taxpayer's AGI exceeds \$100,000, then the \$25,000 allowance is reduced by fifty cents for every dollar of such excess. n293 Therefore, this allowance (and the credit equivalent) is fully phased out for taxpayers with AGIs of \$150,000 or more. However, the LIHC also receives special treatment for the purposes of this restriction--the phase-out is eliminated for low-income housing tax credits. n294 Investors should note that this special rule applies only to the credit itself and does not apply to any losses that are generated from the activity. (See Chapter 13 for a detailed discussion of passive losses and credits.)

[b] General Business Credit Rules

The LIHC is treated as a general business credit under the Code. n295 The Code provides for two types of tax credits: refundable (such as the earned income credit) and non-refundable. General business credits are non-refundable tax credits. Excess non-refundable tax credits are either carried back one year and forward 20 years, effective for credits arising in tax years beginning after December 31, 1997. n296

Credits arising in earlier years may be carried back three years or carried forward for up to 15 years. n297

General business credits reduce a taxpayer's regular federal income tax liability, but are subject to two overall limitations. n298 The first limitation allows 100 percent of the first \$25,000 of credits, then 75 percent of the credits in excess of \$25,000. n299 The second limitation prevents the credit from reducing the taxpayer's regular tax below the tentative minimum tax. n300

[c] Alternative Minimum Tax

The alternative minimum tax (AMT) is a separate tax calculation from that of the "regular" income tax. The alternative

minimum tax is an add-on tax, that is, an addition to the regular tax. To determine if the taxpayer is subject to the AMT, one must first calculate the tentative minimum tax (TMT), n301 and then determine if the taxpayer is eligible for the small corporation exemption from the AMT. n302

Effective for low-income housing credits attributable to buildings placed in service after December 31, 2007 (including any carryback of those credits), the LIHC may offset alternative minimum tax liability. n303 For prior periods, the LIHC could reduce regular income tax, but could not reduce the AMT. n304

[8] Transfers

For the year in which a low-income housing project is sold to a different owner, credits must be allocated between the transferor and the transferee, with proper adjustments made under *IRC Section 42(j)*. n305

The credits for the periods before and after the sale are allocated to the transferor and transferee based on the number of days each held the property. n306 However, the IRS allows the allocation to be made using a mid-month convention. n307 Therefore, the transferor and transferee can agree to allocate the credits for the month of the disposition based on which owner held the property the longest during that month. The owner who held the property for the majority of days in the month would be deemed to have held the property for the entire month. If the owners have each held the property for an equal number of days during the month of disposition, the transferor is deemed to have held the property for the entire month. n308

[9] Recapture Issues

[a] Decreases in Qualified Basis

Generally, if the amount of an LIHC project's qualified basis decreases, then the building owner's tax is increased by two amounts: (1) a tax credit recapture; n309 and (2) an interest charge. n310 Decreases in qualified basis generally result from a reduction in eligible basis, a decrease in the low-income occupancy percentage, or a transfer of the building. n310.1 A transfer of bare legal title in order to escape local real estate taxes will not result in recapture, however, if the taxpayer retains all benefits and burdens of ownership. n310.2 Building owners should note that if any noncompliance is corrected within a reasonable period of time after learning of noncompliance, there will be no tax credit recapture nor interest charge. n311 The transfer of partnership interests (in partnerships that invest in low-income housing) from a parent to a subsidiary as a contribution to capital does not result in credit recapture solely as a result of the assignment, provided that the assignment does not result in a reduction of qualified basis. n312 The IRS has also allowed transfers of low-income housing partnership interests among members of an affiliated group to avoid recapture. n312.1 Similar transfers resulting from entity restructurings that are no more than a change in the form of conducting a business may also not result in credit recapture. n312.2

The increase in tax does not apply if the reduction in qualified basis occurs by reason of a casualty loss, to the extent that the loss is restored by reconstruction or replacement within a reasonable period established by the Secretary. n312.3 For basis reductions occurring beyond the first year of the credit period that result from federally declared disasters, a restoration period up to 24 months after the end of the calendar year in which the disaster declaration for the area where the building is located is allowed. n312.4 For property damaged by Hurricane Katrina and located in the GO ZONE, the restoration period may be as long as 48 months after the end of calendar year 2005. n312.5

[b] Full Recapture of the LIHC

If, at the close of any tax year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of the qualified basis at the close of the preceding tax year, the taxpayer's tax for the tax year must be increased by the credit recapture amount. n313 Thus, full recapture of the LIHC is generally required if the taxpayer disposes of a low-income building or if the building fails to satisfy statutory requirements for the LIHC

during the compliance period. n314

Effective for buildings disposed of after July 30, 2008, there is no recapture solely by reason of a disposition of a building or an interest in it if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remaining compliance period. n314.1 Taxpayers may also elect to have this rule apply with respect to earlier dispositions if it is reasonably expected that the building will continue to be a qualified low-income building for the remaining compliance period. n314.2 If there is a disposition before the end of the compliance period, and there is a reduction in the qualified basis of the building that results in recapture, however, the otherwise applicable statute of limitations for assessing a deficiency with respect to the recapture is extended until three years after the Secretary of the Treasury is notified of the reduction in qualified basis. n314.3

For buildings disposed of before July 31, 2008 and for which the taxpayer does not elect to have the above rule apply, a taxpayer may defer or avoid recapture by furnishing a satisfactory bond to the Secretary if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's compliance period. n315 The IRS may approve a surety bond that is provided by a related taxpayer. n315.1 The purpose of the bond is to secure the taxpayer's liability for LIHC recapture with respect to the taxpayer's disposition of an interest in a qualified low-income building during the compliance period. The bond must be provided for the remainder of the 15-year compliance period after the disposition plus an additional 58 months. A taxpayer who furnishes a bond with respect to the disposition of an interest in a qualified low-income building will be treated solely for purposes of applying *IRC Section 42(j)* with respect to the disposition as if the taxpayer had not disposed of the interest. Instead, the taxpayer's recapture (if any) with respect to the disposed-of interest will be determined under the rules of *IRC Section 42(j)* by deeming the taxpayer to continue to own the disposed-of interest and by determining the qualified basis for the deemed interest in accordance with the rules of *IRC § 42(c)*. Therefore, the taxpayer may be able to avoid any recapture. The taxpayer will not, however, be treated as claiming any additional low-income housing credit with respect to the disposed-of interest for any period following the disposition. n316

If the seller posts a bond, the credits for the year of sale are allocated between the parties based on the number of days each party held the low-income building or interest in it. n316.1 The IRS allows the allocation to be made using a mid-month convention. Essentially, the buyer steps into the shoes of the seller. n317

Because of the relative unavailability of surety bonds, the IRS established a collateral program for pledging certain Treasury securities to the IRS as an alternative to providing a surety bond. Under the program, taxpayers may establish a Treasury Direct Account and pledge certain US Treasury securities to the IRS as security in lieu of a surety bond to secure the taxpayer's liability for credit recapture under *IRC Section 42(j)*. Upon furnishing Treasury securities, the taxpayer will be treated, solely for purposes of *IRC Section 42(j)*, as if the taxpayer had not disposed of the interest and the taxpayer will be deemed to continue to own the disposed-of interest under *IRC Section 42(c)*. The taxpayer will not, however, be treated as claiming any additional low-income housing credit for the disposed-of interest for any period following the disposition. If the qualified basis of the taxpayer's deemed interest in a qualified low-income building decreases after a disposition of the taxpayer's interest in the qualified low-income building, the Treasury securities may be forfeited in whole or in part. n318

Another exception may apply with respect to LIHC projects owned by a partnership with 35 or more partners. Unless the partnership elects otherwise, the partnership itself will be treated as the taxpayer for purposes of the recapture rules, so that a transfer by a partner of its interest in the partnership will not result in recapture. n319 Note that a consequence of this provision is that the continuing partners and the transferee partner remain at risk for the recapture avoided by the transferor partner, if, for example, the building itself should go out of compliance with the tax credit rules, resulting in an overall recapture. The IRS has ruled that a transfer at death of limited partnership interests in low-income housing partnerships does not result in a recapture of the low-income housing credit. n320

[c] Recapture Tax and Interest

The taxable disposition or decrease in qualified basis of a LIHC project triggers both the recapture tax and the additional interest charge. n321 The interest rate is the overpayment rate established under *IRC Section 6621*. The recapture tax (and interest charge) can be avoided in certain statutorily-enumerated situations: posting a bond, originally claiming a reduced credit, receiving no tax benefit for the credit, *de minimis* floor space changes, and disposition due to casualty losses. n322 The IRS has also ruled that the transfer of bare legal title does not trigger the recapture tax if the transferor retains burdens and benefits of ownership. n323 The IRS has also ruled that a corporate reorganization with a transfer of a subsidiary's interest in several partnerships (and underlying low-income housing property) is not a disposition that results in a recapture of low-income housing credits. n324

[d] Recapture Period

The compliance period for a low-income housing project is 15 years. This compliance period begins at the same time as the credit period. If any of the recapture events described in this subsection occur during the 15-year compliance period, tax credit recapture is generally required. The amount of the recapture is based upon the prior LIHC claimed and the time that has elapsed since the credit was first claimed. n325

For years one to 11, one-third of the previously-claimed LIHC is recaptured. During the twelfth year, 4/15 of the credit is subject to recapture. During years 13, 14 and 15, 3/15, 2/15, and 1/15, respectively, is subject to recapture. The following chart summarizes these rules: n326

Years of Recapture Event	Recapture Fraction
Years 1 through 11	1/3
Year 12	4/15
Year 13	3/15
Year 14	2/15
Year 15	1/15

Example (1):

Assume that the project generates \$25,000 of LIHC annually. If the apartment building is disposed of on January 1 of year 6, then the recapture would be equal to 1/3 of the \$25,000 of tax credits that were claimed for each of the five years the building was held. The total recapture of accelerated credit would equal \$41,666 ($1/3 \times \$25,000 \times 5$ years).

Example (2):

If the building was disposed of on January 1 of year 13, then recapture would equal 3/15 of \$25,000 each year for the ten years the LIHC was claimed. The total recapture of accelerated credit would equal \$50,000 ($3/15 \times \$25,000 \times 10$ years). n327

FOOTNOTES:

(n1)Footnote 190. *IRC* § 42.

(n2)Footnote 190.1. *IRC* § 38(b)(5).

(n3)Footnote 190.2. *Reg § 1.42-1(h)*.

(n4)Footnote 191. *IRC § 42(f)(1)*.

(n5)Footnote 191.1. *IRC § 42(f)(1)*; see Ltr Ruls 200842016, 200333011 (extension of time granted to make election).

(n6)Footnote 192. See *IRC § 42(d)(1), (2)*.

(n7)Footnote 192.1. *IRC § 42(e)(1)*; see *Ltr Rul 200335030*.

(n8)Footnote 192.2. *Rev Rul 91-38*, Q&A 7-8, 1991-2 CB 3; *Ltr Rul 200335030*.

(n9)Footnote 193. *IRC § 42(h)*. Congress's expectations were accurate. California, for example, is regularly oversubscribed for credits.

(n10)Footnote 193.1. *IRC § 42(h)(3)(H)*.

(n11)Footnote 193.2. *Rev Proc 2003-85*, 2003-2 CB 1184.

(n12)Footnote 193.3. *Rev Proc 2004-71*, 2004-2 CB 974.

(n13)Footnote 193.4. *Rev Proc 2005-70*, 2005-2 CB 979.

(n14)Footnote 193.5. *Rev Proc 2006-53*, 2006-2 CB 996.

(n15)Footnote 193.6. *IRC § 42(h)(3)(I)(i)*.

(n16)Footnote 193.7. *IRC § 42(h)(3)(I)(ii)*. The 10-percent increase in the dollar amount must be rounded to the next lowest multiple of \$5,000. In 2010, the volume limits will return to the prescribed levels had the increases not been enacted.

(n17)Footnote 193.8. *Rev Proc 2007-66*, 2007-45 IRB 970; *IRC § 42(h)(3)(I)(ii)*. The \$2,555,000 figure is the cost-of-living adjustment amount for 2008 plus 10 percent, rounded to the next lowest multiple of \$5,000 (\$2,325,000 + \$232,500 = \$2,557,500, rounded to \$2,555,000).

(n18)Footnote 193.9. *Rev Proc 2008-66*, § 3.07, 2008-45 IRB 1107.

(n19)Footnote 193.10. *Rev Proc 2009-50*, § 3.08, 2009-45 IRB 617.

(n20)Footnote 194. *IRC § 42(h)(3)(C)*; a state's low-income housing credit volume limit for 2009 is reduced by the amount of certain federal grants made to the state's housing credit agency [*IRC § 42(i)(9)(A)*].

(n21)Footnote 194.1. *IRC § 42(h)(4)(A)*; see *IRC § 146(i)(6)* (treatment of certain bonds as refunding bonds). The provision related to refunding of the financing applies to repayments of loans received after July 30, 2008 [Pub Law 110-289, § 3007(c)].

(n22)Footnote 195. *IRC § 42(h)(4)*. The IRS has ruled that earnings from the investment of the bond sale amounts that accrue during the project period may be included as part of the proceeds of tax-exempt bonds. This may enable a taxpayer to meet the 50-percent threshold (*Rev Rul 2002-21*, 2002-1C B 793; see *Ltr Rul 200109011*; *Ltr Rul 200109014*). The IRS has also ruled that the repayment of a bond loan and the redemption of the tax-exempt bonds after a project is placed in service does not, in and of itself, prevent a project from being treated as financed with tax-exempt bonds under *IRC § 42(h)(4)(B)* (see Ltr Ruls 200334005, 200324025, 200334011, 200234005, 200220011, 200219030).

(n23)Footnote 195.1. *Ltr Rul 200035016* .

(n24)Footnote 195.2. See *IRC § 42(b)(1)(B)*.

(n25)Footnote 196. *IRC §§ 42(l), (m)*.

(n26)Footnote 197. *IRC § 42(f)(2)*.

(n27)Footnote 198. *IRC § 42(h)(6)(D)*.

(n28)Footnote 198.1. *IRC § 42(c)*; see [3], below, for a discussion.

(n29)Footnote 198.2. *IRC § 42(g)*; see [4][a], below, for a discussion.

(n30)Footnote 198.3. *IRC § 42(d)*; see [4][b], below, for a discussion.

(n31)Footnote 198.4. *IRC § 42(a)(1), (b)*; see [5], below, for a discussion.

(n32)Footnote 199. *IRC § 42(c)*. See § 5.04[4], *infra*.

(n33)Footnote 200. *IRC § 42(c)(1)(A)*. See §§ 5.04[4][a], [b], *infra*.

(n34)Footnote 201. *IRC § 42(a)*.

(n35)Footnote 201.1. *IRC § 42(c), (d), (g)*.

(n36)Footnote 201.2. *IRC § 42(a)-(d), (g)*.

(n37)Footnote 201.3. *Rev Rul 2004-82* , *2004-35 IRB 350* ; *Rev Proc 2005-37* , *2005-28 IRB 79* .

(n38)Footnote 201.4. *Rev Proc 2007-54* , *2007-31 IRB 293* . *Notice 2008-58* , *2008-28 IRB 81* ; *Rev Proc 2008-61* , *2008-30 IRB 180*

(n39)Footnote 201.5. *IRC § 42(e)*; see § 5.04[4][c], below, for a discussion.

(n40)Footnote 202. *IRC § 42(b)(1)(B)*.

(n41)Footnote 203. *IRC § 42(b)(1)(B)(ii)*.

(n42)Footnote 203.1. *IRC § 42(i)(2)(A)*.

(n43)Footnote 204. *IRC § 42(b)(1)(B)(i)*; see *Ltr Rul 200624062* (70-percent subsidy not available for existing building).

(n44)Footnote 205. *IRC § 42(f)(1)*.

(n45)Footnote 205.1. *IRC § 42(b)(1)(B)*.

(n46)Footnote 205.2. See *IRC § 42(g)*; see § 5.04[3][b], below, for a discussion.

(n47)Footnote 206. For example, the federal Section 8 program subsidizes tenant rents, but does not limit a building owner's ability to claim the LIHC. United States Housing Act of 1937, *42 USC § 1401*.

(n48)Footnote 207. *IRC § 42(d)(5)(B)*. See § 5.04[4][b], below, for a discussion of high-cost areas.

(n49)Footnote 208. *IRC § 42(c)(2)(A)*. State housing authorities will require an extended compliance period of 30 years or more. *IRC § 42(h)(6)*.

(n50)Footnote 209. *IRC § 42(c)(2)(B)*. These depreciation rules generally require that residential rental property be depreciated on a straight-line basis over 27.5 years. *IRC § 168(c)*. It is frequently necessary for low income housing projects in which the developer/sponsor makes an equity capital investment to use longer depreciable lives to enable them to achieve their goal of allocating substantially all of the credits to the investors.

(n51)Footnote 210. *IRC § 42(g)*.

(n52)Footnote 211. *IRC § 42(g)(1)*. For projects located in New York City (a "high cost housing area"), this test can be satisfied if 25 percent of the units are both rent restricted and occupied by tenants whose gross income is 60 percent or less of the area median gross income. *IRC §§ 42(g)(4); 142(d)(6)*. *Rev Proc 94-10, 1994-1 CB 556*, provides guidance for the making of calculations relating to deep rent skewed projects.

(n53)Footnote 212. *IRC §§ 42(g)(4); 142(d)(4)*.

(n54)Footnote 213. *IRC § 42(g)(1)*; if an election is not made, a taxpayer may request that the IRS grant an extension for making one (Ltr Ruls 200551014, 200519031, 200330023, 200319003, 200217013, 200112051, 200029026). A taxpayer may also request an extension via private letter ruling to change an election if the incorrect set-aside test is inadvertently elected in on the initially filed Form 8609 (*Ltr Rul 201010017*).

(n55)Footnote 214. *IRC § 42(g)(3)(A)*.

(n56)Footnote 215. *IRC §§ 42(g)(2)(D); (h)(6)*.

(n57)Footnote 216. *IRC § 42(g)(2)(D)*.

(n58)Footnote 217. *Treas Reg § 1.42-15*.

(n59)Footnote 218. *Treas Reg § 1.42-15(a)*.

(n60)Footnote 219. *Treas Reg § 1.42-15(c)*.

(n61)Footnote 220. *Treas Reg §§ 1.42-15(d), 1.42-15(h), Example 2*.

(n62)Footnote 221. *Treas Reg § 1.42-15(c)*.

(n63)Footnote 222. *Rev Proc 2004-38, 2004-2 CB 10*. *Rev Proc 94-65, 1994-2 CB 798*.

(n64)Footnote 223. *IRC § 42(g)(1)(A)*.

(n65)Footnote 224. *IRC § 42(g)(1)(B)*.

(n66)Footnote 225. *IRC § 42(g)(2)(A)*. See § 5.04[3][b][ii][A], *infra*.

(n67)Footnote 226. See § 5.04[3][b][2][B], *infra*.

(n68)Footnote 227. *IRC § 42(g)(2)(B)(ii); Treas Reg § 1.42-10*.

(n69)Footnote 228. *Treas Reg § 1.42-11*.

(n70)Footnote 229. *IRC § 42(g)(2)(B)(i)*.

(n71)Footnote 230. *IRC § 42(h)(6)(B)(iv).*

(n72)Footnote 231. *Notice 88-80, 1988-2 CB 396 .*

(n73)Footnote 231.1. *IRC § 42(i)(8)*, effective for determinations after July 30,2008 [Pub Law 110-289, § 3004(i)(5)].

(n74)Footnote 232. *IRC § 42(a).*

(n75)Footnote 233. *IRC § 42(c)(1)(A).*

(n76)Footnote 234. *IRC §§ 42(c)(1)(A)(i), (B).*

(n77)Footnote 235. *IRC § 42(c)(1)(C).*

(n78)Footnote 236. *IRC § 42(c)(1)(C)(ii).*

(n79)Footnote 237. *IRC § 42(c)(1)(D).*

(n80)Footnote 238. *IRC § 42(c)(1)(D)(ii).*

(n81)Footnote 238.1. *IRC § 42 (i)(3)(A)*; see *IRC § 42(g)(l)*. The IRS provides a safe harbor for situations in which a tenant moves into a unit on or after the date a taxpayer acquires an existing building for rehabilitation, but before the beginning of the first taxable year of the building's credit period. Under the safe harbor, if specified requirements are met, the IRS will treat a residential unit in a building as a low-income unit if the income of a tenant meets the statutory income limit on the date the tenant moves in, before the beginning of the first taxable year of the building's credit period. The status of the unit as a low-income unit will not change even if the tenant's income exceeds the statutory income limit at the beginning of the first taxable year of the building's credit period, based on the area median gross income on that date (*Rev Proc 2003-82, 2003-2 CB 1097*).

(n82)Footnote 238.2. *IRC § 42(i)(3).*

(n83)Footnote 239. *IRC § 42(i)(3)(C).*

(n84)Footnote 239.1. *Treas Reg § 1.42-9*. A project that otherwise meets the general public use requirements does not fail to meet those requirements solely because of occupancy restrictions or preferences that favor tenants (1) with special needs; or (2) who are members of specified group under a Federal program or State program or policy that supports housing for that group; or (3) who are involved in artistic and literary activities [*IRC § 42(i)(9)*].

(n85)Footnote 240. *Treas Reg §§ 1.42-9;-11.; Rev Rul 92-61, 1992-2 CB 7 .*

(n86)Footnote 240.1. *IRC § 42(i)(3)(D)(i)*; the exception for prior foster care is effective for determinations made after July 30, 2008 [Pub Law 110-289, § 3004(i)(4)].

(n87)Footnote 241. *IRC § 42(i)(3)(D)(ii).*

(n88)Footnote 242. *IRC § 42(f)(2)(A).*

(n89)Footnote 243. *IRC § 42(f)(2)(A)*. See also *Rev Rul 91-38* , Question and Answer 5, 1991-2 CB 3 .

(n90)Footnote 244. *IRC § 42(f)(2)(B).*

(n91)Footnote 245. *IRC § 42(g)(8).*

(n92)Footnote 246. *Rev Proc 2004-38, 2004-2 CB 10* .

(n93)Footnote 247. *Rev Proc 94-65, 1994-2 CB 798* .

(n94)Footnote 248. *IRC § 42(d)(1), (2)*.

(n95)Footnote 248.1. See HR Rept No 841, 99th Cong, 2d Sess 89 (1986), *1986-3 CB (Vol 4) 89*. See Ltr Rul 200624062 .

(n96)Footnote 248.2. *Commr v Tufts, 461 US 300 (1983)* ; *Crane v Commr, 331 US 1 (1947)* ; *Estate of Franklin v Commr, 544 F2d 1045 (9th Cir 1976)* .

(n97)Footnote 248.3. *Estate of Upham v Commr, 923 F2d 1328 (8th Cir 1991)* , aff'g *TC Memo 1989-253* ; *Durkin v Commr, 872 F2d 1271 (7th Cir 1989)* , aff'g *87 TC 1329 (1986)* ; see *FSA 19948006* .

(n98)Footnote 249. *IRC § 42(d)(4)(B)*. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong, 2d Sess 157 (1986). However, under certain circumstances, the taxpayer is entitled to elect to reduce its eligible basis by the amount by which its cost allocable to the market rate units exceeds the average cost allocable to the low income units; in that event, the reduced cost of the market rate units is included in eligible basis. *IRC § 42(d)(3)*.

(n99)Footnote 250. *IRC §§ 42(d)(1), (2)(A)(i)*.

(n100)Footnote 250.1. *IRC § 42(d)(2)(B)(i)*; see *IRC § 179(d)(2)*.

(n101)Footnote 250.2. *IRC § 42(d)(2)(B)(ii)*. Special statutory rules can come into play in determining whether certain transfers are taken into account in determining when a building was last placed in service [*IRC § 42(d)(2)(D)(i)*; see *Ltr Rul 200235018* (ruling that a foreclosure and subsequent sale of low-income property qualified under *IRC § 42(d)(2)(D)(i)(IV)* so as to allow the 10-year holding period requirement to be met); see *Ltr Rul 200309009* (ruling that a transfer by quitclaim deed of a low-income housing building followed by a rescission of transfer in the same year did not result in a new placed-in-service date)]. The IRS has ruled that the making of *IRC § 743(b)* adjustments to the basis of a housing project when partners of the prior owner transferred their partnership interests to other partners was not a "placed-in-service" event for purposes of the 10-year holding-period requirement [*Ltr Rul 200204006*]. A variety of other transfers can also be ignored in determining whether the 10-year holding-period requirement is met, such as transfers among disregarded entities [*Ltr Rul 200614019*].

(n102)Footnote 250.3. *IRC § 42(d)(6)*; see Pub Law 110-289, § 3003(h)(1).

(n103)Footnote 250.4. *IRC § 42(d)(6)(A)*.

(n104)Footnote 250.5. *IRC § 42(d)(6)(C)(i)*.

(n105)Footnote 250.6. *IRC § 42(d)(6)(C)(ii)*.

(n106)Footnote 250.7. *IRC § 42(d)(6)(B)*.

(n107)Footnote 250.8. *IRC § 42(d)(2)(B)(ii), before amendment* by Pub Law No 110-289. Special statutory rules come into play in determining whether there is a nonqualified substantial improvement [*IRC § 42(d)(2)(D)(i), before repeal* by Pub Law No 110-289].

(n108)Footnote 250.9. *IRC § 42(d)(6)(D), before amendment* by Pub Law No 110-289.

(n109)Footnote 250.10. *IRC § 42(d)(6)(A)(i), before amendment* by Pub Law No 110-289.

(n110)Footnote 250.11. See Ltr Ruls 200628003 , 200607013 , 200517029 , 200224029 , 200219010 , 200219009 , 200105038 , 200017052 , 200033017 , 200024040 , 200009032 , 9830005 , 9817027 , 9730021 .

(n111)Footnote 251. *IRC § 42(d)(2)(B)(iv), (e)*; this requirement does not apply in some instances (see *IRC § 42(f)(5)(B)*).

(n112)Footnote 251.1. *IRC §§ 42(d)(1), (2)(A)*.

(n113)Footnote 251.2. *IRC § 42(d)(4)(A)*.

(n114)Footnote 252. *IRC § 42(d)(4)(B)*.

(n115)Footnote 252.1. See *IRC § 42(d)(5)(B)*.

(n116)Footnote 252.2. *IRC § 42(d)(4)(C)*, in effect for housing credit dollar amounts allocated after Dec 31, 2000, and buildings placed in service after Dec 31, 2000.

(n117)Footnote 252.3. *IRC § 42(d)(4)(C)(ii)*, effective for buildings placed in service after July 30, 2008.

(n118)Footnote 252.4. *IRC § 42(d)(4)(C)(ii)*, *before amendment by Pub Law No 110-289*.

(n119)Footnote 253. See Ltr Rul 9822026 .

(n120)Footnote 253.1. See Ltr Rul 200916007 .

(n121)Footnote 254. *IRC § 42(d)(4)(B)*. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong, 2d Sess 157 (1986). See § 5.02[2].

(n122)Footnote 254.1. See *IRC § 42(d)(4)(B)*; see *TAM 200043017* (ruling that fees paid to a developer for services in acquiring land are not includable in eligible basis).

(n123)Footnote 254.1.1. *IRC § 42(d)(5)(B)*. The addition of buildings designated by a state housing credit agency as qualifying for an increased credit [*IRC § 42(d)(5)(B)(v)*] applies only to buildings placed in service after 7/30/08 [Pub Law 110-289, § 3003(h)(1)].

(n124)Footnote 254.1.2. *IRC § 42(d)(5)(B)(i)*.

(n125)Footnote 254.1.3. *IRC § 42(d)(5)(B)(ii)(II), 42(d)(5)(B)(iii)(II)*.

(n126)Footnote 254.1.4. *IRC § 42(d)(5)(B)(v)*.

(n127)Footnote 254.2. See *TAM 200044005 ; TAM 200043015 ; TAM 200043016 ; TAM 200043017* .

(n128)Footnote 254.3. See *TAM 200043015* .

(n129)Footnote 254.4. *TAM 200043015 ; TAM 200043016 ; TAM 200043017* .

(n130)Footnote 254.5. See *TAM 200043016* .

(n131)Footnote 254.6. *Rev Rul 2002-9, 2002-10 IRB 614* .

(n132)Footnote 254.7. See *Rev Rul 2002-9, 2002-10 IRB 614* .

(n133)Footnote 254.8. *Rev Rul 2002-9, 2002-10 IRB 614 ; see IRC § 42(h)(4)*.

(n134)Footnote 254.9. *TAM 200043016* ; see *TAM 200043017* .

(n135)Footnote 254.9.1. See Notice 88-99, 1988-2 *CB* 422 for details of the substitute cost method.

(n136)Footnote 254.9.2. *Ltr Rul 200305015* .

(n137)Footnote 254.9.3. *IRC § 263A(f)(2)(C)*.

(n138)Footnote 254.9.4. *Ltr Rul 200305015* .

(n139)Footnote 254.10. See *TAM 200043017* .

(n140)Footnote 254.11. *TAM 200043017* .

(n141)Footnote 255. *IRC § 42(m)(2)(B)(iv)*.

(n142)Footnote 256. See *IRC § 42(n)(4)*; *Treas Reg § 1.42-13*; *Ltr Ruls 200002048* ; *200003022* ; *200011034* ; *200013023* ; *199917023* ; *199918062*; *199924033* ; *199926020* ; *199926043* ; *199937024* ; *199943033* .

(n143)Footnote 257. *IRC § 42(d)(5)(A)*, effective for buildings placed in service after July 30, 2008 [Pub Law 110-289, § 3003(h)(1)]; for buildings placed in service before July 31, 2008, the eligible basis of a building had to be reduced by the amount of federally funded grants [*IRC § 42(d)(5)(A)*, *before amendment by Pub Law No 110-289*].

(n144)Footnote 258. *Treas Reg § 1.42-16*.

(n145)Footnote 259. See *42 USC § 1437f*.

(n146)Footnote 260. See *42 USC § 1437g*.

(n147)Footnote 261. See *42 USC §§ 11301, 11401-11402*.

(n148)Footnote 262. *Rev Rul 98-49, 1998-40 IRB 4* ; see *42 USC §§ 11301, 11403-11407b*.

(n149)Footnote 263. *Rev Rul 99-39, 1999-38 IRB 424* ; see *42 USC §§ 12901-12912*.

(n150)Footnote 263.1. *Rev Rul 2002-65, 2002-43 IRB 729* ; see *12 USC § 1701s*.

(n151)Footnote 263.2. *Rev Rul 2002-65, 2002-43 IRB 729* ; see *12 USC § 1715z-l(f)(2)*.

(n152)Footnote 263.3. *Rev Rul 2008-6, 2008-3 IRB 271* .

(n153)Footnote 263.4. *IRC § 42(e)(1)*.

(n154)Footnote 263.5. *IRC § 42(b)(1)(B)*.

(n155)Footnote 263.6. *IRC § 42(e)(2)*; see *IRC § 42(d)(3), (4)*, for certain amounts that are excluded.

(n156)Footnote 263.7. *IRC § 42(e)(3)(A)(ii)*.

(n157)Footnote 263.8. *IRC § 42(e)(3)(D)*. For 2010, there is no inflation adjustment, and the amount remains \$6,000 [*Rev Proc 2009-50* , § 3.07, *2009-45 IRB 617*].

(n158)Footnote 263.9. Pub Law 110-289, § 3003(h)(2).

(n159)Footnote 263.10. *IRC § 42(e)(3)(A)*, *before amendment by Pub Law No 110-289*.

(n160)Footnote 263.11. *IRC § 42(e)(4)(A)*.

(n161)Footnote 263.12. See Ltr Rul 200605004 .

(n162)Footnote 263.13. *IRC § 42(e)(3)(B)*. The same election was available if the \$3,000 per low-income unit test under prior law was met.

(n163)Footnote 264. See *IRC § 42(b)*.

(n164)Footnote 265. *IRC § 42(b)(1)(B)*.

(n165)Footnote 266. See *IRC § 42(b)(1)(B), (e)*.

(n166)Footnote 267. *IRC § 42(b)(1)(A)*.

(n167)Footnote 268. See *Treas Reg § 1.42-8*.

(n168)Footnote 269. *Treas Reg § 1.42-8(a)(3)*.

(n169)Footnote 270. *IRC § 42(b)(1)(C)*.

(n170)Footnote 270.1. *IRC § 42(b)(2)*.

(n171)Footnote 270.1.1. *Notice 2008-106, 2008-94 IRB 1239* .

(n172)Footnote 270.2. *IRC § 42(i)(2)(A)*.

(n173)Footnote 270.3. *IRC § 42(i)(2)(C)*.

(n174)Footnote 271. A federal loan under the Farmers' Home Administration Section 515 program would be treated as a subsidy under this provision [Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong, 2d Sess. 160 (1986)]. So would savings from a refinanced loan partly funded with federal funds [*Ltr Rul 200539003*]. A below market loan from a city, funded by a grant from HUD to the city, is not treated as a federal subsidy for this purpose [*Ltr Rul 8813024*]. Nor are funds lent by a taxpayer that are attributable to payments made by a Federal agency defendant to a housing program as the result of a civil lawsuit [*Ltr Rul 9723014*].

(n175)Footnote 272. *IRC § 42(i)(2), before amendment by Pub Law No 110-289*.

(n176)Footnote 273. *IRC § 42(i)(2)(B)*.

(n177)Footnote 274. *IRC §§ 42(i)(2)(E), before amendment by Pub Law No 110-289, 142(d)(6)*.

(n178)Footnote 275. *IRC § 42(k)* adopts *IRC § 49(a)(1)* by reference, with certain modifications.

(n179)Footnote 276. *IRC §§ 42(k)(1); 49(a)(1)(B)(i); 465(a)(1)*.

(n180)Footnote 277. *IRC §§ 42(k)(1); 49(a)(1)(B)(i); 465(a)(1); 542(a)(2)*.

(n181)Footnote 278. *Id.*

(n182)Footnote 279. *IRC §§ 42(k)(1); 49(a)(1)(A)*.

(n183)Footnote 280. *IRC § 49(a)(1)(A)*.

(n184)Footnote 281. *IRC §§ 42(k)(1); 49(a)(1)(D)(ii)*.

(n185)Footnote 282. *IRC § 49(a)(1)(D)(ii)*, as modified by *IRC § 42(k)(1)*.

(n186)Footnote 283. *IRC §§ 42(k)(1); 49(a)(1)(D)(iv)*.

(n187)Footnote 284. The general *IRC § 465* at-risk rules apply for determining a related party. (*IRC § 49(a)(1)(D)(v)* incorporates *IRC § 465(b)(3)(C)* by reference.)

(n188)Footnote 285. *IRC § 49(a)(1)(D)(iv)*, as modified by *IRC § 42(k)(1)*.

(n189)Footnote 286. Pub L No 99-514, 99th Cong, 2d Sess (Oct 22, 1986). See *IRC § 469*. See also § 13.01, *infra*.

(n190)Footnote 287. *IRC § 469(d)*.

(n191)Footnote 288. *IRC §§ 469(a); (d)*.

(n192)Footnote 289. *IRC § 469(c)(2)*.

(n193)Footnote 290. *IRC § 469(c)(7)*.

(n194)Footnote 291. *IRC § 469(i)(1)*.

(n195)Footnote 292. *Id*; *IRC § 469(i)(6)(B)(i)*.

(n196)Footnote 293. *IRC § 469(i)(3)(A)*.

(n197)Footnote 294. *IRC § 469(i)(3)(C)*.

(n198)Footnote 295. *IRC § 38(b)(5)*.

(n199)Footnote 296. *IRC § 39(a)(1)*.

(n200)Footnote 297. *IRC § 39(a)(1)*, *before amendment by Pub L No 105-34*.

(n201)Footnote 298. *IRC § 38(c)(1)*.

(n202)Footnote 299. *IRC § 38(c)(1)(B)*.

(n203)Footnote 300. *IRC § 38(c)(1)(A)*. See § 5.04[7][c], *infra*.

(n204)Footnote 301. *IRC § 55(a)(1)*.

(n205)Footnote 302. *IRC § 55(e)*.

(n206)Footnote 303. *IRC § 38(c)(4)(B)(ii)*. See Pub Law 110-289, § 3022(d)(2) (effective dates).

(n207)Footnote 304. *IRC § 38(c)(1)(A); IRC § 38(c)(4)(B)*, *before amendment by Pub Law No 110-289*.

(n208)Footnote 305. *IRC § 42(f)(4)*; recapture may also result. See § 5.04[9][b], *below*, for a discussion.

(n209)Footnote 306. *IRC § 42(f)(4)*.

(n210)Footnote 307. *Rev Rul 91-38, 1991-2 CB 3 (Q & A 5)*.

(n211)Footnote 308. Pub L No 103-66, 103d Cong, 1st Sess § 13142 (Aug 10, 1993); See HR Rep No 103-213, 103d Cong, 1st Sess 543 (1993). The statutory change referred to in the Conference Report does not, in fact, appear in

the statute.

(n212)Footnote 309. *IRC § 42(j)(2)(A)*.

(n213)Footnote 310. *IRC § 42(j)(2)(B)*.

(n214)Footnote 310.1. See *IRC § 42(j)(1)*.

(n215)Footnote 310.2. See Ltr Ruls 200232018 ; 200232019 ; 200233013 ; 200233014 ; 200233015 ; 200234010 ; 200029044 .

(n216)Footnote 311. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong, 2d Sess 166 (1986).

(n217)Footnote 312. *Ltr Rul 9737006* .

(n218)Footnote 312.1. See Ltr Rul 200837032 .

(n219)Footnote 312.2. *Ltr Rul 200033030 ; Ltr Rul 200033032* .

(n220)Footnote 312.3. *IRC § 42(j)(4)(E)*; Chief Counsel Memorandum 200134006. See CCA Memo 200913012 (if a building is damaged by a casualty and fully restored and rented to low-income tenants within the same taxable year, then there is no recapture and no loss of credits. If owner failed to restore building by end of taxable year, no credits would be allowed for that year, even if a reasonable time for restoration extended into following year).

(n221)Footnote 312.4. *Rev Proc 2007-54, 2007-31 IRB 293* .

(n222)Footnote 312.5. *Notice 2007-66, 2007-34 IRB 387* .

(n223)Footnote 313. *IRC § 42(j)(1)*, see *IRC § 42(j)(2)* (recapture amount).

(n224)Footnote 314. *IRC § 42(j)(1)*. See *Bentley Court II Ltd Partnership v Commr, TC Memo 2006-113* (taxpayer was required to recapture the LIHC credit taken for closed years, even though it admitted the housing for which the LIHC was claimed was never eligible for the credit. The court ruled that the duty of consistency prevented the taxpayer from arguing it never had a qualified basis and therefore was not subject to the *IRC § 42(j)* recapture rules).

(n225)Footnote 314.1. *IRC § 42(j)(6)(A)*; Pub Law 110-289, § 3004(i)(2)(A).

(n226)Footnote 314.2. Pub Law 110-289, § 3004(i)(2)(B). The procedure for making the election is set forth in *Rev Proc 2008-6, 2008-43 IRB 1006* .

(n227)Footnote 314.3. *IRC § 42(j)(6)(B)*.

(n228)Footnote 315. *IRC § 42(j)(6)*, before amendment by Pub Law No 110-289.

(n229)Footnote 315.1. *Ltr Rul 200617003* .

(n230)Footnote 316. *Rev Rul 90-60, 1990-2 CB 3* ; see Ltr Ruls 200604012 , 200604011 , 200603008 , 200603007 , 200348017 , 200348018 (extensions of time granted for filing bond).

(n231)Footnote 316.1. *IRC § 42(f)(4)*.

(n232)Footnote 317. *Rev Rul 91-38* , Question and Answer 4, 1991-2 CB 3 . See *IRC § 42(d)(7), (j)(6)*.

(n233)Footnote 318. *Rev Proc 99-11, 1999-1 CB 275* .

(n234)Footnote 319. *IRC § 42(j)(5)*.

(n235)Footnote 320. *Ltr Rul 9801028* .

(n236)Footnote 321. *IRC § 42(j)(1)*.

(n237)Footnote 322. See generally *IRC § 42(j)*; *Ltr Rul 9846008* (renovation of 2-bedroom units to a mixture of 1-and 3-bedroom units in a low-income housing project did not decrease qualified basis or cause any credit recapture).

(n238)Footnote 323. *Ltr Ruls 200226033 , 200206037* (transfer of bare legal title in order to avoid local real estate taxes did not trigger recapture); *Ltr Rul 9805018* .

(n239)Footnote 324. *Ltr Rul 199924064* .

(n240)Footnote 325. *IRC § 42(j)(2)*.

(n241)Footnote 326. *Id* (flush language).

(n242)Footnote 327. Note that interest at the overpayment rate would be added to these recapture amounts.

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.05

§ 5.05 Disabled Access Credit

An eligible small business is entitled to a credit with respect to expenditures to provide access to disabled individuals. The amount of the credit is 50 percent of so much of the eligible access expenditures for the taxable year that are in excess of \$250 but not over \$10,250. Thus, the maximum credit for any year is \$5,000. n328 With respect to a partnership, the limit is applied with respect to the partnership and each partner. With respect to an S corporation, the limit is applied with respect to the S corporation and its shareholders. n329

An eligible small business is any person (including an individual, partnership, association, company, or corporation) n330 which either (1) has gross receipts of not more than \$1 million for the preceding taxable year, or (2) employed not more than 30 full-time employees during the preceding taxable year. For this purpose, an employee who is employed at least 30 hours per week for 20 or more calendar weeks in the tax year is considered a full-time employee. n331

Only a taxpayer who has an obligation to comply with ADA requirements may make an eligible expenditure. n331.1 Expenditures eligible for the credit include only those that enable the business to comply with applicable requirements under the Americans With Disabilities Act of 1990 as in effect on November 5, 1990. n332 These include reasonable expenditures to remove architectural, communication, physical, or transportation barriers that prevent a business from being accessible to or usable by individuals with disabilities. A variety of other expenditures not connected with real estate also qualify. n333 No credit is allowed for any amount paid in connection with a facility that is first placed in service after November 5, 1990. n334 No deduction or other credit is allowed for any amount for which the disabled access credit is taken, nor may the adjusted basis of any property be increased by the amount of that credit taken. n335

COMMENT:

A taxpayer may also elect to expense, rather than capitalize, certain expenditures to remove architectural and transportation barriers. n336 See Chapter 4 for a detailed discussion.

FOOTNOTES:

(n1)Footnote 328. *IRC § 44(a)*.

(n2)Footnote 329. *IRC § 44(d)(3)*.

(n3)Footnote 330. *IRC § 7701(a)(1)*.

(n4)Footnote 331. *IRC § 44(b)*.

(n5)Footnote 331.1. *Doherty v Commr, TC Memo 2009-99, affd in unpubl opinion 2010-1 USTC P 50,384 (8th Cir 2010)*; *Loveland v Commr, TC Memo 2009-98, affd in unpubl opinion 2010-1 USTC P 50,383 (8th Cir 2010)*; *Snyder v Commr, TC Memo 2009-97, affd in unpubl opinion 2010-1 USTC P 50,382 (8th Cir 2010)*; *Crooks v Commr, 453 F3d 653 (6th Cir 2006)*; *Arevalo v Commr, 124 TC 244, affd 469 F3d 346 (5th Cir 2006)* (investors in pay phones did not have obligation to comply with ADA and therefore could not claim credit); *Sita v Commr, TC Memo 2007-363, affd 2009-1 USTC P 50,275 (7th Cir 2009)* (same).

(n6)Footnote 332. *IRC § 44(c)(1)*.

(n7)Footnote 333. *IRC § 44(c)(2), (3)*.

(n8)Footnote 334. *IRC § 44(c)(4)*.

(n9)Footnote 335. *IRC § 44(d)(7)*.

(n10)Footnote 336. *IRC § 190*.

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.06

§ 5.06 Nonbusiness Energy Property Credit

[1] In General

Individuals are entitled to a credit for various expenditures that improve the energy efficiency of their homes. n337 Subject to the statutory limits, n338 a credit is allowed for 30 percent of the sum of (1) the amount paid or incurred by the taxpayer during the year for "qualified energy efficiency improvements" n339 and (2) the amount of residential energy property expenditures paid or incurred by the taxpayer during the year. n340

For property placed in service before 2008, the credit was the sum of (1) 10 percent of the amount paid or incurred for qualified energy efficiency improvements that were installed during the year and (2) the entire amount of the residential energy property expenditures paid or incurred during the year. n341 Separate dollar limits applied for these amounts. n341.1

[2] "Qualified Energy Efficiency Improvement" Defined

To qualify as a "qualified energy efficiency improvement," and thereby be eligible for the 10-percent portion of the credit, n342 an improvement must be an energy efficient "building envelope component" that meets specified energy conservation criteria, and also the following requirements: n343

- the component must be installed in or on a dwelling unit n344 located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; n345 This limitation restricts the credit to existing homes; n345.1
- the original use of the component must commence with the taxpayer; and
- the component must be reasonably expected to remain in use for at least 5 years. A component will be treated as reasonably expected to remain in use for at least five years if the manufacturer offers, at no extra charge, at least a two-year warranty providing for repair or replacement of the component in the event of a defect in materials or workmanship. If the manufacturer does not offer such a warranty, all relevant facts and circumstances are taken into account in determining whether the component reasonably can be expected to remain in use for at least five years. n345.2

A "building envelope component" is any of the following: n346

- any insulation material or system that is specifically and primarily designed to reduce the heat loss or gain of a dwelling unit when installed in or on it;
- exterior windows (including skylights);
- exterior doors; and
- any metal roof installed on a dwelling unit, but only the roof has appropriate pigmented coatings that are specifically and primarily designed to reduce the heat gain of the dwelling unit. For property placed in service after October 3, 2008, asphalt roofs are also included, and cooling granules, as well as pigmented coatings, may be used to reduce the heat gain. n346.1

The IRS has provided guidance for manufacturers to follow to certify property as an eligible building envelope component. n346.2

[3] "Residential Energy Property Expenditures" Defined

Residential energy property expenditures are those made by the taxpayer for "qualified energy property" that is installed on or in connection with a dwelling unit located in the United States that is owned and used by the taxpayer as the taxpayer's principal residence n347 (within the meaning of *IRC Section 121*), and originally placed in service by the taxpayer. The term includes expenditures for labor costs that are properly allocable to the onsite preparation, assembly, or original installation of the property. n348 "Qualified energy property" includes the following property, provided that it meets performance and quality standards, and certification requirements to be prescribed in regulations: n349

- "energy-efficient building property," which includes a variety of water heaters, heat pumps, and air conditioners that meet specified energy efficiency standards, n350 and also certain stoves that burn biomass fuel; n350.1
- a qualified natural gas, propane, or oil furnace or hot water boiler; n351 or
- an advanced main air circulating fan. n352

Pending the issuance of regulations, the IRS has issued a notice setting forth interim guidance. The notice provides procedures that manufacturers may follow to certify property as either an "eligible building component" or "qualified energy property." The notice also provides guidance regarding the conditions under which taxpayers seeking to claim the nonbusiness energy property credit may rely on a manufacturer's certification. n352.1

[4] Limits on the Credit

The aggregate amount of credits allowed for taxable years beginning in 2009 and 2010 for any taxpayer is \$1,500. n352.2

For the pre-2008 credit, there are both per-taxpayer and per-item limits on the credit. The per-taxpayer credit is a lifetime limitation. The lifetime credit limit for any taxpayer is \$500. The credit allowed to any taxpayer in any year cannot exceed the excess of \$500 over the aggregate nonbusiness energy property credits allowed for all prior years. n353 This limit means that a taxpayer who claims a \$500 credit in 2006 for improvements to a home cannot again claim the credit for any future year, even if the taxpayer moves and makes otherwise qualifying improvements to a different home. n354

There are also limits to the amount of pre-2008 credit available for particular items. The maximum credit available for exterior windows (including skylights) is \$200. n355 This is also a "lifetime" limit. The maximum credit that can be claimed in any tax year for exterior windows (including skylights) is the excess of \$200 over the amount of credits claimed for those items for all prior years. n356

There is also a per-item limit for other residential energy expenditures, as follows: n357

- \$50 for any advanced main air circulating fan; n358
- \$150 for any qualified natural gas, propane, or oil furnace or hot water boiler; n359 and
- \$300 for any item of "energy-efficient building property," which includes a variety of water heaters, heat pumps, and air conditioners that meet specified energy efficiency standards. n360

[5] Special Rules in Applying Credit

The following special rules apply with respect to the credit: n361

- In determining the amount of available credit, all joint tenants of a single dwelling unit are treated as one taxpayer. The credit may have to be prorated among them if more than one individual makes qualifying expenditures. n362
- Individual tenant-stockholders in cooperative housing corporations n363 and certain condominium owners n364 are entitled to their proportionate share of the credit for any qualifying expenditures by the corporation or condominium association.
- If less than 80 percent of the use of an item that qualifies for the credit is for nonbusiness purposes, only the amount allocated for nonbusiness purposes is eligible for the credit. This restriction prevents taking a credit for improvements to a home office. n365
- An expenditure is generally treated as made only when the original installation of the item for which the expenditure is made is installed. Expenditures that relate to building construction or reconstruction are treated as made when the original use of the constructed or reconstructed structure begins. n366-367
- An expenditure made with respect to two or more dwelling units can qualify for the credit, n368 but the amount of the credit must be computed separately with respect to the amount of the expenditure made for each dwelling unit. n369
- If a credit is allowed for any expenditure with respect to a property, the increase in the basis of the property that would otherwise result from the expenditure must be reduced by the amount of the credit allowed. n370
- For years beginning before January 1, 2009, n370.1 improvements made with subsidized energy financing were not eligible for the credit. n370.2

FOOTNOTES:

(n1)Footnote 337. *IRC* § 25C, effective for property placed in service after Dec 31, 2005 [see Pub L No 109-58, §

1333(c)] and before Jan 1, 2008 [IRC § 25C(g)]. The credit is also available for property placed in service in calendar years 2009 and 2010. The credit is not available for property placed in service during 2008 [IRC § 25C(g)].

(n2)Footnote 338. See IRC § 25C(b), discussed in [4], below.

(n3)Footnote 339. See [2], below, for a discussion of qualified energy efficiency improvements.

(n4)Footnote 340. IRC § 25C(a), effective for taxable years beginning after 12/31/08. See [3], below, for a discussion of residential energy property expenditures.

(n5)Footnote 341. IRC § 25C(a), before amendment by Pub Law No 111-5, § 1121(a).

(n6)Footnote 341.1. IRC § 25C(b), before amendment by Pub Law No 111-5, § 1121(a); see [4], below, for a discussion.

(n7)Footnote 342. See IRC § 25C(a)(1).

(n8)Footnote 343. IRC § 25C(c)(1). The energy conservation criteria that must be met are generally those established by the 2000 International Energy Conservation Code, as in effect on Aug 8, 2005; a metal roof with appropriate pigmented coatings must meet the Energy Star program requirements.

(n9)Footnote 344. The term "dwelling unit" includes certain manufactured homes [IRC § 25C(c)(3)].

(n10)Footnote 345. See IRC § 121 for definition of principal residence.

(n11)Footnote 345.1. See IRC § 45L, discussed in § 5.08, below, for a discussion of the new energy efficient home credit, which is available for new homes.

(n12)Footnote 345.2. See Notice 2009-53, 2009-25 IRB 1095.

(n13)Footnote 346. IRC § 25C(c)(2).

(n14)Footnote 346.1. IRC § 25C(c)(2)(D).

(n15)Footnote 346.2. Notice 2009-53, 2009-25 IRB 1085 .

(n16)Footnote 347. See IRC § 121 for definition of principal residence.

(n17)Footnote 348. IRC § 25C(d)(1).

(n18)Footnote 349. IRC § 25C(d)(2)(A); see IRC § 25C(d)(2)(B), (C) regarding standards.

(n19)Footnote 350. IRC § 25C(d)(3). Geothermal heat pumps were qualified property only for property placed in service before January 1, 2008. Their inclusion as qualified property was eliminated to conform with the establishment of a residential geothermal heat pump credit under IRC § 25D, discussed at § 5.07, below. See IRC § 25C(d)(3)(C), before repeal by Pub Law No 110-343.

(n20)Footnote 350.1. IRC § 25C(d)(3)(C), (d)(6), (g). This biomass fuel property is qualified property only for property placed in service in 2009.

(n21)Footnote 351. See IRC § 25C(d)(4) for a definition.

(n22)Footnote 352. See IRC § 25C(d)(5) for a definition.

(n23)Footnote 352.1. *Notice 2009-53, 2009-25 IRB 1085 , superseding Notice 2006-26, 2006-1 IRB 622 , as clarified by Notice 2006-53, 2006-26 IRB 1180 , and amended by Notice 2006-71, 2006-34 IRB 316 .*

(n24)Footnote 352.2. *IRC § 25C(b).*

(n25)Footnote 353. *IRC § 25C(b)(1), before amendment by Pub Law No 111-5.*

(n26)Footnote 354. *IRC § 25C(b)(1), before amendment by Pub Law No 111-5.*

(n27)Footnote 355. *IRC § 25C(b)(2), before amendment by Pub Law No 111-5.*

(n28)Footnote 356. *IRC § 25C(b)(2), before amendment by Pub Law No 111-5.*

(n29)Footnote 357. *IRC § 25C(b)(3), before amendment by Pub Law No 111-5.*

(n30)Footnote 358. *See IRC § 25C(d)(5) for a definition.*

(n31)Footnote 359. *See IRC § 25C(d)(4) for a definition.*

(n32)Footnote 360. *IRC § 25C(d)(3).*

(n33)Footnote 361. *IRC § 25C(e)(1).*

(n34)Footnote 362. *See IRC § 25D(e)(4).*

(n35)Footnote 363. *See IRC § 25D(e)(5).*

(n36)Footnote 364. *See IRC § 25D(e)(6).*

(n37)Footnote 365. *See IRC § 25D(e)(7).*

(n38)Footnote 366-367. *See IRC § 25D(e)(8).*

(n39)Footnote 368. *IRC § 25C(e)(2)(A).*

(n40)Footnote 369. *IRC § 25C(e)(2)(B).*

(n41)Footnote 370. *IRC §§ 25C(f), 1016(a)(33).*

(n42)Footnote 370.1. *See Pub Law No 111-5, § 1103(c)(2).*

(n43)Footnote 370.2. *See IRC § 25D(e)(9), before repeal by Pub Law No 111-5.*

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.07

§ 5.07 Residential Energy Efficient Property Credit

[1] In General

Individuals are entitled to a credit for certain expenditures for residential energy efficient property. n371 Subject to the annual statutory limits, n372 a credit is allowed equal to the sum of the following: n373

- 30 percent of the qualified solar electric property expenditures; n374--prior to December 20, 2006, only qualified photovoltaic property expenditures qualified for this credit; n374.1
- 30 percent of the qualified certified solar water heating property expenditures; n375
- 30 percent of the qualified fuel cell property expenditures; n376
- 30 percent of the qualified small wind energy property expenditures; n376.1 and
- 30 percent of the qualified geothermal heat pump property expenditures. n376.2

The credit is allowed only for qualifying property to be used in a dwelling unit in the U.S. that is used as a residence by the taxpayer. n377 For qualified fuel cell property only, the residence must also be the taxpayer's principal residence. n378

The statute clarifies that expenditures for the following qualify for the credit: n379

- labor costs that are properly allocable to the onsite preparation, assembly, or original installation of qualifying property; and
- costs of piping or wiring to interconnect qualifying property to the dwelling unit.

A solar panel or other property installed as a roof (or portion of a roof) is not ineligible for the credit simply because it may constitute a structural component of the structure on which it is installed. n380 There is, however, a storage medium restriction. Expenditures that are properly allocable to a swimming pool, hot tub, or any other energy storage

medium which has a function other than storage are not eligible for the credit. n381

NOTE:

The IRS by notice has set forth procedures that manufacturers may follow to certify that property satisfies certain statutory conditions under *IRC Section 25D*, as well as guidance regarding the conditions under which taxpayers seeking to claim the credit may rely on a manufacturer's certification. n381.1

[2] Limits to the Credit

For tax years beginning after December 31, 2008, dollar limitations on the credit (apart from those based on the amount of tax) n381.2 exist only for qualified fuel cell property expenditures. The limit for these expenditures for any taxable year cannot exceed \$500 for each half kilowatt of capacity of qualified property to which the expenditures relate. There is no dollar limit for the other types of expenditures. n381.3

For earlier years, annual dollar caps apply for the various expenditures, as follows: n382

- \$2,000 for solar electric property, for taxable years beginning before January 1, 2009. For later years, this limitation is repealed. n382.1 Prior to December 20, 2006, this \$2,000 limit applied to qualified photovoltaic property expenditures; n382.2
- \$2,000 for solar water heating property;
- \$500 for each 0.5 kilowatt of capacity of qualified fuel cell property;
- \$500 with respect to each half kilowatt of capacity, not to exceed \$4,000, for qualified small wind energy property; n382.3 and
- \$2,000 for qualified geothermal heat pump property. n382.4

[3] Carryover of Credit

The credit is allowed against both regular tax liability and the AMT. n382.5 For years in which all personal credits are allowed against regular tax and the AMT, n382.6 if the credit allowable exceeds the statutory limitation based on tax liability for the year, n383 reduced by the sum of the other credits allowed under Subpart A of the Code, n384 the excess is carried to the next taxable year and added to the residential energy efficient property credit allowable for that year. n385 For other years, if the credit allowable exceeds the statutory limitation n385.1 for that taxable year, the excess is carried to the succeeding taxable year and added to the residential energy efficient property credit allowable for that year. n385.2

[4] Special Rules in Applying Credit

The following special rules apply with respect to the credit:

- In determining the amount of available credit, all joint occupants of a single dwelling unit are treated as one taxpayer. The credit may have to be prorated among them if more than one individual makes qualifying expenditures. n386
- Individual tenant-stockholders in cooperative housing corporations n387 and certain condominium owners n388 are entitled to their proportionate share of the credit for any qualifying expenditures by the corporation or condominium association.

- If less than 80 percent of the use of an item that qualifies for the credit is for nonbusiness purposes, only the amount allocated for nonbusiness purposes is eligible for the credit. This restriction would prevent taking a credit for an improvement that benefits only a home office. n389
- An expenditure is generally treated as made only when the original installation of the item for which the expenditure is made is installed. Expenditures that relate to building construction or reconstruction are treated as made when the original use of the constructed or reconstructed structure begins. n390
- For tax years beginning before 2009, improvements made with subsidized energy financing were not eligible for the credit. n391
- If a credit is allowed for any expenditure with respect to a property, the increase in the basis of the property that would otherwise result from the expenditure must be reduced by the amount of the credit allowed. n392

FOOTNOTES:

(n1)Footnote 371. *IRC § 25D*, effective for property placed in service after Dec 31, 2005 in tax years ending after that date [see Pub L No 109-58, § 1335(c)] and before Jan 1, 2017 [*IRC § 25D(g)*].

(n2)Footnote 372. See *IRC § 25D(b)*, discussed in [2], below.

(n3)Footnote 373. *IRC § 25D(a)*.

(n4)Footnote 374. See *IRC § 25D(d)(2)* for a definition.

(n5)Footnote 374.1. *IRC § 25D(a)(1)*, before amendment by Pub Law No 109-432.

(n6)Footnote 375. See *IRC § 25D(d)(1)* for a definition. To be eligible for the credit, solar water heating property must be certified for performance by the nonprofit Solar Rating and Certification Corporation or a comparable entity endorsed by the government of the state where the property is installed [*IRC § 25D(b)(2)*].

(n7)Footnote 376. See *IRC §§ 25D(d)(3)*, *48(c)(1)* for a definition.

(n8)Footnote 376.1. *IRC § 25D(a)(4)*, effective for property placed in service after Dec 31, 2007.

(n9)Footnote 376.2. *IRC § 25D(a)(5)*, (b)(1)(D), effective for property placed in service after Dec 31, 2007.

(n10)Footnote 377. *IRC § 25D(d)(1)*, (2).

(n11)Footnote 378. *IRC § 25D(d)(3)*; see *IRC § 121* (definition of principal residence).

(n12)Footnote 379. *IRC § 25D(e)(1)*.

(n13)Footnote 380. *IRC § 25D(e)(2)*.

(n14)Footnote 381. *IRC § 25D(e)(3)*.

(n15)Footnote 381.1. Notice 2009-41, 2009-19 IRB 933.

(n16)Footnote 381.2. See *IRC § 25D(c)*.

(n17)Footnote 381.3. *IRC § 25D(b)(1)*; see Pub Law No 111-5, § 1122(b) (effective date).

(n18)Footnote 382. *IRC § 25D(b)(1), before amendment by Pub Law No 111-5, § 1122(a)(1).*

(n19)Footnote 382.1. *See IRC § 25D(b)(1)(A), before amendment by Pub Law No 110-343.*

(n20)Footnote 382.2. *IRC § 25D(b)(1), before amendment by Pub Law No 109-432.*

(n21)Footnote 382.3. *IRC § 25D(b)(1)(C).*

(n22)Footnote 382.4. *IRC § 25D(b)(1)(D).*

(n23)Footnote 382.5. *IRC § 25D(c)(1), (2).*

(n24)Footnote 382.6. *See IRC § 26(b)(2).*

(n25)Footnote 383. *See IRC § 26(a).*

(n26)Footnote 384. *See IRC §§ 21-26.*

(n27)Footnote 385. *IRC § 25D(c)(2)(A).*

(n28)Footnote 385.1. *See IRC § 25D(c)(1).*

(n29)Footnote 385.2. *IRC § 25D(c)(2)(B).*

(n30)Footnote 386. *See IRC § 25D(e)(4).*

(n31)Footnote 387. *See IRC § 25D(e)(5).*

(n32)Footnote 388. *See IRC § 25D(e)(6).*

(n33)Footnote 389. *See IRC § 25D(e)(7).*

(n34)Footnote 390. *See IRC § 25D(e)(8).*

(n35)Footnote 391. *See IRC § 25D(e)(9), before repeal by Pub Law No 111-5. See Pub Law No 111-5, § 1103(c)(2) (effective date of repeal).*

(n36)Footnote 392. *IRC §§ 25D(f), 1016(a)(34).*

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Federal Taxes Affecting Real Estate

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.08

§ 5.08 New Energy Efficient Home Credit

[1] In General

As part of the general business credit, n393 an eligible contractor may take the new energy efficient home credit. n394 The amount of the credit for a tax year is the applicable amount for each qualified new energy efficient home that is: n395

- Constructed by that eligible contractor, and
- Acquired by a person from that eligible contractor for use as a residence during the tax year.

For purposes of the credit, construction includes substantial reconstruction and rehabilitation. n396 The "applicable amount" depends on the energy saving requirements that the dwelling unit meets. The applicable amount is \$2,000 for dwellings (or certain manufactured homes) that are certified (1) to have annual heating and cooling energy consumption at least 50 percent below that of a comparable dwelling unit, and (2) to have building envelope component improvements account for at least 1/5 of that 50 percent. n397 The applicable amount is \$1,000 for certain manufactured homes that are certified (1) to have annual heating and cooling energy consumption at least 30 percent below that of a comparable dwelling unit, and (2) to have building envelope component improvements account for at least 1/3 of that 30 percent. n398 The IRS has set forth the manner in which an eligible contractor may obtain a certification that a dwelling unit is an energy efficient home that satisfies conditions for the credit. The IRS has also provided a list of software programs that may be used in calculating energy consumption for purposes of obtaining certification. n399 A separate notice provides the certification process for manufactured homes. n399.1

Any expenditure taken into account for purposes of the rehabilitation credit n400 or the energy credit n401 cannot be claimed for purposes of the new energy efficient home credit. n402 The new energy efficient home credit is one of the credits eligible for the deduction under *IRC Section 196* for unused business credits. n403

If the new energy efficient home credit is allowed for any expenditure with respect to a property, the increase in the basis of the property that would otherwise result from the expenditure must be reduced by the amount of the credit allowed. n404

[2] "Eligible Contractor" Defined

For purposes of the credit, an eligible contractor is the person who constructed the qualified new energy efficient home or the person who produced the manufactured home that qualifies as one. n405 Curiously, it is the term "qualified new energy efficient home" in the definition of "eligible contractor" that imposes significant limitations on the use of the credit. A qualified new energy efficient home must meet the following requirements: n407

- It must be located in the United States;
- Its construction must be substantially completed after August 8, 2005; and
- It must meet specified energy saving requirements.

The specified energy saving requirements are either of the standards discussed in connection with the applicable amount of the credit in [1], above. Thus, the home must either: n407.1

- Have annual heating and cooling energy consumption at least 50 percent below that of a comparable dwelling unit, and have building envelope component improvements account for at least 1/5 of that 50 percent; n408 or
- For certain manufactured homes, have annual heating and cooling energy consumption at least 30 percent below that of a comparable dwelling unit, and have building envelope component improvements account for at least 1/3 of that 30 percent. n409

FOOTNOTES:

(n1)Footnote 393. See *IRC §§ 38(b)(23), 45L(a)*.

(n2)Footnote 394. *IRC § 45L*, effective for qualified new energy efficient homes acquired after Dec 31, 2005, in tax years ending after that date [Pub L No 109-58, § 1332(f)], and before Jan 1, 2010 [*IRC § 45L(g)*].

(n3)Footnote 395. *IRC § 45L(a)(1)*.

(n4)Footnote 396. *IRC § 45L(b)(3)*.

(n5)Footnote 397. *IRC § 45L(a)(2)(A), (c)(1), (2)*.

(n6)Footnote 398. *IRC § 45L(a)(2)(B), (c)(3)*.

(n7)Footnote 399. *Notice 2006-27, 2006-1 CB 626*, modified by *Announcement 2006-88, 2006-2 CB 910*.

(n8)Footnote 399.1. *Notice 2006-28, 2006-1 CB 62*, modified by *Announcement 2006-88, 2006-2 CB 910*.

(n9)Footnote 400. See *IRC § 47*.

(n10)Footnote 401. See *IRC § 48(a)*.

(n11)Footnote 402. *IRC § 45L(f)*.

(n12)Footnote 403. *IRC § 196(a), (c)(13)*.

(n13)Footnote 404. *IRC §§ 45L(e), 1016(a)(32).*

(n14)Footnote 405. *IRC § 45L(b)(1).*

(n15)Footnote 407. *IRC § 45L(b)(2).*

(n16)Footnote 407.1. *IRC § 45L(b)(2)(C), (c).*

(n17)Footnote 408. *IRC § 45L(a)(2)(A), (c)(1), (2).*

(n18)Footnote 409. *IRC § 45L(b)(2)(C), (c)(3).*

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Federal Taxes Affecting Real Estate

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CHAPTER 5 Depreciation and Credits on Real Estate *

1-5 Federal Taxes Affecting Real Estate § 5.09

§ 5.09 First-Time Homebuyer Credit

[1] Allowance of Credit

A first-time homebuyer may claim a refundable tax credit equal to the lesser of a specified dollar limit n410 or 10 percent of the purchase price of a principal residence located in the United States. n411 For purposes of the credit, the "purchase price" is the adjusted basis of the residence on the date of purchase. n412 The term "principal residence" has the same meaning as under *IRC Section 121*, n413 and may include a house, condominium, cooperative apartment, houseboat, house trailer, mobile home. n414 If a taxpayer purchases property and uses only part of the property as his/her principal residence, and uses a separate part (such as the second unit in a duplex) to produce rental income, the credit is available only with respect to the portion of the purchase price that is allocable to the part the taxpayer uses as a principal residence. n415

For purchases after November 6, 2009, no credit is allowed if the purchase price of the residence exceeds \$800,000. n416

The credit is available for homes purchased on or after April 9, 2008 and before May 1, 2010. n417 Long-time residents of the same principal residence are also eligible for the credit, effective for qualifying new residences purchased after November 6, 2009 and before May 1, 2010. n418

A taxpayer who enters into a binding contract before May 1, 2010 to close on the purchase of a principal residence before July 1, 2010, and who purchases the residence before October 1, 2010 may claim the credit if the purchase is completed by October 1, 2010. n419 The above May 1, 2010 date is extended for one year for individuals on qualified official extended duty outside the United States and their spouses. The July 1, 2010 and October 1, 2010 dates are extended to July 1, 2011 for those individuals. n419.1 To qualify for these extended dates, the qualifying service outside the U.S. must be for at least 90 days during the period beginning after December 31, 2008 and ending before May 1, 2010. n420

The credit generally is allowed for the tax year in which the taxpayer purchases the residence. n421 For purchases made after 2008, however, a taxpayer may elect to treat the purchase as occurring on December 31 of the prior year, and thereby claim the credit in the prior year. n422 It should be noted that taxpayers who purchase a home in 2009, but claim the credit on a 2008 return, may still claim an \$8,000 credit on the 2008 return. Carrying the credit back to 2008

does not re-instate the lower 2008 credit limit of \$7,500. n423 A taxpayer who elects the application of *Internal Revenue Code Section 36(g)*, is entitled to interest on the refundable credit, in accordance with *IRC Section 6611*. n423.1

PLANNING GUIDE:

Taxpayers who would qualify for a higher credit in the later year should of course not elect to claim the credit in the prior year. This could occur when a taxpayer has reduced income in the later year that removes them from the credit-phase-out range. n424

The credit is claimed by filing the proper version of IRS Form 5405, *First-Time Homebuyer Credit and Repayment of the Credit*. The 2008 Form 5405 must be used for homes purchased before November 7, 2009, for which an election is made to claim the credit for 2008. The December 2009 revision of Form 5405 must be used for all homes purchased after November 6, 2009 (whether the credit is claimed for 2008 or for 2009) and for all claims on 2009 returns for homes purchased any time in 2009. It must also be used for homes purchased in 2010.

NOTE:

Taxpayers who claim the credit on their 2009 return will not be able to file electronically; they will need to file a paper return. n425

[2] Dollar Limitations to the Credit

[a] In General

The maximum dollar amount of the credit depends on the date of purchase. For homes purchased before January 1, 2009, the maximum credit is \$7,500 (\$3,750 for a married individual filing separately). n426 The maximum credit for homes purchased after December 31, 2008, is \$8,000 (\$4,000 for a married individual filing separately). n427

[b] Dollar Limit for Long-Time Residents of Same Principal Residence

The maximum dollar amount of the credit for long-time residents of the same principal residence is \$6,500 (\$3,250 for a married individual filing separately). n428

[c] Phase-Out of Credit Based on Modified Adjusted Gross Income

The credit phases out for individual taxpayers with modified adjusted gross income in excess of stated amounts. For residences purchased after November 6, 2009, the credit phases out at modified adjusted gross income between \$125,000 and \$145,000 (\$225,000-\$245,000 for joint filers) for the year of purchase. Taxpayers with higher income do not qualify for the credit. n429 For qualified purchases before November 7, 2009, the credit phases out at modified adjusted gross income between \$75,000 and \$95,000 (\$150,000-\$170,000 for joint filers) for the year of purchase. n430 For qualified purchases after November 6, 2009, the credit is phased out using the following formula: n431

$$\begin{array}{rcl} \text{Maximum Allowable} & \times & \text{MAGI in excess of } \$125,000 \text{ (}\$225,000 \text{ for married filing jointly)} \\ \text{Credit} & & \\ & & \$20,000 \end{array}$$

Modified adjusted gross income is AGI n432 increased by any amount excluded from gross income under *IRC Sections 911, 931, or 933*. n433

[3] Allocation of Credit Among Unmarried Taxpayers

If two or more unmarried individuals purchase a principal residence, the amount of any allowable credit is allocated

among them, and the total credits allowed cannot exceed the otherwise applicable dollar maximum. n434 The allocation may be done using any reasonable method. A "reasonable method" is one that does not allocate any portion of the credit to a taxpayer not eligible to claim that portion. A reasonable method includes allocating the credit between taxpayers who are eligible to claim the credit based on (1) the taxpayers' contributions towards the purchase price of a residence as tenants in common or joint tenants, or (2) the taxpayers' ownership interests in a residence as tenants in common. n435

Example:

A contributes \$45,000 and B contributes \$15,000 toward the \$60,000 purchase price of a residence. Each owns a one-half interest in the residence as tenants in common. A and B are not married to each other, and both are otherwise eligible to claim the credit. The allowable credit is limited to 10 percent of the purchase price, or \$6,000. A and B may allocate the allowable \$6,000 credit three-fourths to A and one-fourth to B based on their contributions toward the purchase price of the residence, one-half to each based on their ownership interests in the residence, or using any other reasonable method (for example, allocating the entire credit to A or B because both A and B are eligible to claim the entire allowable credit). n436

[4] First-Time Homebuyer Defined

[a] In General

In general, only first-time homebuyers are eligible for the credit. A "first-time homebuyer" is an individual who had no ownership interest in a principal residence in the United States during the 3-year period prior to the purchase of the home to which the credit applies. If the taxpayer is married, the taxpayer's spouse must also meet this requirement. n437 A person may qualify as a first-time homebuyer, even if another person who is not eligible for the credit co-signs the mortgage loan. n438

[b] Long-Time Resident of Same Principal Residence

A long-time resident of the same principal residence (and if married, that individual's spouse) is eligible for a credit of up to \$6,500 (\$3,250 if married filing separate returns). n439 To qualify, the individual must have owned and used the same residence as his or her principal residence for any 5-consecutive-year period during the 8-year period ending on the date of the purchase of a subsequent principal residence. If this requirement is met, the individual is treated as a first-time homebuyer with respect to the purchase of the subsequent residence, and may therefore qualify for the credit if other statutory requirements are satisfied. n440

[5] Purchase Requirements

To qualify for the credit, a taxpayer must purchase a principal residence. n441 The term "principal residence" has the same meaning as under *IRC Section 121*, n442 and may include a house, condominium, cooperative apartment, houseboat, house trailer, mobile home. n443-444 A "purchase" generally includes any acquisition, including construction by the taxpayer. n445 A residence constructed by the taxpayer is treated as purchased on the date the taxpayer first occupies it. n446

Several purchase restrictions apply, however. The following acquisitions do not qualify for the credit:

- An acquisition from a person related to the person acquiring the property, and for purchases after November 6, 2009, an acquisition by a married individual from a person related to that individual's spouse. n447 Whether a person is related is determined under rules in *IRC Sections 267* and *707(b)*, except that an individual's family includes only that individual's spouse, ancestors, and lineal descendants. n448 In response to a request regarding a taxpayer who purchased a home from his father's estate, the IRS noted that the executor of an estate and a beneficiary of the estate are related persons.

n448.1 If the taxpayer were a beneficiary of the estate, he would therefore be eligible for the credit only if the sale satisfied a pecuniary bequest. n448.2

- An acquisition if the basis of the residence to the person acquiring it is determined in whole or part by reference to the adjusted basis of the residence in the hands of the person from whom it is acquired, as in the case of a gift. n449

- An acquisition from a decedent in which the basis of the residence is determined under *IRC Section 1014*. n450

[6] Restrictions Causing Disallowance of Credit

There are several circumstances that will cause the credit to be disallowed. The triggers that cause disallowance of the credit vary, depending on the date of purchase. For residences purchased after November 6, 2009, n451 the credit is not allowed in any of the following situations: n452

Several purchase restrictions apply, however. The following acquisitions do not qualify for the credit:

- If the purchase price of the residence is more than \$800,000; n453
- If the purchaser is a dependent of another taxpayer in the year of purchase; n454
- If the taxpayer is not at least 18 years old on the date of purchase. A married taxpayer is treated as being at least 18 if the taxpayer or the taxpayer's spouse is at least 18. n455
- If the taxpayer is a nonresident alien; n456 or
- If the taxpayer disposes of the residence (or it ceases to be a principal residence of the taxpayer and, if married, the taxpayer's spouse) before the close of the taxable year for which the credit otherwise would be allowable. n457 This can occur if a taxpayer converts the home to a business or rental property or if the lender forecloses on the home.

The credit is also disallowed if a taxpayer fails to attach to the return in which the credit is claimed a properly executed copy of the settlement statement used to complete the purchase. n458

NOTE:

An entry on a return claiming the first-time homebuyer's credit is treated as a mathematical or clerical error if any of the following occurs: n459

- The Secretary obtains information from the person issuing the TIN of the taxpayer that indicates that the taxpayer is not at least 18 years of age as of the date of purchase; n460
- Information provided to the Secretary by the taxpayer on an income tax return for at least one of the 2 preceding taxable years is inconsistent with eligibility for the first-time homebuyer's credit; or
- The taxpayer fails to attach to the return a properly executed copy of the settlement statement used to complete the purchase. n461

This characterization of the above entries as a mathematical or clerical error allows the IRS to issue an assessment and

collect the amount due without having to resort to statutory notice of deficiency procedures. In addition, taxpayers cannot petition the Tax Court to contest the amount claimed due. n462

For residences purchased after 2008 n463 and before November 7, 2009, n464 the credit is not allowed in the following situations: n465

- If the taxpayer is a nonresident alien; or
- If the taxpayer disposes of the residence (or it ceases to be a principal residence of the taxpayer and, if married, the taxpayer's spouse) before the close of the taxable year for which the credit otherwise would be allowable.

For residences purchased before 2009, n466 the credit is not allowed in the following situations: n467

- If the D.C. homebuyer credit n468 is allowable to the taxpayer or the taxpayer's spouse for the taxable year the residence is purchased or a prior taxable year;
- If the residence is financed by the proceeds of a qualified mortgage issue the interest on which is tax-exempt under *IRC Section 103*;
- If the taxpayer is a nonresident alien; or
- If the taxpayer disposes of the residence (or it ceases to be a principal residence of the taxpayer and, if married, the taxpayer's spouse) before the close of the taxable year for which the credit otherwise would be allowable.

[7] Recapture of Credit

[a] In General

In general, there is no recapture of the first-time homebuyer credit for purchases after 2008. n469 For qualifying purchases in 2008, the credit is recaptured ratably over fifteen years with no interest charge beginning in the second taxable year after the taxable year in which the home is purchased. For example, if the taxpayer purchases a home in 2008, the credit is allowed on the 2008 tax return, and recapture commences with the 2010 tax return. n470 The recapture occurs by increasing the amount of income tax due in each year of the 15-year recapture period by 6-2/3 percent of the credit that was allowed. Thus, if the maximum \$7,500 credit is claimed, an additional \$500 income tax will be owed for each year of the recapture period. n471

If the taxpayer sells the home (or the home ceases to be used as the principal residence of the taxpayer or the taxpayer's spouse) prior to complete recapture of the credit, any remaining credit recapture amount is due on the tax return for the year in which the home is sold (or ceases to be used as the taxpayer's principal residence). n472 However, in the case of a sale to an unrelated party, the acceleration of the recapture in the year of sale is limited to the amount of gain from the sale. For this purpose only, gain is determined by reducing the basis of the residence by the amount of the credit to the extent not previously recaptured. n473

NOTE:

An omission of any increase in the tax due as the result of recapture of the first-time homebuyer's credit is treated as a mathematical or clerical error. n474 This characterization allows the IRS to issue an assessment and collect the amount due without having to resort to statutory notice of deficiency procedures. In addition, taxpayers cannot petition the Tax Court to contest the amount claimed due. n475

There are several exceptions with respect to recapture of the credit: n476

- No amount is recaptured after the death of a taxpayer, either through regular recapture or acceleration of recapture. n477
- In the case of an involuntary conversion of the home, recapture is not accelerated if the taxpayer acquires a new principal residence within a two-year period beginning on the date of disposition of the home or the taxpayer's ceasing to use the home as a principal residence. Acceleration of recapture during the recapture period can occur with the new principal residence in the same manner as with the converted residence. n478
- In the case of a transfer of the residence to a spouse or to a former spouse incident to divorce, the transfer itself does not cause acceleration of recapture, and the transferee spouse (and not the transferor spouse) will be responsible for any future recapture. n479

[b] Waiver of Recapture for Purchases After 2008

Recapture of the credit is generally waived for qualifying home purchases after December 31, 2008. This waiver of recapture applies without regard to whether the taxpayer elects to treat the purchase in 2009 as occurring on December 31, 2008. n480 If a taxpayer disposes of the residence, or if the residence otherwise ceases to be the principal residence of the taxpayer within 36 months from the date of purchase, however, the waiver is retroactively nullified, and the credit must be recaptured. In that case, the taxpayer must repay the credit by including the amount of the credit as additional tax on the tax return for the year in which the repayment event occurs. n481 The credit recapture amount is due with the tax return for the year in which the residence is sold or ceases to be used as the taxpayer's principal residence. n482 If the residence is sold to an unrelated party, the amount of the credit recapture is limited to the amount of gain from the sale. For this purpose only, gain is determined by reducing the basis of the residence by the amount of the credit to the extent not previously recaptured. n483

[c] Waiver of Recapture for Individuals on Qualified Official Extended Duty

Accelerated recapture of the first-time homebuyer credit n484 is waived in the case of an early disposition or termination of use of the purchased home as a principal residence, if either of those events occurs in connection with Government orders received by the taxpayer or the taxpayer's spouse for qualified official extended duty service. n485 Furthermore, if the residence was acquired before January 1, 2009, the ordinary 6-2/3% recapture of the credit n486 is waived both in the taxable year in which the disposition (or cessation) occurs and for all subsequent taxable years. n487

For these waiver purposes, "qualified official extended duty service" means service on qualified official extended duty as any of the following: n488

- A member of the uniformed services;
- A member of the Foreign Service of the United States; or
- An employee of the intelligence community.

Qualified official extended duty means any extended duty while serving at a duty station that is at least 50 miles from the residence or while residing under Government orders in Government quarters. The duty must be pursuant to a call or order to that duty for a period of more than 90 days or for an indefinite period. n489

NOTE:

For purposes of the recapture waiver, the duty station need not be outside the United States. n490 In contrast, the extended dates of availability of the first-time homebuyer credit is available only for individuals (and spouses) whose qualified official extended duty is outside the United States. n491

[8] Interaction with D.C. Homebuyer Credit

A \$5,000 credit is allowed to qualifying first-time homebuyers of a principal residence in District of Columbia (D.C. homebuyer credit). n492 No D.C. homebuyer credit under *IRC Section 1400C* is allowed to any taxpayer with respect to the purchase of a residence after 2008 if a first-time homebuyer credit is allowable to the taxpayer (or the taxpayer's spouse) under *IRC Section 36* with respect to the purchase. Taxpayers thus qualify for the more generous national first-time homebuyer credit under *IRC Section 36* rather than the D.C. homebuyer credit for qualifying purchases after 2008. n493 For residences purchased before 2009, taxpayers for whom the D.C. homebuyer credit was allowable in the year of purchase or a prior taxable year could not claim the first-time homebuyer credit under *IRC Section 36*. n494

FOOTNOTES:

(n1)Footnote 410. See § 5.09[2], below, for a discussion of the dollar limits.

(n2)Footnote 411. *IRC* § 36(a), (b).

(n3)Footnote 412. *IRC* § 36(c)(4).

(n4)Footnote 413. *IRC* § 36(c)(2).

(n5)Footnote 414. *Treas Reg* § 1.121-1(b)(1).

(n6)Footnote 415. See INFO 2009-0167 (Aug 24, 2009).

(n7)Footnote 416. *IRC* § 36(b)(3); Pub Law No 111-92, § 11(j)(1) (effective date).

(n8)Footnote 417. *IRC* § 36(h)(1); see INFO 2009-0143, INFO 2009-0147 (credit not available for purchases before effective date).

(n9)Footnote 418. *IRC* § 36(c)(6), (h)(1); see Pub Law No 111-92, § 11(j)(1) (effective date). See § 5.09[4][b], below, for a discussion.

(n10)Footnote 419. *IRC* § 36(h)(2).

(n11)Footnote 419.1. *IRC* § 36(h)(3)(B).

(n12)Footnote 420. *IRC* § 36(h)(3), effective for residences purchased after Nov 30, 2009 [Pub Law No 111-92, § 11(j)(2)].

(n13)Footnote 421. *IRC* § 36(a).

(n14)Footnote 422. *IRC* § 36(g).

(n15)Footnote 423. See *IRC* § 36(b)(1)(A). See 2008 IRS Form 5405.

(n16)Footnote 423.1. PMTA-2009-162.

(n17)Footnote 424. See *IRC* § 36(b)(2)(A); see § 5.09[2][c], below, for a discussion.

(n18)Footnote 425. See IR-2009-108 (Nov 24, 2009).

(n19)Footnote 426. *IRC § 36(b)(1)(A),(B), before amendment by Pub Law No 111-92.*

(n20)Footnote 427. *IRC § 36(b)(1)(A), (B).*

(n21)Footnote 428. *IRC § 36(b)(1)(D); see IRC § 36(c)(6), and § 5.09[4][b], below, for a discussion for the credit for long-time residents.*

(n22)Footnote 429. *IRC § 36(b)(2); see Pub Law No 111-92, § 11(j)(1) (effective date).*

(n23)Footnote 430. *IRC § 36(b)(2), before amendment by Pub Law No 111-92.*

(n24)Footnote 431. *IRC § 36(b)(2).*

(n25)Footnote 432. See *IRC § 62.*

(n26)Footnote 433. *IRC § 36(b)(2)(B); the excluded items that increase AGI include foreign earned income and house cost amounts of citizens or residents living abroad [IRC § 911], and income from sources within Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico [IRC §§ 931, 933].*

(n27)Footnote 434. *IRC § 36(b)(1)(C).*

(n28)Footnote 435. *Notice 2009-12, 2009-6 IRB 446 .*

(n29)Footnote 436. *Notice 2009-12, 2009-6 IRB 446 .*

(n30)Footnote 437. *IRC § 36(c)(1).* INFO 2010-0074 (April 14, 2010) (prior spouse's ownership of residence made taxpayer ineligible for credit). See INFO 2009-0107 (May 26, 2009) (taxpayer whose spouse had previously purchased and used a mobile home as a principal residence could not be a first-time homebuyer and was not eligible for the credit); see INFO-2009-0135 (June 24, 2009) (although a court in separation proceedings ordered the taxpayer to vacate the family home more than three years prior to a proposed purchase of a new residence, he held an interest in the residence until his divorce became final. Because this date was less than 3 years from the date of a proposed purchase of a new residence, the taxpayer did not qualify as a first-time homebuyer); see INFO 2009-0132 (June 15, 2009) (credit not available if either spouse previously used a mobile home as a principal residence); INFO 2009-0087 (June 26, 2009) (same determination when spouse previously owned a condo).

(n31)Footnote 438. INFO 2009-0101 (April 27, 2009) (a child qualified as a first-time homebuyer even though her parents co-signed the mortgage loan); INFO 2009-0171 (Aug 19, 2009) (taxpayer was eligible for credit even though a brother--who was not eligible--co-signed the loan and was listed on the deed).

(n32)Footnote 439. *IRC § 36(b)(1)(D).*

(n33)Footnote 440. *IRC § 36(c)(6), effective for residences purchased after Nov 6, 2009 [Pub Law No 111-92, § 11(j)(1)].*

(n34)Footnote 441. *IRC § 36(a), (c)(1).*

(n35)Footnote 442. *IRC § 36(c)(2).*

(n36)Footnote 443-444. *Treas Reg § 1.121-1(b)(1).*

(n37)Footnote 445. *IRC § 36(c)(3)(A), (B).*

(n38)Footnote 446. *IRC* § 36(c)(3)(B).

(n39)Footnote 447. *IRC* § 36(c)(3)(A)(i); Pub Law No 111-92, § 12(e)(1) (effective date).

(n40)Footnote 448. *IRC* § 36(c)(5). Note that for purchases before Nov 7, 2009, in-laws are not treated as related persons [see INFO 2009-0131].

(n41)Footnote 448.1. See *IRC* §§ 36(c)(5), 267(b)(13).

(n42)Footnote 448.2. See INFO 2010-0071 (March 25, 2010).

(n43)Footnote 449. *IRC* § 36(c)(3)(A)(ii)(I).

(n44)Footnote 450. *IRC* § 36(c)(3)(A)(ii)(II).

(n45)Footnote 451. See Pub Law No 111-92, §§ 11(j)(1), 12(e)(1) (effective dates).

(n46)Footnote 452. *IRC* § 36(d), *before amendment by* Pub Law No 111-92.

(n47)Footnote 453. *IRC* § 36(b)(3).

(n48)Footnote 454. *IRC* § 36(d)(3); see *IRC* § 151.

(n49)Footnote 455. *IRC* § 36(b)(4).

(n50)Footnote 456. *IRC* § 36(d)(1).

(n51)Footnote 457. *IRC* § 36(d)(2).

(n52)Footnote 458. See *IRC* § 36(d)(4), effective for returns for taxable years ending after Nov 6, 2009 [Pub Law No 111-92, § 12(e)(2)].

(n53)Footnote 459. *IRC* § 6213(g)(2)(P), effective for returns for tax years ending on or after April 9, 2008 [Pub Law No 111-92, § 12(e)(3)].

(n54)Footnote 460. See *IRC* § 36(b)(4).

(n55)Footnote 461. See *IRC* § 36(d)(4).

(n56)Footnote 462. *IRC* § 6213(b)(1).

(n57)Footnote 463. See Pub Law No 111-5, § 1006(f) (effective date).

(n58)Footnote 464. See Pub Law No 111-92, §§ 11(j)(1), 12(e)(1).

(n59)Footnote 465. *IRC* § 36(d), *before amendment by* Pub Law No 111-92.

(n60)Footnote 466. See Pub Law No 111-5, § 1006(f) (effective date).

(n61)Footnote 467. *IRC* § 36(d), *before amendment by* Pub Law No 111-5.

(n62)Footnote 468. See *IRC* § 1400C.

(n63)Footnote 469. *IRC* § 36(f)(4)(D); see § 5.09[7][b], below, for a discussion.

(n64)Footnote 470. *IRC* § 36(f)(1), (7).

(n65)Footnote 471. *IRC* § 36(f)(1).

(n66)Footnote 472. *IRC* § 36(f)(2).

(n67)Footnote 473. *IRC* § 36(f)(3).

(n68)Footnote 474. *IRC* § 6213(g)(2)(O), effective for returns for tax years ending on or after April 9, 2008 [Pub Law No 111-92, § 11(j)(4)].

(n69)Footnote 475. *IRC* § 6213(b)(1).

(n70)Footnote 476. *IRC* § 36(f)(4).

(n71)Footnote 477. *IRC* § 36(f)(4)(A).

(n72)Footnote 478. *IRC* § 36(f)(4)(B).

(n73)Footnote 479. *IRC* § 36(f)(4)(C).

(n74)Footnote 480. *IRC* § 36(f)(4)(D)(i).

(n75)Footnote 481. *IRC* § 36(f)(4)(D)(ii).

(n76)Footnote 482. *IRC* §§ 36(f)(2), (f)(4)(D)(ii).

(n77)Footnote 483. *IRC* §§ 36(f)(3), (f)(4)(D)(ii).

(n78)Footnote 484. See *IRC* § 36(f)(2).

(n79)Footnote 485. *IRC* § 36(f)(4)(E)(i)(I), effective for dispositions and cessations after Dec 31, 2008 [Pub Law No 111-92, § 11(j)(3)].

(n80)Footnote 486. See *IRC* § 36(f)(1).

(n81)Footnote 487. *IRC* § 36(f)(4)(E)(i)(II).

(n82)Footnote 488. *IRC* § 36(f)(4)(E)(ii).

(n83)Footnote 489. *IRC* §§ 36(f)(4)(E)(ii), (iii), 121(d)(9)(C)(i), (v)

(n84)Footnote 490. *IRC* §§ 36(f)(4)(E)(ii), (iii), 121(d)(9)(C)(i), (v).

(n85)Footnote 491. *IRC* § 36(h)(3); see § 5.09[1], above, for a discussion.

(n86)Footnote 492. *IRC* § 1400C(a), effective for property purchased before 2010 [*IRC* § 1400C(i)].

(n87)Footnote 493. *IRC* § 1400C(e)(4).

(n88)Footnote 494. *IRC* § 36(d)(1), before repeal by Pub Law No 111-5; see Pub Law No 111-5, § 1106(f) (effective date).

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Federal Taxes Affecting Real Estate

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CHAPTER 6 Dispositions of Real Estate by Sale, Abandonment and Casualty

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CHAPTER 6 Dispositions of Real Estate by Sale, Abandonment and Casualty

1-6 Federal Taxes Affecting Real Estate Scope

Scope

SCOPE

In general, a property owner who plans to dispose of property (or who suffers a casualty with respect to property) will have as a goal minimizing the taxes on the transaction and maximizing the after-tax economic benefits of the transaction. This chapter explains the tax rules applicable to sales and other dispositions of real estate and suggests tax planning strategies for maximizing the after-tax return on a disposition of real property.



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CHAPTER 6 Dispositions of Real Estate by Sale, Abandonment and Casualty

1-6 Federal Taxes Affecting Real Estate § 6.01

§ 6.01 Character of Gain or Loss

The character of gain or loss on a sale affects the amount of tax that must be paid. The sale of real property may result in:

- (1) capital gain or loss; n1
- (2) gain or loss from disposition of an asset used in a trade or business or an asset that was involuntarily converted; n2 or
- (3) ordinary gain or loss.

[1] Capital Gain or Loss

The opportunity to receive favorable capital gain treatment on the disposition of real property is a significant benefit to those investing in real estate, n3 although if real estate is sold at a loss, the limitations on the deduction of capital losses can be a significant disadvantage. n4 The character of gains also affects the timing of their recognition in some situations (e.g., see Chapter 7). Consequently, it is essential to determine and account for the capital gain and ordinary income components of gains and losses from the disposition of real property.

[a] Assets That Qualify for Capital Gain Treatment

All real estate qualifies for capital gain treatment, either as a capital asset or as an asset used in a trade or business, unless it is inventory or otherwise held primarily for sale to customers in the ordinary course of business. In that case, the real estate is not a capital asset, n5 and any gain from its sale is taxed as ordinary income. n6 The special rules that apply to real estate used in a trade or business are discussed in § 6.01[4], below.

The test, then, is whether property is held primarily for sale to customers in the ordinary course of a trade or business. n7 Although such a determination initially appears simple, it is one of the most controversial areas of taxation and is discussed in detail in Chapter 10.

Capital gains on the sale of personal residences are subject to special rules covered in Chapter 9. n8

[b] Determining the Effect of Capital Gain Transactions

The sale or exchange of a capital asset results in capital gain or loss. n9 A long-term capital gain or loss results if an asset has been held for more than one year at the time of its disposition. n10 If the asset is held for one year or less, the gain or loss is short-term. n11

To determine the effect of capital asset transactions for a taxpayer, it is generally necessary to follow these steps:

- (1) Gains and losses are separated into two groups--long-term and short-term.
- (2) All short-term gains and losses are combined to determine the net short-term capital gain or loss. Likewise, all long-term gains and losses are combined to determine the net long-term capital gain or loss. The net capital gain is the excess of the net long-term capital gains over the net short-term capital losses. n12
- (3) If there are net gains from both short-term and long-term transactions, they are considered separately. Short-term capital gain is fully includable in income and is taxed at ordinary rates for both corporate and noncorporate taxpayers. Because of the requirement to net short-term and long-term capital gains and losses, it is generally a good tax planning idea to shift long-term capital losses into years when there are net short-term capital gains but no long-term capital gains.

It is only when there is a net capital gain--an excess of net long-term capital gains over net short-term capital losses n13--that the differential capital gains rate can provide tax advantages. n13.1

[c] Terminations of Certain Rights with Respect to Property

Gain or loss from the cancellation, lapse, expiration or other termination of a right or obligation with respect to property that is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as capital gain or loss from the sale of a capital asset. This rule, however, does not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement). n14

[2] Capital Gain Taxation of Individuals

[a] In General

The amount of tax imposed on individual capital gains is determined under *IRC Section 1(h)*. The major rules follow:

- Any net gain from sales of capital assets held less than one year are taxed as ordinary income. n15
- For individuals, estates and trusts, the maximum tax rate on gain from capital assets held at least 12 months is generally 15 percent (5 percent for taxpayers in the lowest tax bracket). n16
- The maximum tax rate on gain attributable to unrecaptured Section 1250 gain, however, is 25 percent. n17
- The maximum rate on gain from the sale or exchange of collectibles or small business stock is 28 percent. n18

[b] Adjusted Net Capital Gain Defined

The term "adjusted net capital gain" refers to net capital gain (determined without regard to any dividends taxed at

capital gains rates) n19-21 reduced (but not below zero) by the sum of unrecaptured Section 1250 gain plus 28-percent rate gain. n22 The net capital gain for any tax year must be reduced (but not below zero) by the amount which the taxpayer takes into account as investment income under *IRC Section 163(d)(4)(B)(iii)*. n23 "Net capital gain" refers to the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for that year. n24

[c] 28-Percent Rate Gain Defined

The term "28-percent rate gain" means the excess (if any) of (1) the sum of collectibles gain and Section 1202 gain over (2) the sum of collectibles loss, the net short-term capital loss, and the amount of long-term capital loss carried over to the tax year. n25

[d] Unrecaptured Section 1250 Gain Defined

The term "unrecaptured section 1250 gain" means the excess (if any) of: (1) the amount of long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if *IRC Section 1250(b)(1)* included all depreciation and the applicable percentage under *IRC Section 1250(a)* were 100 percent, over (2) the excess (if any) of the 28-percent rate gain loss n26 over the 28-percent collectibles and small business stock gain. n27 The amount of long-term capital gain taken into account in determining the unrecaptured Section 1250 gain cannot exceed the amount of net Section 1231 gain for the year. n28-30

[e] Election for Assets Held in Trade or Business in 2001

Under an uncodified provision, a noncorporate taxpayer holding a capital asset used in the taxpayer's trade or business on January 1, 2001, could elect to treat the asset as having been sold on that date for an amount equal to its fair market value, and as having been reacquired on that date for the same amount. n31 If the election was made, any gain had to be recognized, but any loss was disallowed. n32 The Secretary prescribed the manner of making the election. n33 The election, once made was irrevocable. n33.1

[f] Netting Capital Gains and Losses

Gains and losses within each tax rate group (i.e. the 15-percent group, the 25-percent group, and the 28-percent group n34 must be netted in order to determine the net capital gain or loss within that group. The netting procedure is incorporated into *IRC Section 1(h)*, and is explained in detail in *Notice 97-59*. n35 The 1998 technical correction amendments to *IRC Section 1(h)* follow the netting rules set forth in *Notice 97-59*, so the netting procedures detailed in *Notice 97-59* continue to apply. The following netting rules should be noted: n36

(1) *Short-term capital gains and losses.* Short-term capital losses (including short-term capital loss carryovers) are applied first to reduce short-term capital gains, if any, otherwise taxable at ordinary income rates. A net short-term capital loss is then applied to reduce any net long-term gain from the 28-percent group, then to reduce gain from the 25-percent group, and finally to reduce net gain from the 15-percent group.

(2) *Long-term capital gains and losses.* A net loss from the 28-percent group (including long-term capital loss carryovers) is used first to reduce gain from the 25-percent group, then to reduce net gain from the 20-percent group. A net loss from the 15-percent group is used first to reduce net gain from the 28-percent group, then to reduce gain from the 25-percent group.

Any resulting net capital gain that is attributable to a particular rate group is taxed at that group's marginal tax rate.

[g] Limitation and Carry Forward of Losses

For individuals, capital losses in any year are allowed only to the extent of capital gains for that year, plus \$3,000 (\$1,500 in the case of a married individual filing a separate return).ⁿ³⁷ Where both short term and long term capital losses are available, the short term losses are absorbed first.ⁿ³⁸ Excess capital loss may not be carried back to prior years, but may be carried forward indefinitely to subsequent years, at which time it is first deducted from capital gains and then from other income, up to the \$3,000 (\$1,500) limitation described above.ⁿ³⁹ Losses carried over to future years retain their long-term or short-term characteristics. When both short-term and long-term losses are carried over, the short-term loss is similarly absorbed against the \$3000 (\$1500) ordinary income limit before the long-term capital loss carryover is absorbed.ⁿ⁴⁰

Example 1:

In Year 1 an individual investor has the following sales of real property, held for investment, in addition to other taxable income of \$25,000:

Short-term--

Parcel A held three months, sold at a loss of	[6,400)
Parcel B held four months, sold at a gain of	2,000
Net short-term loss	[4,400)

Long-term--

Parcel C held for more than one year, sold at a loss of	[5,000)
Net long-term loss	[5,000)

Assuming that the individual is not a married individual filing a separate return, three thousand dollars (\$3,000) of the short-term loss is offset against the investor's other taxable income in Year 1. The remaining \$1,400 is a carryover to Year 2 as a short-term loss. The \$5,000 long-term loss is a carryover to Year 2 as a long-term loss.

Example 2:

Assume that the taxpayer in the preceding example has taxable income in Year 2 in excess of \$3,000 and no other capital transactions. The remaining \$1,400 short-term capital loss carryover is first deducted from other taxable income, and \$1,600 of the long-term loss carryover is also allowed. The combined deduction in Year 2 for capital losses would then be \$3,000. The taxpayer can carry over the remaining \$3,400 of Year 1 long-term capital loss to Year 3 and subsequent years under the same carryover rules.

[3] Capital Gain Taxation of Corporations

Corporations generally are not eligible for a reduced rate of tax on capital gains.ⁿ⁴¹ Although *IRC Section 1201* provides a maximum tax rate of 35 percent on a corporation's net capital gain,ⁿ⁴² the reduced rate does not come into play because general corporate income tax rates do not exceed that rate.ⁿ⁴³

There is one exception. A temporary reduced 15-percent tax rate applies to qualified corporate timber gains. The reduced tax rate applies for corporations on the portion of a corporation's taxable income that consists of qualified timber gain (or, if less, the net capital gain). The special rate applies only for a tax year ending after May 22, 2008, and beginning on or before May 22, 2009.^{n43.1} In the case of a non-calendar fiscal year that includes either May 22, 2008 or May 22, 2009, only the portion of qualified timber gain occurring between those two dates is eligible for the lower regular tax rate.^{n43.2} The 15-percent rate applies to the least of a corporation's (1) the qualified timber gain, (2) net capital gain, or (3) taxable income.^{n43.3} The temporary 15-percent tax rate also applies for AMT purposes.^{n43.4}

Corporations may deduct capital losses only to the extent of capital gains. n44 Subject to certain limitations and special rules, n44.1 corporation can carry back capital losses for three years and obtain a refund of the taxes paid on capital gains during that period. n44.2 If the entire capital loss cannot be used as a carryback, a five-year carryforward period is provided. n45 Although the character of the capital loss carryover as short-term or long-term is not currently relevant to a corporation, corporate capital loss carryovers are treated as short term capital losses. The benefit of any capital loss that has not been offset against capital gains during the carryback and carryforward periods is lost to the taxpayer.

[4] IRC Section 1231 Gain or Loss

Property subject to depreciation and real property used in a trade or business are not capital assets, but are instead subject to an even more favorable tax regime. n46 Examples of this category of property are land, buildings, and machinery used by a taxpayer in a business, such as a manufacturing plant, or rental property such as apartments, shopping centers, etc. This type of property is known as "Section 1231 property", and the disposition of this type of property can result in even more favorable tax treatment than that given to capital assets because--

- (1) A net gain from all sales of Section 1231 property is taxed as a long-term capital gain. n47
- (2) A net loss from all such sales is fully deductible against other income without the limitations imposed on the deductibility of a capital loss. n48

To qualify for treatment under *IRC Section 1231*, real property must have been held for longer than one year. n49 Property held for a shorter period is not Section 1231 property, and any gain or loss is ordinary income or ordinary loss. n50

Gain or loss from Section 1231 0property is determined as follows:

- (1) Aggregate all gains and losses of Section 1231 property. n51
- (2) If there is a net gain, it is considered long-term capital gain and is grouped with other long-term capital gains.
- (3) If there is a net loss, it is *not* offset against other capital gains, but instead is fully deductible against other income of the taxpayer.

Example:

In Year 1, a taxpayer has the following transactions--

Long-term capital gain--	
Real property held for investment for five years, sold at a gain of	\$10,000
.....	
Section 1231 gains and losses--	
Land used in business held for two years, sold at a gain of	\$15,000
Building used in business held for ten years sold at a loss of	(20,000)
.....	

Net Section 1231 gain or loss	(\$5,000)

.....

Since there is a net loss from the sale of Section 1231 property, it is considered an ordinary loss resulting in an ordinary loss of \$5,000 and a net long term capital gain of \$10,000 resulting in a total net long-term gain of	\$20,000

Had the loss on the building been \$5,000, there would have been a net Section 1231 gain, and the loss of \$5,000 would be offset against long term capital gains and could not be deducted against other ordinary income.

See § 6.02[5], below, for a discussion of depreciation recapture on the sale or exchange of depreciable real estate.

[5] Ordinary Gain or Loss

The sale of real property which is held neither as a capital asset nor as a Section 1231 asset results in ordinary gain or loss. For example, the gain or loss on the disposition of property held primarily for sale to customers in the ordinary course of a trade or business, such as condominium units sold by a condominium developer, is ordinary gain or loss.
n52

[6] Necessity of a Sale or Exchange

In general, a taxpayer can have capital gain or loss, or *IRC Section 1231* gain or loss, only if the property is sold or exchanged. n53 A mere reduction in property value does not generally create a deductible loss if there is no closed and completed transaction. For example, the failure to obtain a hoped-for rezoning for property does not necessarily give rise to a deductible loss if the taxpayer retains the property. n54 There may be, however, a regulatory taking of property that could constitute a realization event for the loss in value of the property, even if the taxpayer retains the property.
n55

A partition of a contiguous jointly-owned tract of real property is generally not a sale or other disposition of property, but merely the severance of joint ownership. Accordingly no gain or loss is realized on the partition. n55.1 A critical factor in one ruling was that no exchange of separate parcels among the owners took place. In addition, each partitioned parcel of property was approximately equal in value to the value of the taxpayers' respective undivided interests in the property immediately prior to the partition, none of the taxpayers benefitted disproportionately as a result of the partition, and no gift was made or received as a result of the partition. Finally, no interest in the property that was subject to a mortgage was transferred or assumed by any of the taxpayers as a result of the partition. n55.1.1 In contrast, an exchange of separate parcels among unrelated tenants-in-common so that each party becomes the sole owner of one of the parcels is a sale or exchange, so that gain or loss must be recognized unless the conditions of *IRC Section 1031* are met. n55.2

[7] Limit to Conversion of Income from Constructive Ownership Transactions

[a] In General

Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property. These arrangements provide investors with the same or similar economic benefits as owning the property directly, but with potentially different tax consequences (as to the character and timing of any gain). A special rule

limits the amount of long-term capital gain that can be recognized from certain derivative contracts ("constructive ownership transactions") with respect to certain financial assets. n56 The amount of long-term capital gain which a taxpayer can recognize is limited to the amount of such gain the taxpayer would have recognized if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount is treated as ordinary income. n57 An interest charge is imposed on the amount of gain that is treated as ordinary income. n58

[b] Constructive Ownership Transactions

A taxpayer is treated as having entered into a constructive ownership transaction with respect to a financial asset if the taxpayer: n59

- holds a long position under a notional principal contract with respect to the financial asset;
- enters into a forward contract to acquire the financial asset;
- is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates; or
- to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

Treasury regulations, when issued, are expected to provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction. n60

IRC Section 1260 does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under the Code or regulations. n61

Taxpayers are treated as holding a long position under a notional principal contract with respect to a financial asset if they: (1) have the right to be paid (or receive credit) for all or substantially all of the investment yield (including appreciation) on the financial asset for a specified period; and (2) are obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the financial asset. n62 A forward contract is a contract to acquire in the future (or to provide or receive credit for the future value of) any financial asset. n63

Treasury is authorized to prescribe regulations, as necessary, to carry out the purposes of the provision, including regs to: (1) permit taxpayers to mark to market constructive ownership transactions in lieu of the provision; and (2) exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset. n64

[c] Definition of "Financial Asset"

A "financial asset" is defined as any equity interest in a pass-thru entity, and, to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-thru entity. n65 A "pass-thru entity" refers to: n66

- (1) a regulated investment company;
- (2) a real estate investment trust (REIT);
- (3) a real estate mortgage investment conduit (REMIC);

- (4) an S corporation;
- (5) a partnership;
- (6) a trust;
- (7) a common trust fund; and
- (8) a passive foreign investment company. n67

[d] Recharacterization of Gain

The amount of recharacterized gain is calculated as the excess of the amount of long-term capital gain, which the taxpayer would have had absent *IRC Section 1260*, over the "net underlying long-term capital gain" attributable to the financial asset. n68 The net underlying long-term capital gain is the amount of net capital gain which the taxpayer would have realized if it had acquired the financial asset for its fair market value on the date the constructive ownership transaction was opened and sold the financial asset on the date the transaction was closed (only taking into account gains and losses that would have resulted from a deemed ownership of the financial asset). n69 The long-term capital gains rate on the net underlying long-term capital gain is determined by reference to the individual capital gains rates in *IRC Section 1(h)*. n70

Note:

A taxpayer must establish the amount of the net underlying long-term capital gain with clear and convincing evidence. Otherwise, the amount is deemed to be zero. n71 To the extent that the economic positions of the taxpayer and the other party do not equally offset each other, the amount of the net underlying long-term capital gain may be difficult to establish.

[e] Special Rule Where Taxpayer Takes Delivery

If the constructive ownership transaction is closed by reason of taking delivery of the underlying financial asset, the taxpayer is treated as having sold the contract, option or other position that is part of the transaction for its fair market value on the closing date. However, the amount of gain that is recognized as a result of having taken delivery is limited to the amount of gain that is treated as ordinary income by reason of this provision (with appropriate basis adjustments for such gain). n72

[8] Sale of Depreciable Property Between Related Taxpayers

Any gain from the sale or exchange of property between related persons must be recognized as ordinary gain, rather than capital gain, if the property is depreciable property to the transferee. The rule applies to both direct and indirect sales and exchanges. n72.1 "Related persons" for this purpose include the following: n72.2

- A person and all entities that are "controlled entities" [as defined in *IRC § 1239(c)*] with respect to that person;
- A taxpayer and any trust in which the taxpayer or his spouse is a beneficiary, unless that beneficiary's interest is a remote contingent interest [as described in *IRC § 318(a)(3)(B)(i)*];
- Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate;

- An employer and any person related to the employer; and
- A welfare benefit fund that is controlled by an employer or persons related to the employer.

The related party attribution of ownership rules that apply under *IRC Section 1239* are complex and confusing. A "controlled entity" under *IRC Section 1239* means, with respect to any person, a corporation more than 50 percent of the value of the outstanding stock of which is owned (directly or indirectly) by or for that person, a partnership more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by or for that person, and any other entity that is a related person to that person under *IRC Section 267(b)(3)* (two corporations that are members of the same controlled group), *IRC Section 267(b)(10)* (corporation and partnership with the same persons have more than 50 percent overlapping interests), or *IRC Section 267(b)(11)*, or (12) (two S corporations or an S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation). n72.3

The constructive ownership rules that apply are those of *IRC Section 267(c)*, other than *IRC Section 267(c)(3)*. n72.4 The *IRC Section 267(c)* constructive ownership rules determine the extent to which stock constructively owned by one person will, as a result of that constructive ownership, be deemed to be constructively owned by another person.

[9] Alternative Minimum Tax Considerations

[a] In General

Although a detailed discussion of the alternative minimum tax (AMT) is beyond the scope of this publication, practitioners should be aware of its potential application in several areas involving real estate. The AMT is a separate tax involving separate calculations from the "regular" income tax. n72.5 The AMT is imposed on the excess of the tentative minimum tax for the tax year over the regular tax. n72.6 The tentative minimum tax is imposed on a taxpayer's alternative minimum taxable income (AMTI) in excess of a statutory exemption amount. n72.7 AMTI is the taxable income of the taxpayer as computed for regular tax purposes, except that various statutory adjustments are taken into account n72.8 and tax preference items are not permitted to reduce AMTI. n72.9 The AMT rate is applied to the AMTI in excess of the exemption amount, which results in the tentative minimum tax. n72.10 If the tentative minimum tax exceeds the regular income tax for the year, the excess is imposed as an additional tax for the year. n72.11 If the tentative minimum tax is less than the regular tax, no additional tax is due, but certain business credits are limited to the excess of the regular tax over the tentative minimum tax. n72.12

The AMT adjustments and preferences most likely to come into play for real estate are the following:

- Depreciation deductions for nonresidential real property and residential rental property placed in service after 1986 and before 1999 must be computed for AMT purposes using a 40-year recovery period. n72.13 For real property placed in service after 1998, AMT and regular tax depreciation deductions are the same, using the straight-line method over the property's MACRS recovery period. n72.14
- Certain mining exploration and development costs must be amortized over 10 years, although certain losses are allowed in the year the loss is sustained. n72.15
- The taxable income from long-term contracts other than home construction contracts must be determined under a modified percentage-of-completion method of accounting. n72.16
- For AMT purposes, any cost recovery deduction for pollution control facilities placed in service

before 1999 must be taken using the alternative depreciation system under *IRC Section 168(g)*. Cost recovery deductions for pollution control facilities placed in service after 1999 must be determined under *IRC Section 168*, using the straight line method over the facilities MACRS recovery period. n72.17 The 5-and 7-year amortization allowed for regular tax purposes n72.18 is not allowed for AMT purposes. n72.19

- For noncorporate taxpayers, no interest deduction is allowed for refinanced home mortgages to the extent the indebtedness resulting from the refinancing exceeds the amount of the indebtedness before the refinancing. n72.20

- Any net operating losses must be computed under AMT rules in *IRC Section 56(d)* rather than under regular tax rules in *IRC Section 172*. Under these rules, the AMT net operating loss is generally limited to 90 percent of the alternative minimum taxable income, determined without regard to the AMT NOL deduction and the deduction under *IRC Section 199* for domestic production activities. n72.21 An exception applies, however, for 2008 or 2009 NOLs that a taxpayer elects to carry back under *IRC Section 172(b)(1)(H)*. The amount of a deduction attributable to a NOL with respect to which a carryback election is made may offset 100 percent of a taxpayer's alternative minimum taxable income in the carryback years. n72.21.1

- Corporations may need to make depreciation, intangible drilling cost, and depletion adjustments in computing their adjusted current earnings. n72.22

- Certain depletion and intangible drilling costs are items of tax preference. n72.23

- Interest on specified tax-exempt private activity bonds is an item of tax preference. n72.24

- Accelerated depreciation or amortization on certain real property placed in service before 1987 is an item of tax preference. n72.25

- Certain farm losses are disallowed in computing AMT income. n72.26

- Passive activity losses must be separately determined under AMT rules in a manner parallel to regular tax rules, with due regard for AMT adjustments and preferences. n72.27

[b] AMT Tax Rates

For corporations, the AMT rate is a flat 20 percent. n72.28 For noncorporate taxpayers, the AMT rate is generally 26 percent for amounts up to \$175,000 and 28 percent for amounts in excess of \$175,000. n72.29 A taxpayer's effective AMT rate is higher than the above rates, however, over the AMT exemption phase-out range. n72.30

Notwithstanding the above rates, however, the maximum AMT rate on any net capital gain of noncorporate taxpayers cannot exceed the capital gains rate that applies for regular tax purposes. In other words, the regular tax capital gains tax rates also apply for AMT purposes. n72.31 This result is accomplished by way of complex computations on Form 6251. Under the limitation, the amount of AMT computed with the usual 26-and 28-percent AMT tax rates cannot exceed the sum of the following amounts: n72.32

- The amount determined by applying the 26-and 28-percent rates on the amount of the taxable excess to which the AMT applies (i.e. alternative minimum taxable income less the applicable exemption amount), reduced by the lesser of (1) the net capital gain, or (2) the sum of (a) the adjusted net capital gain, plus (b) the unrecaptured *IRC Section 1250* gain; plus

- 0 percent (5 percent for tax years beginning before 2008) of so much of the adjusted net capital gain (or, if less, the taxable excess) as does not exceed an amount equal to the excess described in *IRC Section 1(h)(1)(B)*; plus
- 15 percent of the adjusted net capital gain (or, if less, the taxable excess) in excess of the amount on which a tax is determined using the 0-or 5-percent rate in the above step; plus
- 25 percent of the taxable excess in excess of the sum of the amounts on which tax is determined in the above steps.

A special temporary tax rate applies for corporate timber gains. For regular tax purposes, a temporary 15-percent tax rate applies to qualified corporate timber gains. The reduced tax rate applies for corporations on the portion of a corporation's taxable income that consists of qualified timber gain (or, if less, the net capital gain). The special rate applies only for a tax year ending after May 22, 2008, and beginning on or before May 22, 2009. n72.33 In the case of a non-calendar fiscal year that includes either May 22, 2008 or May 22, 2009, only the portion of qualified timber gain occurring between those two dates is eligible for the lower regular tax rate. n72.34 The 15-percent rate applies to the least of a corporation's (1) the qualified timber gain, (2) net capital gain, or (3) taxable income. n72.35

The temporary 15-percent tax rate also applies for AMT purposes. n72.36 The AMT provision reaches this result in a somewhat roundabout way. For provision sets a maximum limit on the amount of tax that can be imposed on qualified timber gains of corporations, determined by reference to the 15-percent regular corporate tax provision on qualified timber gains. The AMT cannot exceed the sum of the following: n72.37

- 20 percent of so much of the taxable excess (if any) as exceeds the qualified timber gain (or, if less, the net capital gain), plus
- 15 percent of the taxable excess in excess of the amount on which the 20-percent tax is imposed.

The end result is that qualified timber gains of corporations are subject to a 15-percent tax rate for AMT purposes for the same periods that the special rate applies for regular tax purposes. n72.38

[c] Small Corporation Exemption from AMT

"Small corporations" are exempt from the AMT. n72.39 The exemption applies only for C corporations. n72.40 The exemption works by treating a corporation's tentative minimum tax as zero for any year in which it qualifies as a small corporation. n72.41

A C corporation is automatically treated as a "small corporation" (and is therefore exempt from the AMT) in the first taxable year of its existence, regardless of the amount of its gross receipts. n72.42 This rule applies, however, only if the corporation does not lose its status as a small corporation because it is aggregated with other corporations, or is treated as having a predecessor corporation. n72.43

After its first year of existence, a corporation qualifies as a small corporation exempt from the AMT only if it has annual gross receipts for all 3-taxable-year periods ending before the tax year in question of not more than \$7.5 million. n72.44 In applying this test for a corporation's first taxable year, a \$5 million limit is used. n72.45 A corporation that fails to qualify as a small corporation for any tax year can never again qualify for the small corporation exemption in a later tax year. n72.46 If a corporation is not in existence for an entire three-year period, the tests are applied using the period that the corporation has been in existence. n72.47 Gross receipts must be annualized if the tax year is less than 12 months. n72.48

NOTE:

The \$5 million test is applied just once, during a corporation's second taxable year. The statutory language relating to the \$5 million test makes reference to looking at the corporation's "first 3-taxable-year period (*or portion thereof*)" ending before the tax year in question. n72.49 In actual practice, however, because of the parenthetical qualification, only the corporation's gross receipts in its first taxable year of existence will ever come into play in applying the test. This is because the corporation's first taxable year will be a "portion" that qualifies for the corporation's first testing period. n72.50 In contrast, the \$7.5 million test applies, and must be separately computed, for every year after the corporation's second taxable year of existence. n72.51

A corporation that fails to meet the gross receipts tests becomes subject to the AMT, but generally only with respect to preferences and adjustments that relate to transactions and investments entered into after the corporation loses its status as a small corporation. n72.52 The restriction in computing AMT does not apply, however, to items acquired by the corporation in a corporate acquisition to which *IRC § 381* applies or to certain substituted basis property. n72.53

[d] AMT Exemption Amounts

Corporations are entitled to a flat \$40,000 exemption. n72.54 Estates and trusts are entitled to a flat \$22,500 exemption. n72.55 The AMT exemption amount for other non-corporate taxpayers varies, depending on their filing status and the particular tax year. n72.56

The AMT exemption for all taxpayers is phased out above certain income amounts. n72.57

For taxable years beginning in 2009 only, the exemption amounts and their phase-out ranges are as follows: n72.57.1

Taxpayer	AMT Exemption	Phase-out Starts at AMT Income of	Phase-out Ends at AMT Income of
Married filing jointly, and qualified surviving spouse	\$70,950	\$150,000	\$433,800
Unmarried and not a surviving spouse	\$46,700	\$112,500	\$298,800
Married filing Separately	\$35,475	\$75,000	\$216,900
Corporations	\$40,000	\$150,000	\$310,000
Estates and trusts	\$22,500	\$75,000	\$165,000

For taxable years beginning in 2008 only, the exemption amounts and their phase-out ranges are as follows: n72.57.1.1

Taxpayer	AMT Exemption	Phase-out Starts at AMT Income of	Phase-out Ends at AMT Income of
Corporation	\$40,000	\$150,000	\$310,000
Married filing	\$69,950	\$150,000	\$429,800

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jointly, and qualified
surviving spouse

Unmarried and not a surviving spouse	\$46,200	\$112,500	\$297,300
Married filing separately	\$34,625	\$75,000	\$213,500
Estates and trusts	\$22,500	\$75,000	\$165,000

For taxable years beginning in 2007 only, the exemption amounts for noncorporate taxpayers and their phase-out ranges are as follows: n72.58

Taxpayer	AMT Exemption	Phase-out Starts at AMT Income of	Phase-out Ends at AMT Income of
Married filing jointly, and qualified surviving spouse	\$66,250	\$150,000	\$415,000
Unmarried and not a surviving spouse	\$44,350	\$112,500	\$289,900
Married filing separately	\$33,125	\$75,000	\$207,500
Corporations	\$40,000	\$150,000	\$310,000
Estates and trusts	\$22,500	\$75,000	\$165,000

For taxable years beginning in 2006 only, the exemption amounts for noncorporate taxpayers and their phase-out ranges are as follows: n72.61

Taxpayer	AMT Exemption	Phase-out Starts at AMT Income of	Phase-out Ends at AMT Income of
Married filing jointly, and qualified surviving spouse	\$62,550	\$150,000	\$400,200
Unmarried and not a surviving spouse	\$42,500	\$112,500	\$282,500
Married filing separately	\$31,275	\$75,000	\$200,100
Corporations	\$40,000	\$150,000	\$310,000
Estates and trusts	\$22,500	\$75,000	\$165,000

For taxable years beginning in 2003, 2004, and 2005 only, the exemption amounts for noncorporate taxpayers and their

phase-out ranges are as follows: n72.62

Taxpayer	AMT Exemption	Phase-out Starts at AMT Income of	Phase-out Ends at AMT Income of
Married filing jointly, and qualified surviving spouse	\$58,000	\$150,000	\$382,200
Unmarried and not a surviving spouse	\$40,250	\$112,500	\$273,500
Married filing separately	\$29,000	\$75,000	\$191,000
Corporations	\$40,000	\$150,000	\$310,000
Estates and trusts	\$22,500	\$75,000	\$165,000

For all other taxable years, the exemption amounts for noncorporate taxpayers and their phase-out ranges are as follows:
n72.63

Taxpayer	AMT Exemption	Phase-out Starts at AMT Income of	Phase-out Ends at AMT Income of
Married filing jointly, and qualified surviving spouse	\$45,000	\$150,000	\$330,000
Unmarried and not a surviving spouse	\$33,750	\$112,500	\$247,500
Married filing separately	\$22,500	\$75,000	\$165,000
Corporations	\$40,000	\$150,000	\$310,000
Estates and trusts	\$22,500	\$75,000	\$165,000

NOTE:

Because the AMT is not indexed for inflation, frequent legislative "AMT patches" have been enacted to increase the AMT exemption amount in order to prevent subjecting even more middle-class taxpayers to its reach.

FOOTNOTES:

(n1)Footnote 1. *IRC §§ 1221, 1222; see § 6.01[1] through [3], infra.*

(n2)Footnote 2. *IRC § 1231; see §§ 6.01[4] and 8.02, infra.*

(n3)Footnote 3. *IRC § 1(h); see § 6.01[2] and [3], infra.*

(n4)Footnote 4. *See IRC §§ 1211, 1212; Keenan v Commr, TC Memo 1998-388 ; see § 6.01[2] and [3], infra.*

(n5)Footnote 5. *IRC § 1221(a)(1)*.

(n6)Footnote 6. *IRC § 61(a)(3)*; *Jarret v Commr, TC Memo 1993-516* ; *Walsh v Commr, TC Memo 1994-293* , *affd* 95-2 *USTC P 50,398* (8th Cir 1995); *Briggs v Commr/Morris v Commr, TC Memo 2000-380* .

(n7)Footnote 7. See *Walsh v Commr, TC Memo 1994-293* , *affd* 95-2 *USTC P 50,398* (8th Cir 1995); *IRC § 1221(1)*.

(n8)Footnote 8. See *IRC § 121*.

(n9)Footnote 9. *IRC § 1222*.

(n10)Footnote 10. *IRC § 1222(3), (4)*.

(n11)Footnote 11. *IRC § 1222(1), (2)*.

(n12)Footnote 12. *IRC § 1222(11)*.

(n13)Footnote 13. See *IRC § 1222*.

(n14)Footnote 13.1. See *IRC § 1(a)-(e), (h), (i)*.

(n15)Footnote 14. *IRC § 1234A*.

(n16)Footnote 15. *IRC §§ 1(a)-(e), (i), 1222(1), (5)*.

(n17)Footnote 16. *IRC § 1(h)(1), (B), (C)*. For taxpayers in the lowest tax bracket, a 0-percent rate applies after for tax years beginning after Dec 31, 2007.

(n18)Footnote 17. *IRC § 1(h)(1)(D)*; see [d], below, for a definition of unrecaptured section 1250 gain.

(n19)Footnote 18. *IRC § 1(h)(1)(E), (4), (5)*.

(n20)Footnote 19-21. See *IRC § 1(h)(11)*.

(n21)Footnote 22. *IRC § 1(h)(3)*; see [c], below, for a definition of 28-percent rate gain and [d], below, for a definition of unrecaptured Section 1250 gain.

(n22)Footnote 23. *IRC § 1(h)(2)*.

(n23)Footnote 24. *IRC § 1222(11)*.

(n24)Footnote 25. *IRC § 1(h)(4)*; see *IRC §§ 1(h)(5), 408(m)* regarding collectibles.

(n25)Footnote 26. See *IRC § 1(h)(6)(A)*.

(n26)Footnote 27. *Id*; see [c], above, for a definition of 28-percent rate gain.

(n27)Footnote 28-30. *IRC § 1(h)(6)(B)*.

(n28)Footnote 31. Pub L 105-34, § 311(e)(1); § 311(e) was later amended by Pub L 106-554, § 314(c) and Pub L 107-147, § 414.

(n29)Footnote 32. Pub L 105-34, § 311(e)(2).

(n30)Footnote 33. *Notice 2002-58, 2002-2 CB 432* .

(n31)Footnote 33.1. Pub L 105-34, § 311(e)(3).

(n32)Footnote 34. See *IRC § 1(h)(1)*; see [a], above, for a discussion.

(n33)Footnote 35. See *Notice 97-59, 1997-2 CB 309*; the lowest capital gain rate involved in the netting when *Notice 97-59* was published was 20 percent. The same netting rules apply to the 15-percent rates (or 5-percent rates) that are in effect for tax years ending on or after May 6, 2003 (see *IRC § 1(h)(1)(B), (C)*).

(n34)Footnote 36. *IRC § 1(h)*; *Notice 97-59, 1997-2 CB 309* .

(n35)Footnote 37. *IRC §§ 165(f), 1211(b)*.

(n36)Footnote 38. *Treas Reg § 1.1211-1(b)(4)*.

(n37)Footnote 39. *IRC § 1212(b)*.

(n38)Footnote 40. *Treas Reg § 1.1211-1(b)(4)*.

(n39)Footnote 41. *IRC §§ 11, 1201*.

(n40)Footnote 42. *IRC § 1201(a)*.

(n41)Footnote 43. *IRC § 11*.

(n42)Footnote 43.1. *IRC § 1201(b)(1)*.

(n43)Footnote 43.2. *IRC § 1201(b)(3)*.

(n44)Footnote 43.3. *IRC § 1201(b)(1)(B)(i)*.

(n45)Footnote 43.4. *IRC § 55(b)(4)*; see § 6.01[9][b], below, for a discussion.

(n46)Footnote 44. *IRC §§ 165(f), 1211(a)*.

(n47)Footnote 44.1. See *IRC § 1212(a)(2), (3)*.

(n48)Footnote 44.2. *IRC § 1212(a)(1)(A)*.

(n49)Footnote 45. *IRC § 1212(a)(1)(B)*.

(n50)Footnote 46. *IRC § 1221(a)(2)*.

(n51)Footnote 47. *IRC § 1231(a)(1)*.

(n52)Footnote 48. *IRC § 1231(a)(2)*.

(n53)Footnote 49. *IRC § 1231(b)*.

(n54)Footnote 50. See *IRC § 1231(b)(1)*.

(n55)Footnote 51. *IRC § 1231(b)*.

(n56)Footnote 52. *Jarret v Commr, TC Memo 1993-516 ; Tollis v Commr, TC Memo 1993-63 , aff'd 46 F3d 1132,*

95-1 USTC P 50,076 (6th Cir 1995).

(n57)Footnote 53. See *IRC* §§ 1222, 1231.

(n58)Footnote 54. *Lakewood Associates v Commr*, 109 TC 450 (1997) , *affd* 99-1 USTC P 50,127 (4th Cir 1999).

(n59)Footnote 55. *Id.*

(n60)Footnote 55.1. Ltr Ruls 200411023 (no disposition because only a single contiguous property was involved, and the partition would be pursuant to an action under state law), 200328034, 200303023; see *Rev Rul* 56-437, 1956-2 CB 507 (conversion of joint tenancy in stock into tenancy in common is nontaxable).

(n61)Footnote 55.1.1. *Ltr Rul* 200303023 .

(n62)Footnote 55.2. *Rev Rul* 73-476, 1973-2 CB 300 ; *Rev Rul* 79-44, 1979-1 CB 265 .

(n63)Footnote 56. *IRC* § 1260, eff generally for transactions entered into on or after July 12, 1999.

(n64)Footnote 57. *IRC* § 1260(a).

(n65)Footnote 58. *IRC* § 1260(b).

(n66)Footnote 59. *IRC* § 1260(d)(1).

(n67)Footnote 60. *IRC* § 1260(d)(1)(D).

(n68)Footnote 61. *IRC* § 1260(d)(2).

(n69)Footnote 62. *IRC* § 1260(d)(3).

(n70)Footnote 63. *IRC* § 1260(d)(4).

(n71)Footnote 64. *IRC* § 1260(g).

(n72)Footnote 65. *IRC* § 1260(c)(1).

(n73)Footnote 66. *IRC* § 1260(c)(2)

(n74)Footnote 67. For this purpose, a passive foreign investment company includes an investment company that is also a controlled foreign corporation. *IRC* §§ 1260(c)(2)(G), 1297.

(n75)Footnote 68. *IRC* § 1260(a).

(n76)Footnote 69. *IRC* § 1260(e).

(n77)Footnote 70. *IRC* § 1260(a)(2).

(n78)Footnote 71. *IRC* § 1260(e).

(n79)Footnote 72. *IRC* § 1260(f).

(n80)Footnote 72.1. *IRC* § 1239(a).

(n81)Footnote 72.2. *IRC* § 1239(b),(d).

(n82)Footnote 72.3. *IRC § 1239(c)(1)*.

(n83)Footnote 72.4. *IRC § 1239(c)(2)*; see *Ltr Rul 200133030* (ruling applies attribution rules to complex set of interlocking relationships).

(n84)Footnote 72.5. See *IRC §§ 55-59*.

(n85)Footnote 72.6. *IRC § 55(a)*.

(n86)Footnote 72.7. *IRC § 55(b)*.

(n87)Footnote 72.8. See *IRC §§ 56, 58*.

(n88)Footnote 72.9. *IRC § 57*.

(n89)Footnote 72.10. *IRC § 55(b)*.

(n90)Footnote 72.11. *IRC § 55(a)*.

(n91)Footnote 72.12. *IRC § 38(c)(1)*.

(n92)Footnote 72.13. *IRC §§ 56(a)(1)(A)(i), 168(g)(2)(C)*.

(n93)Footnote 72.14. *IRC §§ 56(a)(1)(A), 168(a), (b)(3), (c)*.

(n94)Footnote 72.15. *IRC § 56(a)(2)*.

(n95)Footnote 72.16. *IRC § 56(a)(3)*.

(n96)Footnote 72.17. *IRC § 56(a)(4)*.

(n97)Footnote 72.18. See *IRC § 169*.

(n98)Footnote 72.19. *IRC § 56(a)(4)*.

(n99)Footnote 72.20. *IRC § 56(b)(1)(C), (e), 163(h)(3)(B)(i)*; this is consistent with the regular tax rules.

(n100)Footnote 72.21. *IRC § 56(d)(1)(A)(i)*.

(n101)Footnote 72.21.1. *IRC § 56(d)(1)(A)(ii)(I)*, effective for taxable years ending after Dec 31, 2002 [Pub Law 111-92, § 13(e)(2)].

(n102)Footnote 72.22. *IRC § 56(g)(4)(A), (D)(i), (F)*.

(n103)Footnote 72.23. *IRC § 57(a)(1), (2)*.

(n104)Footnote 72.24. *IRC § 57(a)(5)*.

(n105)Footnote 72.25. *IRC § 57(a)(6)*.

(n106)Footnote 72.26. *IRC § 58(a)*.

(n107)Footnote 72.27. *IRC § 58(b)*.

(n108)Footnote 72.28. *IRC § 55(b)(1)(B)(i)*.

(n109)Footnote 72.29. *IRC § 55(b)(1)(A)(i)*. For married taxpayers filing separate returns, the 28-percent tax rate is triggered at \$87,500. See *IRC § 55(b)(1)(A)(iii)*.

(n110)Footnote 72.30. See *IRC § 55(d)*.

(n111)Footnote 72.31. *IRC §§ 1(h), 55(b)(3)*; see *Notice 97-59, 1997-2 CB 309*.

(n112)Footnote 72.32. *IRC § 55(b)(3)*.

(n113)Footnote 72.33. *IRC § 1201(b)(1)*.

(n114)Footnote 72.34. *IRC § 1201(b)(3)*.

(n115)Footnote 72.35. *IRC § 1201(b)(1)(B)(i)*.

(n116)Footnote 72.36. *IRC § 55(b)(4)*.

(n117)Footnote 72.37. *IRC §§ 55(b)(4), 1201(b)(1)(B)*.

(n118)Footnote 72.38. *IRC §§ 55(b)(4), 1201(b)*.

(n119)Footnote 72.39. *IRC § 55(e)*.

(n120)Footnote 72.40. *Treas Reg §§ 1.6045; Holloway v. Commr, T.C. Memo. 2006-256*.

(n121)Footnote 72.41. *IRC § 55(e)(1)(A)*.

(n122)Footnote 72.42. *IRC § 55(e)(1)(C)*.

(n123)Footnote 72.43. *IRC §§ 55(e)(1)(C), (D), 448(c)(2), (3)(A), (D)*.

(n124)Footnote 72.44. *IRC § 55(e)(1)(A), (B)*.

(n125)Footnote 72.45. *IRC § 55(e)(1)(B)*.

(n126)Footnote 72.46. *IRC § 55(e)(1)*.

(n127)Footnote 72.47. *IRC §§ 55(e)(1), 448(c)(3)(A)*.

(n128)Footnote 72.48. *IRC §§ 55(e)(1)(D), 448(c)(3)(B)*.

(n129)Footnote 72.49. *IRC § 55(e)(1)(B)*.

(n130)Footnote 72.50. See *IRC § 55(e)(1)(B)*.

(n131)Footnote 72.51. *IRC § 55(e)(1)(A)*.

(n132)Footnote 72.52. *IRC § 55(e)(2)*.

(n133)Footnote 72.53. *IRC § 55(e)(3)*.

(n134)Footnote 72.54. *IRC § 55(d)(3)*.

(n135)Footnote 72.55. *IRC § 55(d)(1)(D)*.

(n136)Footnote 72.56. *IRC § 55(d)(1)(A),(B), (C).*

(n137)Footnote 72.57. *IRC § 55(d)(3).*

(n138)Footnote 72.57.1. *IRC § 55(d).*

(n139)Footnote 72.57.1.1. *IRC § 55(d).*

(n140)Footnote 72.58. *IRC § 55(d).*

(n141)Footnote 72.61. *IRC § 55(d).*

(n142)Footnote 72.62. *IRC § 55(d), before amendment by Pub Law No 109-222.*

(n143)Footnote 72.63. *IRC § 55(d), before amendment by Pub Law No 109 222.*



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Federal Taxes Affecting Real Estate

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CHAPTER 6 Dispositions of Real Estate by Sale, Abandonment and Casualty

1-6 Federal Taxes Affecting Real Estate § 6.02

§ 6.02 Reporting and Timing of the Sale

Having determined the nature of the gain or loss, the seller of real property is then faced with the problem of reporting the sale. The seller needs to know the selling price or amount realized and the tax basis to compute the amount of gain or loss, and needs to know the year in which the sale took place for tax purposes. n73

[1] Computation of Selling Price

The gross selling price of real property generally is the sum of:

- (1) The cash received by the seller.
- (2) Any other amounts receivable by the seller from the purchaser.
- (3) Any liability encumbering the property if the buyer either assumes the liability or takes the property subject to it. n74
- (4) Any other obligations of the seller paid or assumed by the buyer.
- (5) The fair market value of any other property received. n75

A mortgage note or other liability that is discharged on a disposition of property must be included in the selling price or amount realized even if the seller is not personally liable on the note. This can occur where a seller has been relieved of a personal obligation to pay a note in a bankruptcy proceeding. As long as the mortgagee has a legally enforceable obligation to proceeds of sale of the underlying property in the amount of the note, the amount realized includes that amount. n76

Expenses of the sale paid by the seller, such as commissions, recording fees, legal fees, and the like, are reductions of the gross profit if the seller is an investor. n77 For real estate dealers, such expenses are ordinary business deductions (see discussion in Chapter 7). State and local transfer taxes should be deductible as taxes rather than as a reduction in the sales price, if the property sold was held for investment or used in a trade or business.

[2] Computation of Gain or Loss

Gain or loss is the difference between the selling price (amount realized) and the seller's tax basis in the property sold.
n78

Example:

An investor sells real property with a tax basis of \$50,000 and receives from the buyer \$50,000 in cash plus a note with a face amount and fair market value of \$25,000. The buyer takes the property subject to a \$25,000 mortgage. The seller pays a real estate commission of \$5,000 and legal fees of \$200. The gain is computed as follows:

Gross selling price--

Cash received	\$50,000
Note receivable	25,000
Mortgage against property	25,000
	\$100,000

Less--

Sales commission	\$5,000	
Legal fees	200	5,200
Net selling price		\$94,800
Less--Tax basis of property		50,000
Gain realized		\$44,800

Note:

Usually, the amount received on a sale is fairly straightforward, and the amount realized readily determined. Settlement proceeds received in litigation may, however, be characterized as an amount realized from a sale. In one ruling, a taxpayer purchased a home and shortly thereafter sold it (at a loss) because of unanticipated noise that was not disclosed at the time of purchase. He sued the real estate agents and sellers, and in the following year obtained a settlement. The IRS ruled that he could treat the settlement proceeds as proceeds from his sale of the home. The increased proceeds transformed the loss on his sale into a gain, and he was able to exclude a portion of the gain from gross income under *IRC* § 121. n78.1

[3] Timing of the Sale

While there is no single factor that controls the determination of when a real estate transaction is consummated for tax purposes, n79 passage of title is probably the most significant event. n80 In the typical real estate transaction, passage of title occurs at the close of escrow. n80.1

In addition to the passage of title, factors such as receipt of the purchase price by the seller or transfer of possession of the property and risk of loss to the purchaser have been considered in fixing the date of sale. This is particularly true when the escrow is held "open" and the deed is retained by the seller merely to manipulate the timing of the close of sale. n81

A properly drafted escrow agreement has been held to be a valid income-deferral device. In *John E. Reed v. United*

States n82 a contract for the sale of stock calling for deferred payment of the purchase price through the use of an escrow arrangement was effective in deferring income recognition by a cash-basis seller until after the year of sale. The court reached its conclusion based on the following three conditions:

- (1) the escrow arrangement was part of a bona fide, arm's-length agreement between the purchaser and seller calling for a deferred payment;
- (2) the seller received no present beneficial interest from the purchase funds while they were in escrow; and
- (3) the escrowee was not acting under the exclusive authority of the seller.

The purchaser, for business reasons, wanted to close in one year; the seller, however, to minimize taxes, wanted to close in a subsequent year. The court noted that the sale would not have been completed had the purchaser not agreed to the escrow arrangement calling for a deferred payment. The escrow arrangement was bargained for and made a part of the purchase-sale agreement before the date the transaction was executed.

Reed, a cash-basis taxpayer, did not actually or constructively receive the money until after the year it was placed in escrow. Reed was not allowed to receive interest or obtain a line of credit on the deposited funds in escrow. In addition, Reed could not compel the escrowee to distribute the funds to him before the bargained-for date in the subsequent year. Therefore, the court concluded Reed did not recognize income on this sale until after the year the funds were deposited in escrow.

Transfer of possession and the assumption of the benefits and burdens of ownership before the close of escrow have been held to result in a completed sale for tax purposes, when the parties have executed a contract of sale imposing an absolute and unconditional obligation on the seller to deliver a deed to the purchaser upon payment of the purchase price. n83

The view that appears to be the most widely accepted today is that a sale is consummated, for tax purposes, when there has been such a substantial performance of the conditions precedent as to impose on the seller an unconditional obligation to execute and deliver a deed to the purchaser and to impose on the purchaser an unconditional obligation to pay the purchase price. n84 In other words, a sale occurs at the time the risks and rewards of ownership are transferred from seller to buyer. In one case, the Tax Court held that sales of real property were completed at the time contracts for deeds of sale were entered into. Therefore, the accrual basis taxpayer had to recognize gain from the sales in the year the contracts were entered into. n85 Under the agreements, purchasers obtained possession; assumed responsibility for taxes, insurance, and maintenance; and became obligated to make monthly payments, with interest, of the purchase price. The seller would issue a warranty deed only upon full payment of the purchase price, and any default by the buyers before full payment was made would render the contract null and void, with the seller retaining all amounts paid as liquidated damages. The Tax Court held that income attributable to each sale of property had to be recognized in full in the year the contract of deed was executed because, although legal title did not pass on execution of a contract of deed, the purchaser did assume the practical burdens and benefits of ownership at that time. What the seller retained was essentially a security interest. The taxpayer, an accrual basis taxpayer, had a right to receive the income at the time the contracts were executed, and the amount of the income became reasonably determinable at that time as well. The court found that the possibility of default by a purchaser was only a condition subsequent; it did not otherwise affect the taxpayer's entitlement to the sums at the time the contracts were entered into. n86

[4] Holding Period of Property

For gain to qualify as long-term capital gain, the property sold must have been held for more than one year n87 (see § 6.01[1][b], above). For non-corporate taxpayers, a transaction that results in long-term gain (instead of short-term

capital gain) will be eligible for a maximum 20 percent tax rate (25 percent in the case of certain unrecaptured depreciation), rather than the maximum 39.6 percent tax rate applicable to ordinary income and short-term capital gain. Therefore, the taxpayer must know how the holding period of property is determined. A mistake of even one day may mean the difference between the gain being classified as a short-term capital gain or as long-term capital gain.

Usually, the date of acquisition of property is the date on which the buyer takes title. In most instances, this occurs at the closing, when the deed is delivered. Likewise, delivery of the deed at closing normally would end the holding period of the seller. However, if possession and the burdens and privileges of ownership are acquired before the transfer of title, the holding period will commence at the earlier date. ⁿ⁸⁸ This rule normally follows state law. Holding period is discussed more fully in Chapters 2 and 8.

The holding period begins on the day after the property is acquired and ends on the day the property is sold. ⁿ⁸⁹

Example:

A seller purchases investment real estate on June 28, Year 1, and sells the property at a gain on June 29, Year 2. The holding period begins on June 29, Year 1 and ends on June 29, Year 2. Since the seller did not hold the property for more than one year, he realizes a short-term capital gain.

Determining the holding period of improvements made subsequent to the original acquisition of real property often requires careful consideration. A tax problem arises when a taxpayer sells improved property held for less than one year after completion of the improvements but held for more than one year since the land was purchased and the construction began.

Example:

A taxpayer begins construction of an apartment complex in January, Year 1. The total cost of construction is \$60,000. Through March 10, Year 1, \$40,000 of the total cost has been incurred. The complex is sold on March 11, Year 2, for \$90,000. For computation of the holding period on sale, the seller counts back one year and one day (March 10, Year 1). Since the cost of the pre-March 10, Year 1 work was \$40,000, two-thirds of the total cost (\$40,000/\$60,000) was incurred more than one year before the sale. The courts have ruled that the seller is, in effect, selling two properties—one held for the required holding period and the other held for less than the required holding period. ⁿ⁹⁰ The result is that \$20,000 (two-thirds of the \$30,000 profit) is taxed as a long-term capital gain.

This rule applies only to the cost of work actually completed one year before the sale. An advance payment for the construction work does not qualify for this treatment.

This discussion illustrates that proper timing of a sale is critical to the determination of the gain or loss as long-term or short-term. See Chapter 2 for a discussion of the special rules for determining holding periods for property having a substituted basis.

[5] Recapture of Depreciation

Depreciation reduces the tax basis of property. ⁿ⁹¹ The basis is reduced by the greater of the amount of the depreciation allowable or the amount allowed. Thus, the reduction in basis may exceed the amount of depreciation deductions actually claimed by the taxpayer, if a larger amount was actually allowable. ^{n91.1} Consequently, when depreciable property is sold the gain on sale is greater than it otherwise would have been by the amount of depreciation previously allowed or allowable. ⁿ⁹²

The IRS has issued a revenue procedure under which a taxpayer may change its method of determining depreciation for a depreciable or amortizable asset after its disposition. The taxpayer may make the change if the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable, for the asset in computing taxable income in the year of disposition or in prior taxable years. Because the taxpayer is permitted to claim the allowable depreciation not taken into account for this asset, the taxpayer's lifetime income is not permanently affected by the "allowed or allowable" rule. n92.1 The possibility that the depreciation deductions, which offset ordinary income during the period of ownership of the property, may be recovered upon the disposition of the property at capital gain rates, historically has been a major factor in the popularity of investing in real estate. However, the Code now contains provisions that tax depreciation recapture at ordinary income tax rates, and that provide for a maximum 25 percent long-term capital gain tax rate with respect to unreaptured depreciation for non-corporate taxpayers. n92.2

The amount of depreciation recapture on the disposition of real estate that will be subject to tax at ordinary income tax rates depends on two factors: the type of real estate and the holding period. n93 In general, the depreciation recapture rules apply to the excess of accelerated depreciation over straight line depreciation, in some cases subject to phase out rules.

The recapture rules under *IRC Section 1250* therefore do not apply for most real property depreciated under MACRS because under MACRS, real property is ordinarily eligible only for straight-line depreciation deductions over the applicable recovery period. n94

The statute (*IRC Section 1250*) segregates depreciation into the three periods described below and provides recapture rules for depreciation deducted during each of the periods.

Post-1975 recapture--For dispositions after 1975, depreciation recapture for the post-1975 period is determined by applying the applicable percentage described immediately below to the lower of the following amounts: n95

- (1) the additional depreciation attributable to periods after 1975; or
- (2) the excess of the amount realized (for sales, exchanges or involuntary conversions) or the fair market of the property (for any other disposition) over the adjusted basis of the property.

Additional depreciation is generally any depreciation in excess of straight-line. If the property has not been held for more than one year, however, additional depreciation includes all depreciation adjustments with respect to the property. n96

The applicable percentage is generally 100 percent. n97 For the following property, however, the applicable percentage is reduced by one percentage point for each month that the property is held in excess of 100 months: n98

- (1) Property financed by a mortgage insured under Section 221(d)(3) or Section 236 of the National Housing Act (or similar state or local statutes, under which return to the investor is limited).
- (2) Property held for occupancy by families or individuals eligible to receive subsidies under Section 8 of the United States Housing Act of 1937 or under the provisions of state or local law authorizing similar levels of subsidy for lower-income housing.
- (3) Property subject to a loan made or incurred pursuant to Title V of the Housing Act of 1949.
- (4) Property subject to a depreciation deduction for rehabilitation expenditures under former *IRC Section 167(k)*.

Post-1969 and pre-1976 recapture--Special recapture rules are provided for depreciation claimed after December 31, 1969, and before January 1, 1976, with respect to certain classes of subsidized housing and residential rental property; however, additional depreciation deducted during this period on all other real estate is subject to 100 percent recapture. n99

The percentage of depreciation recapture for residential rental property is reduced by one percentage point per month for each month the property is held in excess of 100 months. n100 Thus, if property has been held for 200 months (16 2/3 years), there will be no recapture of depreciation deducted during this period. For subsidized housing, the reduction is one percentage point per month for each month the property is held in excess of 20 months. n101

Pre-1970 recapture--Additional depreciation during this period (1964 through 1969) is subject to 100 percent recapture. However, this percentage is reduced by one percentage point per month for each month the property is held in excess of 20 months. Thus, if property has been held for 120 months, there will be no recapture of additional depreciation deducted during this period. These pre-1970 recapture provisions apply to all Section 1250 property. n102

[6] Information Reporting

IRC Section 6045 and regulations thereunder impose reporting requirements for real estate transactions. The "reporting person" must report the following information on Form 1099-S:

- (1) name, address, and taxpayer identification number of the transferor;
- (2) a general description of the real estate transferred;
- (3) the date of closing;
- (4) the gross proceeds of the transaction and, in the case of multiple transferors, the gross proceeds allocated to the transferor;
- (5) whether property or services are part of the consideration;
- (6) whether the transferor may receive non-cash property (other than cash) or services in satisfaction of an obligation having a stated principal amount;
- (7) whether the transferor may receive in connection with a contingent payment transaction an amount of gross proceeds that cannot be determined with certainty and is therefore not includable in gross proceeds;
- (8) the "reporting person's" name, address, and taxpayer identification number; and
- (9) any other information required by Form 1099 or its instructions. n103

In addition, in the case of a real estate transaction involving a residence, the "reporting person" must report:

- (10) the portion of any real property tax which is treated as a tax imposed on the purchaser; and
- (11) whether or not the financing (if any) of the seller was federally-subsidized indebtedness. n104

The reporting requirements do not apply to sales of residences for \$250,000 or less (\$500,000 or less if the seller is

married) if the "reporting person" receives written assurances that the residence is the seller's principal residence within the meaning of Section 121 of the Code; that the seller is married (if applicable); if applicable, that there is no subsidized mortgage financing assistance with respect to the property and various other certifications set forth by the IRS. n105

Although the statute applies to all other real estate transactions, Treasury regulations limit its application. Under the regulations, a transaction is a "real estate transaction" only if it consists in whole or in part of the sale or exchange of "reportable real estate" for money, indebtedness, property other than money, or services. n106 The term "sale or exchange" includes tax-deferred exchanges and sales of a principal residence qualifying under the law as in effect before the enactment of the *Taxpayer Relief Act of 1997* for rollover of gain. n107 The term "reportable real estate" means any present or future ownership interest in:

- (1) improved and unimproved land, including air space;
- (2) inherently permanent structures, including any residential, commercial, or industrial building;
- (3) any condominium unit and its appurtenant fixtures and common elements, including land; or
- (4) any stock in a cooperative housing corporation. n108

Excluded from the reporting requirement is any transaction that is not a sale or exchange, such as a gift, bequest, or financing or refinancing that is not related to the acquisition of reportable real estate, transfers to a creditor whose debt is secured by the property, and transfers for *de minimis* consideration (less than \$600). n109 Transactions involving a corporate or governmental transferor are also excluded. n110

For purposes of this provision, the "reporting person" is defined as:

- (1) the person (including any attorney or title company) responsible for closing the transaction;
- (2) the mortgage lender;
- (3) the seller's broker;
- (4) the buyer's broker; or
- (5) the buyer. n111

The primary responsibility for filing is on the person responsible for the closing. However, other parties to the transaction are also responsible in the order stated above. For example, if the person responsible for closing fails to report the transaction, the reporting obligation falls on the mortgage lender, and so on. A designation agreement may be executed transferring the primary responsibility to either the person (including any attorney or title company) responsible for closing the transaction or the mortgage lender. n112

The requisite form must be filed with the Service between January 1 and February 28 of the calendar year following the year of the transaction. n113 A copy of the form must be furnished to the transferor on or after the date of closing and before February 15 of the following year. n114

Penalties are provided for responsible parties who fail to comply with these information reporting requirements. n115

[7] Escrow Deposits

Real estate transactions frequently require escrow deposits at the time the transaction is entered into. An earnest money deposit, received on the execution of a contract, is not income until the taxpayer acquires an unconditional right to retain it. n116 If the sale is consummated, it fixes the seller's right to retain the deposit, and the earnest money is included as part of the sales proceeds. n117 If the sale is not consummated, the terms of the sales contract determine whether the seller may retain the deposit. If so, the deposit is included in income at the time the contract fixes the seller's right to retain it. n118 Because earnest money is in the nature of a payment for an option, it is included as ordinary income when it is forfeited to the seller. n119

FOOTNOTES:

(n1)Footnote 73. *IRC § 1001(a)*.

(n2)Footnote 74. *Crane v Commr*, 331 US 1 (1947) ; *Commr v Tufts*, 461 US 300 (1983) .

(n3)Footnote 75. *IRC § 1001(b)*.

(n4)Footnote 76. *Neighbors v Commr*, TC Memo 1998-263 .

(n5)Footnote 77. Some such expenses reduce the sale price and others that may appear similar increase the tax basis. The result is the same unless an installment sale is contemplated. See the discussion of this point in Ch 7.

(n6)Footnote 78. *IRC § 1001(a)*. The Tax Court has held that the payment of a guaranteed debt collateralized by property, made to avoid foreclosure following a default on the guaranteed debt, cannot be added to the seller's basis in computing gain or loss on the subsequent sale of the property. *Heger v Commr*, TC Memo 1993-408 , *affd in unpub opin* (5th Cir 1994).

(n7)Footnote 78.1. *Ltr Rul 200702032* .

(n8)Footnote 79. *Commr v Segall*, 114 F2d 706 (6th Cir 1940), 25 AFTR 698 , cert denied 313 US 562 (1941) , revg 38 BTA 43 .

(n9)Footnote 80. *Id*; *EK Wood Lumber Co v Commr*, 25 BTA 1013 (1932) , acq XI-2 CB 10; *American Land & Inv Co v Commr*, 40 F2d 336 (4th Cir 1930), 8 AFTR 10738 ; *Newaygo Portland Cement Co v Commr*, 27 BTA 1097 (1933) , acq XII-1 CB 9; *Borrelli v Commr*, TC Memo 1972-178 .

(n10)Footnote 80.1. See *Lowry v Commr*, TC Memo 2003-225, *motion for reconsideration and motion to vacate or revise denied TC Memo 2004-10*, *affd in unpubl opinion 2006-1 USTC P 50,187*, 171 Fed Appx 6 (9th Cir 2006) (court rejected taxpayer's argument that a sales transaction closed in an earlier year in which documents were delivered to escrow, rather than in the later year title to the property passed).

(n11)Footnote 81. *William v US*, 219 F2d 523 (5th Cir 1955), 46 AFTR 1725 .

(n12)Footnote 82. *Reed v US*, 723 F2d 138, 53 AFTR2d 335 .

(n13)Footnote 83. *Commr v Union Pacific RR Co*, 86 F2d 637 (2d Cir 1936), 18 AFTR 636 .

(n14)Footnote 84. *Keith v Commr*, 115 TC 605 (2000) ; *Commr v Segal*, 114 F2d 706 (6th Cir 1940), 25 AFTR 698 , cert denied 313 US 562 (1941) , revg 38 BTA 43 ; *Commr v Segall*, see n 81, *supra*.

(n15)Footnote 85. *Keith v Commr*, 115 TC 605 (2000) .

(n16)Footnote 86. *Keith v Commr*, 115 TC 605 (2000) ; see *Baertschi v Commr*, 412 F2d 494 (6th Cir 1969) , revg 49 TC 289 (1967) (Sixth Circuit refused to allow a "no recourse" clause to delay the finality of a contract of sale until

final payment of the total purchase price was made).

(n17)Footnote 87. *IRC § 1222(3)*.

(n18)Footnote 88. *Rev Rul 72-252, 1972-1 CB 193 ; Merrill v Commr, 40 TC 66 (1963) , affd 336 F2d 771 (9th Cir 1964), 14 AFTR2d 5703 .*

(n19)Footnote 89. *Rev Rul 66-7, 1966-1 CB 188 ; Weir v Commr, 10 TC 996 (1948) , affd 173 F2d 222 (3d Cir 1949), 37 AFTR 1022 .*

(n20)Footnote 90. *Paul v Commr, 206 F2d 763 (3d Cir 1953) .*

(n21)Footnote 91. *IRC § 1016(a)(2)*.

(n22)Footnote 91.1. *IRC § 1016(a)(2); Stoddard v Commr, TC Memo 2002-31*

(n23)Footnote 92. *IRC § 1001; see IRC §§ 1011, 1016(a)(2)*.

(n24)Footnote 92.1. *Rev Proc 2004-11, 2004-1 CB 311 ; see IRC § 1016(a)(2); also see Temp Treas Reg § 1.1016-3T(h)* (the "allowed or allowable" rule does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting under *IRC § 446(e)*).

(n25)Footnote 92.2. *IRC §§ 1(h)(1)(D), 1250(a)*.

(n26)Footnote 93. *IRC § 1250*.

(n27)Footnote 94. *IRC § 168(a)(1), (c)(3)*.

(n28)Footnote 95. *IRC § 1250(a)(1)(A)*.

(n29)Footnote 96. *IRC § 1250(b)(1)*.

(n30)Footnote 97. *IRC § 1250(a)(1)(B)(v)*.

(n31)Footnote 98. *IRC § 1250(a)(1)(B)(i)-(iv)*.

(n32)Footnote 99. *IRC § 1250(a)(2)(B)(iv)*.

(n33)Footnote 100. *IRC § 1250(a)(2)(B)(iii)*.

(n34)Footnote 101. *IRC § 1250(a)(2)(B)(i), (ii)*.

(n35)Footnote 102. *IRC § 1250(a)(3)*.

(n36)Footnote 103. *IRC § 6045(e)(1); Treas Reg §§ 1.6045-4(g), (h)*.

(n37)Footnote 104. *IRC § 6045(e)(4)*.

(n38)Footnote 105. *IRC § 6045(e)(5). Rev Proc 2007-12, 2007-4 IRB 354 . See Chapter 9.*

(n39)Footnote 106. *Treas Reg § 1.6045-4(b)(1)*.

(n40)Footnote 107. *Treas Reg § 1.6045-4(b)(1)*.

(n41)Footnote 108. *Treas Reg § 1.6045-4(b)(2)*.

(n42)Footnote 109. *Treas Reg* § 1.6045-4(c)(1).

(n43)Footnote 110. *Treas Reg* § 1.6045-4(d).

(n44)Footnote 111. *IRC* § 6045(e)(2); *Treas Reg* § 1.6045-4(e).

(n45)Footnote 112. *Treas Reg* § 1.6045-4(e)(1), (4), (5).

(n46)Footnote 113. *Treas Reg* § 1.6045-4(j).

(n47)Footnote 114. *IRC* § 6045(b); *Treas Reg* § 1.6045-4(m).

(n48)Footnote 115. *Treas Reg* § 1.6045-4(n).

(n49)Footnote 116. *Ahadpour v Commr*, *TC Memo* 1999-9 ; *Bourne v Commr*, 62 F2d 648 (4th Cir 1933) , affg 23 BTA 1287 (1931) .

(n50)Footnote 117. *Ahadpour v Commr*, *TC Memo* 1999-9 ; *Kang v Commr*, *TC Memo* 1993-601 ; *Kellstedt v Commr*, *TC Memo* 1986-435 .

(n51)Footnote 118. *Baird v US*, 65 F2d 911 (5th Cir 1933) ; *Ahadpour v Commr*, *TC Memo* 1999-9 .

(n52)Footnote 119. *Ahadpour v Commr*, *TC Memo* 1999-9 ; *Elrod v Commr*, 87 TC 1046 (1986) ; see *Kang v Commr*, *TC Memo* 1993-601 (taxpayers' right to earnest money was not fixed before they refunded a portion of it; the portion they kept was includable in ordinary income in the year they made refund, not the year they received the earnest money).



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Federal Taxes Affecting Real Estate

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CHAPTER 6 Dispositions of Real Estate by Sale, Abandonment and Casualty

1-6 Federal Taxes Affecting Real Estate § 6.03

§ 6.03 Use of Options in the Sale of Real Estate

The use of options offers advantages to both the buyer and seller of real property. A typical option will grant the proposed buyer the right to buy the property for a specified price within a specific period of time, and will require the prospective buyer to pay a non-refundable option premium. The option will give the buyer time to arrange the necessary financing and to decide if he really wants the property, and if the buyer does not exercise the option, the option premium gives the seller some compensation for having taken the property off the market during the option period.

n120

[1] Treatment of Proceeds

An option is a unilateral agreement. It imposes an obligation on the seller, who must sell, but not on the prospective purchaser, who is not required to buy. A binding purchase and sale contract is initiated only when the option is exercised. Therefore, the receipt of proceeds from the granting of an option to purchase real estate does not constitute a taxable event to either the seller or the buyer. n121 The seller has received cash or other consideration with no immediate taxable income to report, and the buyer has made payments having no immediate tax effect.

If an option lapses, the premium received by the grantor is taxable as ordinary income, n122 and the loss realized by the grantee will have the same character as the grantee would have had on a loss from the sale of the property subject to the option. n123

If an option is exercised, the seller treats the proceeds as part of the selling price of the property. This can result in capital gain treatment for the option payments as part of the proceeds from the sale of the underlying asset. n124 The amount paid for the option by the purchaser is added to its basis in the property.

The distinction between a payment pursuant to a contract of sale and an option premium is important because the first may give rise to a taxable event while the latter does not. For an option to exist, there must be a continuing offer that does not ripen into a contract until accepted, and an agreement to leave the offer open for a period of time. In addition, the holder of the option must have a present ability to accept the offer. n125 A premium payment for a right that does not constitute a true option to purchase property may be taxable to the grantor on receipt. A nonrefundable deposit received in connection with a proposed sale of a parcel of real estate may be economically equivalent to a premium for an option to purchase and, in that case, would be taxable when the purchase did not take place, or treated as part of the

purchase price if the transaction does close. n126 The court's reasoning was that the nonrefundable deposit was to be applied to the purchase price of the real estate.

The length and price of the option should be evidence that the agreement is not a sale. For example, the price of the option should not be equal to the fair market value of the property. The title to the property should remain in the seller's name and the option should not convey possession of the property or other incidents of ownership.

The distinction between granting an option and entering into a contract of sale can have implications beyond the timing of the tax obligation. The Service has ruled that the granting of an option to purchase property exercisable only after the taxpayer's death would not result in income in respect of a decedent if and when the option is exercised. The granting of the option is not a sale, exchange, or other disposition of the property and so is not a taxable event to the optionor. A transaction will create income in respect to a decedent under *IRC Section 691(a)(1)* if the right to receive that income is acquired by the decedent's estate from the decedent. Instead, the property would be included in the taxpayer's estate, valued at its fair market value taking into account the existence of the option. n127

[2] Sale or Exchange of Options

The nature of gain or loss from the sale or exchange of an option is determined by the character of the underlying property.

- (1) If the underlying property is or, if acquired, would be a capital asset, the holder of the option realizes capital gain or loss on its sale or exchange. The period during which the taxpayer holds the option determines whether the gain or loss is short-term or long-term.
- (2) Section 1231 gain or loss results if a sale of the underlying property by the holder of the option would have been subject to the provisions of *IRC Section 1231*. In this case, the option must have been held longer than one year.
- (3) Gain or loss from the sale or exchange of an option which does not result in capital gain or loss or Section 1231 gain or loss is considered ordinary gain or loss. n128

[3] Contribution of Options

Options can be used to make as charitable contributions. The writer of an option on real property to a charitable organization is allowed a charitable deduction for the year in which the organization exercises the option. n129 The value of the contribution is the excess of the fair market value of the property on the date the option was exercised over the exercise price. However, this is not a particularly tax efficient way to make a charitable contribution, because the taxpayer will recognize gain with respect to a portion of the transaction that is treated as a sale.

[4] Failure to Exercise an Option

A holder of an option who incurs a loss upon failure to exercise the option is deemed to have sold the option on the date it expired. n130 The loss cannot be claimed in a later year. n131 The rules for determining the nature of the loss are explained above in *Section 6.03[2]*. Gain to the grantor of an option arising at the time of the holder's failure to exercise the option is ordinary income to the grantor.

A taxpayer will face resistance from the tax system if it attempts to manipulate the time and circumstances in which it will become entitled to claim a loss relating to an expired option. In *Dunlap v. Commissioner*, n132 the taxpayer structured an option for property so that it constituted a series of one-year options. The Tax Court allowed each transaction to stand separately and allowed a loss upon each failure to exercise. However, the case was reversed on

appeal, wherein the court held that the option was still open by virtue of successive options. It should be noted that if the taxpayer had prevailed in *Dunlap*, the logical corollary would have been that the grantor would have had ordinary income as each one-year option "lapsed," even if the property was ultimately sold at a capital gain.

FOOTNOTES:

(n1)Footnote 120. *IRC § 1234*.

(n2)Footnote 121. *Lucas v N Texas Lumber Co*, 281 US 11 (1930), 8 AFTR 10276 . This rule applies, however, only to a true option; it would not apply to a "deep-in-money" option that is virtually certain to be exercised, and it would not apply to an option that is, in economic substance, a loan. *US Freight Co & Subs v Commr*, 442 F2d 887 (Ct Cls 1970) . *Rev Rul 80-72*, 1980-1 CB 109 .

(n3)Footnote 122. *Rev Rul 57-40*, 1957-1 CB 266 .

(n4)Footnote 123. *IRC § 1234(a)(1)*.

(n5)Footnote 124. *Koch v Commr*, 67 TC 71 (1976) , *acq* 1980-2 CB 1 ; *Dill Co v Commr*, 33 TC 196 (1959) , *nonacq* 1961-2 CB 6 , *affd* 294 F2d 291 (3d Cir 1961) .

(n6)Footnote 125. *Old Harbor Native Corp v Commr*, 104 TC 191 (1995) ; *Saviano v Commr*, 80 TC 955 (1983) , *affd* 765 F2d 643 (7th Cir 1985) .

(n7)Footnote 126. *Westall v Commr*, TC Memo 1988-421 ; see *Rev Rul 69-93*, 1969-1 CB 139 .

(n8)Footnote 127. *Rev Rul 71-265*, 1971-1 CB 223 ; *Ltr Rul 9325029* .

(n9)Footnote 128. *IRC § 1234*; *Treas Reg § 1.1234-1(a)(1)*, (2), (3).

(n10)Footnote 129. *Rev Rul 82-197*, 1982-2 CB 72 .

(n11)Footnote 130. *IRC § 1234(a)(2)*.

(n12)Footnote 131. *Patterson v Commr*, TC Memo 1998-182 .

(n13)Footnote 132. 670 F2d 785, 49 AFTR2d 82-667 (8th Cir 1982) , *revd* 74 TC 1377 (1980) .



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CHAPTER 6 Dispositions of Real Estate by Sale, Abandonment and Casualty

1-6 Federal Taxes Affecting Real Estate § 6.04

§ 6.04 Certain Voluntary and Involuntary Dispositions

Tax planning is also important when the owner of real property makes a voluntary or involuntary disposition of his property. Sound tax planning may minimize what appears to be an economic loss or may even convert it into an economic gain. The tax will depend on the type of disposition made. This section discusses the tax rules applicable to abandonments, casualties, and easements. Condemnations are discussed in detail in Chapter 8.

[1] Abandonments

The provision for depreciation is expected to take into consideration normal obsolescence applicable to depreciable property over the estimated useful life of such property. In most cases, taxpayers will be aware of ultimate obsolescence before the occurrence of the event or events which cause the abandonment of the asset. However, when the usefulness of the property is suddenly terminated, a deduction is available to the owner of the property at that time. This deduction is referred to as an abandonment loss.

A deduction is allowed for abandonments of land and buildings and other assets used in a business or held for investment. n133 The loss will be an ordinary loss if no sale or exchange is involved. Usually, there must be both a complete extinguishment of value and an identifiable event evidencing abandonment in the year in which the abandonment loss is taken for tax purposes. Some courts, however, have held that a loss can be claimed with respect to an abandonment even without worthlessness if a taxpayer can show any other closed and completed transaction or other event supporting worthlessness. n134 Similarly, some courts have held that abandonment is not a prerequisite to the deductibility of a loss based on worthlessness. While the test of complete extinguishment of value is a matter of reasonableness, the courts generally have held that a mere shrinkage of value is not sufficient to qualify for an abandonment deduction. n135 In their determination of "worthlessness," the courts have considered many factors, including:

- (1) The taxpayer's good faith determination of worthlessness.
- (2) Proof that the encumbrances upon the property exceed the property's value.
- (3) The refusal of the taxpayer to pay real estate taxes and other assessments with respect to the property when he is financially able to make such payments.

(4) Attempts made by the owner to sell the property prior to the year of loss.

(5) Increases in operating expenses that made the property uneconomic.

For an abandonment to take place, there must be an intent to abandon and a specific, identifiable event within the taxable year that shows a positive act of abandonment. n136 An abandonment may take place even if the taxpayer retains title to the property. n137 To qualify for a loss from the physical abandonment of raw land or depreciable buildings, a taxpayer must show an intent to discard the asset either irrevocably or permanently so that it will neither be used again by the taxpayer nor retrieved by the taxpayer for sale, exchange or other disposition. n138

Whether an abandonment has taken place is determined from all facts and circumstances. n139 Mere non-use of the property is not sufficient. The following acts can be significant indicators of abandonment:

- (1) refusing to make payments on indebtedness or taxes on the property;
- (2) vacating mortgaged premises and leasing new premises;
- (3) attempting to deed the mortgaged premises to the mortgagee or the local taxing authority;
- (4) cancelling all insurance on the property along with heat, light, and water used on the property;
- (5) cancelling an outstanding lease on the property;
- (6) charging off the lease on the taxpayer's books; or
- (7) surrendering control of the premises.

An abandonment cannot occur if a transferor intends for a particular person to be a transferee. Therefore, no abandonment loss is permitted if a taxpayer merely deeds a parcel of property to another. n139.1

An abandonment loss is allowable to the owner of business property to the extent of the adjusted basis of the property less any salvage. The adjusted basis of real estate is the depreciated basis of the building and the basis of the land. The extent of the tax benefit resulting from the disposition of property will depend on whether the loss offsets ordinary income or capital gains. There are certain instances in which such a loss could offset capital gains. Generally, however, losses resulting from the abandonment of depreciable business property will offset ordinary income. n140

There are several relevant cases that explain the circumstances that must be present to constitute an abandonment. In *Chevy Chase Land Company v. Commissioner*, n141 the landowner negotiated a long-term lease subject to the obtaining of certain zoning. When such zoning was rejected, the application costs were deducted as an abandonment loss. The court, while noting that rezoning costs are not deductible, held for the taxpayer on the basis of abandonment.

In *Hanover v. Commissioner*, n142 a hotel that was not required to meet the building code subjected itself to the code in accordance with an arrangement whereby a lessee would make the improvements. The lessee backed out, and the hotel was boarded up in lieu of a substantial expenditure for demolition. Utilities were cut off, insurance and maintenance were discontinued, and no efforts were made to lease or sell the building. The Tax Court allowed an abandonment loss even though the taxpayer still owned the land.

In *Gilman v. Commissioner*, n143 the taxpayer demolished a roof and replaced tenants' air conditioners scrapped in the demolition so that a second story could be placed on the building. The tax basis of the roof and the cost of the

replacement air conditioners were allowed as losses and were not required to be capitalized as a cost of the second-story addition.

A different result was reached in *Daily v. Commissioner*.ⁿ¹⁴⁴ In that case, the taxpayer purchased a building for use in his rental property business. After a few years of renting the property it was determined that the cost of maintaining and operating the rental property exceeded the rental income. After failing to sell the property, the taxpayer took steps intended to establish that it had abandoned the property. The Tax Court held against the taxpayer, however, disallowing the abandonment deduction because of a provision in the taxpayer's purchase contract entitling the seller to compel specific performance and require the taxpayer to pay the unpaid balance of the purchase price.

An otherwise abandoned expenditure, if part of an integrated plan that is implemented, is not an abandonment loss. This rule has been applied to disallow a deduction for the costs of unsuccessful lease applications that were part of a plan to eventually acquire a lease,^{n144.1} to engineering fees to examine potential, but unchosen, building sites as part of single project to investigate all available sites,^{n144.2} and to costs related to a purchase agreement that was canceled, when the taxpayer eventually purchased the property under different terms in the following year.^{n144.3}

[2] Casualty Losses

Casualty losses, namely, losses resulting from a sudden, unexpected, and identifiable event causing damage to or destruction of a taxpayer's property generally are deductible for tax purposes. Casualty losses include losses from fire, storm, shipwreck or other casualty.ⁿ¹⁴⁵ There must be evidence of physical damage in order to claim a casualty loss.^{n145.1} The loss must also be permanent in nature, and not merely temporary damage or interruption in the use of the property.^{n145.1.1} Expropriation is neither a casualty nor a theft, for loss deduction purposes.ⁿ¹⁴⁶ Neither is a governmental restriction, even if it is implemented in response to a casualty.^{n146.1} For example, a reduction in value to a beach lot owing to a new county setback restriction that was implemented after a hurricane is not a casualty loss because the proximate cause of any "loss" relating to it is a governmental restriction rather than the hurricane itself, and the government restriction is not a casualty.^{n146.2}

Surprisingly, the Internal Revenue Code and the regulations do not define the term "casualty loss," so courts determine on a case-by-case basis whether a casualty loss has occurred. A casualty does not include the progressive deterioration of property through a steadily operating cause.^{n146.3}

The required degree of suddenness is not clear however; deductions have been permitted for such slow casualties as termite damage^{n146.4} damage to trees caused by beetle infestation,^{n146.5} a 40-foot subsidence of land over a one-year period,^{n146.6} and cracks to a building that developed suddenly as the result of considerable, although not catastrophic, seismic activity occurring around the time they appeared.^{n146.7}

Casualty losses incurred with regard to property used in a trade or business or in any transaction entered into for profit are fully deductible.ⁿ¹⁴⁷ Other casualty losses (nonbusiness losses) by individual taxpayers are allowed only to the extent that: (1) they exceed \$100 per casualty (\$500, for tax years beginning in 2009);ⁿ¹⁴⁸ and (2) the net personal casualty losses for the year exceed 10 percent of the taxpayer's adjusted gross income.ⁿ¹⁴⁹

[a] General Comments on Casualty Losses

A casualty loss is deductible in the year in which it is sustained provided the amount of the loss is known.^{n149.1} However, if a taxpayer has a reasonable prospect of recovering insurance or other reimbursement at the end of a tax year, no deduction is allowed for that year; instead, the loss deduction is deferred until it can be ascertained with reasonable certainty whether or not such reimbursement will be received because, to the extent a taxpayer is reimbursed for a loss, it has not really "sustained" the loss.ⁿ¹⁵⁰ The loss is then allowed in the year any insurance claims are settled.ⁿ¹⁵¹ In general, casualty and theft losses are not subject to the passive loss rules.ⁿ¹⁵² (See Chapter 13 for

further discussion.)

Providing proof of a casualty loss is the responsibility of the taxpayer, and carelessness may result in a loss of all or part of the tax benefit. First, of course, a causative connection between the casualty and the physical damage must be shown. n152.1 Proof of the amount of loss must also be offered. It is important that the taxpayer's accumulation of proof be complete and objective. The best time to accumulate support for a casualty claim is as soon after the casualty as possible, certainly before cleaning up or making repairs. Receipted repair bills, photographs, and independent appraisals have proved invaluable in sustaining casualty deductions and, together with any other supporting evidence, should be obtained contemporaneously and retained until the tax issues relating to the casualty have been finally resolved. n153

In certain instances, it may be difficult or impossible to determine the amount by which the value of the property may have declined as a result of the casualty. It is then necessary for the taxpayer to look to the cost of restoration or repair to determine the amount of loss. In some instances, the cost of repair is the only accurate measure of the loss. Under these circumstances, it is necessary to show that the repairs are reasonable and necessary, cover only the damage suffered, and in no way increase either the value or useful life of the property beyond that which existed immediately prior to the casualty. n154 Estimates of the cost of repairs, however, are not evidence of the actual costs of repairs (and therefore sufficient evidence of casualty loss) unless the repairs are actually made. n154.1

Costs of precautionary measures to avoid a future casualty are not deductible as a casualty loss. Thus, the cost of removing trees to protect against potential damage to a residence, installing a burglar alarm or smoke detector, n154.1.1 or installing vinyl siding to protect a brick exterior of a home n154.1.2 is not deductible. In addition, no casualty deduction is permitted for a loss in market value due to temporary buyer resistance that is not the result of a permanent casualty to the property. n155 Regulations do not address the problem of loss created by buyer resistance, as opposed to physical damage. At least one court has held that permanent buyer resistance--as opposed to a temporary market fluctuation--may support a casualty loss deduction even in the absence of physical damage to property. n155.1 Absent physical damage to property, however, courts have been reluctant to find deductible casualty losses. n155.2

Special rules come into play in valuing casualty losses to timber. A timber depletion block is treated as the single, identifiable property for purposes of determining the limitation of a taxpayer's casualty loss deductions. n156 For losses to timber, a casualty loss exists only if there is a diminution in the fair market value of the single identifiable property. n156.1

Because the provisions dealing with damages or destruction to business property differ from those that apply to nonbusiness property, it will be necessary to discuss each separately.

[b] Business Property--Casualties

Business property includes all property used in a trade or business or held for the production of income. In the case of business property, any loss due to damage or destruction of a taxpayer's property is deductible. n157 However, if a sudden termination of usefulness is not caused by a tangible external force, it is considered "obsolescence" and may be eligible for a depreciation deduction. n158

If business property is completely destroyed, the allowed loss is equal to the adjusted basis of the property less any insurance and/or salvage. This is the amount of loss even if the fair market value of the property before the casualty is less than the adjusted basis of the property. n159 If the property is only partially destroyed, the allowable loss is limited to the lesser of the loss in value at the time of destruction or the adjusted basis of the asset. The loss in value caused by the destruction is equal to the difference between the fair market value of the property immediately before and immediately after the casualty. n160 Of course, insurance and other recoveries reduce the loss. n161

For property used in a trade or business, the loss must be determined by reference to the single identifiable property

damaged or destroyed. In the case of land with improvements, a separate basis must be assigned to each depreciable improvement to distinguish it from the land, which is not depreciable. n162 This requirement limits the amount of loss by preventing taxpayers from applying their entire cost basis in a property to calculate the amount of a casualty loss on a depreciable improvement. n163

When property has been used for both business and nonbusiness purposes (such as a realtor's combined office and home), loss must be computed as though two separate pieces of property were involved. The loss is allocated between business and nonbusiness losses according to the percentages by which the asset is used for business and nonbusiness purposes. The amounts deductible as business and non-business losses are determined separately. The \$100 per casualty requirement (\$500, for tax years beginning in 2009) n164 and the limitation based on 10 percent of the taxpayer's adjusted gross income n165 apply only to the non-business portion of the loss. n166

[c] Nonbusiness Property--Casualties

Nonbusiness property encompasses all property not held for investment or for use in a trade or business. The rules governing the deductibility of losses due to damage or destruction of a taxpayer's nonbusiness property are much more strict than those governing business property; only losses arising from storm, fire, shipwreck, theft, or other casualty are allowable. n167 "Other casualty" has been defined as a loss created by an external force that is sudden, unusual, and unexpected. Damage to lawn, trees, and shrubs from an erroneous application of weed killer has been allowed as a loss resulting from an "other casualty. n167.1 The omission of one of the aforementioned requirements generally will result in disallowance of the loss. n168 A casualty loss deduction has been allowed, however, for losses that, at first blush, would not qualify as a casualty. In one case, the Tax Court held that negligent work done by workmen, resulting in significant damage to a residence, gave rise to a deductible casualty loss. n169 An "other casualty" must not be due to the deliberate actions of the taxpayer. n170

The Service has long held that drought losses are not sudden, unusual, and unexpected. However, the President of the United States has announced in the past that certain drought areas qualify as disaster areas because of the impact of a drought in those regions. Since the disaster loss election of *IRC Section 165(i)* is available only if the loss qualifies as a casualty loss, this announcement seems to contradict the Service position that drought losses are not casualty losses.

A nonbusiness property loss is limited to the lesser of:

- (1) the reduction in the property's fair market value as a result of the casualty; or
- (2) the property's adjusted basis for determining the loss from a sale or other disposition. n171

Where property has a high fair market value and a low basis, insurance proceeds may well exceed the adjusted basis of the property. In that case, no casualty loss will be allowed. n171.1 Nonbusiness casualty losses by individual taxpayers are allowed only to the extent that they exceed \$100 (\$500, for tax years beginning in 2009). n172 In addition, nonbusiness casualty losses are allowed only to the extent that the taxpayer's net personal casualty losses for the year exceed 10 percent of the taxpayer's adjusted gross income. n173

In determining the adjusted basis of nonbusiness property subject to a casualty loss, the adjusted basis of the entire economic unit is used (rather than only the adjusted basis allocable to the specific property destroyed). n174 A further limit for nonbusiness property is that any individual nonbusiness loss that is covered by insurance is allowed only if the individual files a timely insurance claim with respect to the loss. n175

[d] Special Election for Disaster Losses

A special rule applies for losses arising from federally declared disasters. Taxpayers may elect to deduct these losses for

the tax year immediately preceding the tax year in which the disaster occurred. n176 Details regarding the election are discussed in Chapter 1, at § 1.05[2].

NOTE:

A variety of other special rules can come into play with respect to losses attributable to federally declared disasters, including an increase in the standard deduction by the amount of the disaster loss deduction, n177 a 5-year NOL carryback for qualified disaster losses, n178 a deduction for qualified disaster expenses, n179 and a waiver of certain mortgage bond revenue requirements for principal residences that are destroyed in disasters. n180-181 These rules are discussed in detail in Chapter 1, at § 1.05.

[3] Voluntary Removal or Destruction of Buildings

No deduction is allowed for the cost of demolition or for any loss associated with the demolition of any building. n182 This applies regardless of when the building was acquired or what the intention of the taxpayer was at the time of acquisition or whether the taxpayer is the owner or merely the lessee of the land. In lieu of the deduction, the tax basis of the land on which the building is located is increased. n183 This rule makes the costs and losses from demolition nondeductible. It also prevents these costs from being considered part of the depreciable basis of any replacement building, even if the demolition is undertaken as a necessary step in the construction of a new building. As a result, the costs involved cannot be recovered until the land is sold. n184 Where the demolished structure was on leased land, presumably the recovery of the demolition cost will be deferred until the end of the lease.

Under *IRC Section 280B*, the term "structure" includes only a building and its structural components, but not other inherently-permanent structures, such as oil and gas storage tanks, blast furnaces and coke ovens. n185

IRC Section 280B takes precedence over contrary Code provisions that otherwise might apply. For example, although *IRC Section 168(i)(8)* may allow a landlord to take a loss on lessor improvements that are abandoned or disposed of at the end of a lease term, n186 that provision does not apply to the extent *IRC Section 280B* applies to the demolition of a structure, a portion of which may include leasehold improvements. n187 *IRC Section 280B* also renders obsolete existing regulations under *IRC Section 165* that deal with losses relating to the demolition of buildings, to the extent those regulations are inconsistent. n188

The Service has issued a revenue procedure under which certain structural modifications to a building are not treated as a demolition under *IRC Section 280B*, but are instead subject to treatment as otherwise provided in the Code. n191 Depending on the particular expenditure, the modification may be expensed, capitalized and depreciated, or simply capitalized. n192

The revenue procedure contains two safe harbors. For buildings other than certified historic structures, a modification is not treated as a demolition under *IRC Section 280B* if:

- (1) 75 percent or more of the existing external walls of the building are retained in place as internal or external walls; and
- (2) 75 percent or more of the existing internal structural framework of the building is retained in place. n193

For certified historic structures, n194 a modification will be treated as a demolition under *IRC Section 280B* unless the above conditions are met and the modification is also part of a certified rehabilitation. n195

For tax planning purposes, the renovation of an older or damaged building may provide greater tax benefits than the

demolition of the building. In general, rehabilitation costs increase the depreciable basis of the building. n196 Rehabilitation costs may be recovered over the statutory recovery period through depreciation deductions. n197 In addition to depreciation deductions, tax credits may be available for rehabilitation expenses for older industrial and commercial buildings as well as for certified historic structures. n198 The tax savings resulting from recovering rehabilitation expenses through depreciation deductions instead of increasing the basis of land for demolition expenses may be significant. n199

[4] Proceeds From Granting of Easements

Although the term "easement" is susceptible to many definitions, it generally is defined as an interest in real property for a special purpose. Before a determination can be made as to the proper tax treatment of the grantor's receipt of proceeds from the easement, it is necessary to know the effect of the easement on the grantor.

If the grantor is deprived of the beneficial use of the land, the grant is treated as a sale of all or a portion of the land on which gain or loss is recognized. If the grantor retains the beneficial use of the land, however, the transaction is considered a "sale of an easement in which proceeds are first applied to reduce the basis of the burdened land." n200 The following examples demonstrate this distinction:

Example:

Sale of an easement:

The owner of real property grants rights to the U.S. government to flood land for flood control purposes under a "flowage deed." The flooding occurs infrequently, and the owner reserves the use of the land when not flooded. The owner is deemed to retain beneficial use of the land, and the grant is considered a "sale of an easement."

The proceeds from the "sale of an easement" first reduce the basis of the subservient land, and only after all tax basis is recovered will gain or loss be recognized. n201

Example:

Sale of land:

The owner of real property grants an easement to a levee district to utilize the land to suit its needs. The land is usually flooded, and the owner is deprived of substantial use of the land under easement. The grant is deemed to be a "sale of land" since only bare legal title is retained by the owner.

Gain or loss must be recognized on the "sale of land," whereas when gain or loss is recognized, it is subject to the same rules as apply to a sale of land.

If the easement affects only part of the taxpayer's property, only the basis allocable to such portion is taken into account in determining the amount of gain realized. n202 As previously stated, any excess of proceeds from the sale of the easement over the allocated basis of the property subject to the easement results in taxable gain. n203

If it is not possible to allocate between the portion of the transaction that is a "sale of land" or a "sale of an easement," the transaction results in gain only if the consideration for the grant exceeds the basis of the entire property. In addition, when it is impossible to determine how much of the property would be affected by the easement, the consideration received for the easement reduces the basis of the entire property. n204

The following is an example of the tax treatment applicable to amounts received for granting an easement:

Example:

A purchased 20,000 acres of land for \$1 million to be used for raising cattle. A granted an easement to a public utility covering a narrow strip of land running through 1,000 acres. In return for this right, A received \$10,000. Based upon appraisals, A has allocated \$20,000 as the cost basis of the portion of the land burdened by the easement. In Case 1 below, the tax consequences are presented, assuming that A is deprived of all beneficial interest in the portion of the land burdened by the easement. In Case 2, A has retained beneficial use of the property.

Case 1		Case 2	
Allocated basis	\$..... 20,000	Allocated basis	\$.....20,0 00
Proceeds received	10,000	Proceeds received	10,000
Loss recognized	\$..... 10,000	Loss recognized	--0--
		Revised adjusted basis	\$.....10,0 00

If the proceeds had been \$30,000 a gain of \$10,000 would be recognized in both cases since the proceeds exceed the allocated basis of the easement.

FOOTNOTES:

(n1)Footnote 133. *Treas Reg § 1.165-2(a)*. Losses incurred in connection with nonbusiness assets are not eligible for abandonment loss deductions. See *Millstein v Commr, TC Memo 1994-14* where architectural fees paid for the construction of a house that was never built were not deductible as an abandonment loss because they were found by the Tax Court to be nondeductible personal expenses.

(n2)Footnote 134. *Echols v Commr, 935 F2d 703 (5th Cir 1991)*, rehearing denied 950 F2d 209 (5th Cir 1991); see *Proesel v Commr, 77 TC 992 (1981)*.

(n3)Footnote 135. *White Star Line v Commr, 20 BTA 111 (1930)*.

(n4)Footnote 136. *Echols v Commr, 935 F2d 703 (5th Cir 1991)*, rehearing denied 950 F2d 209 (5th Cir 1991); *Middleton v Commr, 77 TC 310 (1981)*, affd 693 F2d 124 (11th Cir 1982); *Chevy Chase Land Co v Commr, 72 TC 481 (1979)*; *Orozco v Commr, TC Memo 1994-407*, affd 67 F3d 314 (11th Cir 1995).

(n5)Footnote 137. *Rhodes v Commr, 100 F2d 966 (6th Cir 1939)*.

(n6)Footnote 138. *Treas Reg §§ 1.165-2(a), 1.167(a)-8(a)(4)*.

(n7)Footnote 139. *Orozco v Commr, TC Memo 1994-407*, affd 67 F3d 314 (11th Cir 1995); *United California Bank v Commr, 41 TC 437 (1964)*, affd per curiam 340 F2d 320 (9th Cir 1965).

(n8)Footnote 139.1. *Strandquist v Commr, TC Memo 1970-84*; *Tsakopoulos v Commr, TC Memo 2002-8*, affd 63 Fed Appx 400 (9th Cir 2003).

(n9)Footnote 140. See *Treas Reg § 1.167(a)-8(a)(4)*.

- (n10)Footnote 141. *72 TC 481 (1979)* .
- (n11)Footnote 142. *TC Memo 1979-332* .
- (n12)Footnote 143. *72 TC 730 (1979)* .
- (n13)Footnote 144. *81 TC 161 (1983)* , *affd 742 F2d 1461 (9th Cir 1984)* .
- (n14)Footnote 144.1. *Nicolazzi v Commr, 79 TC 109 (1982)* , *affd 722 F2d 324 (6th Cir 1983)* .
- (n15)Footnote 144.2. *United Dairy Farmers, Inc v US, 2001-2 USTC P 50,680 (6th Cir 2001)*.
- (n16)Footnote 144.3. *FRGC Investments LLC v Commr, TC Memo 2002-276* .
- (n17)Footnote 145. *IRC § 165(c)(3); Treas Reg § 1.165-7(a); White v Commr, 48 TC 1334 (1980)* ; *Portman v US, 683 F2d 1280 (9th Cir 1982)* .
- (n18)Footnote 145.1. *Kamanksi v Commr, 477 F2d 452 (9th Cir 1973)* , *affg TC Memo 1970-352* ; *Torre v Commr, TC Memo 2001-218* (racial harassment that prompted a taxpayer to sell his home did not support a casualty loss deduction because there was no physical damage or destruction to the property resulting from the harassment).
- (n19)Footnote 145.1.1. *Godwin et al v Commr, TC Memo 2003-289* (no casualty loss to beach property found when the sand lost during a hurricane had been replenished); *Bidelspacher v Commr, TC Memo 1980-538* .
- (n20)Footnote 146. *Houhari et al v US, 98-2 USTC P 50,677 (D Md 1998)*.
- (n21)Footnote 146.1. *Kemper v Commr, 30 TC 546 (1958)* , *affd 269 F2d 184 (8th Cir 1959)* ; *Maher v Commr, 680 F2d 91 (11th Cir 1982)*, *affg 75 TC 593 (1981)*; *Coleman v Commr, 76 TC 580 (1981)* .
- (n22)Footnote 146.2. *Godwin et al v Commr, TC Memo 2003-289* .
- (n23)Footnote 146.3. *Barnes v Commr, TC Memo 2000-254* , *affd 12 Fed Appx 415 (7th Cir 2001)* (casualty loss deduction denied for costs of restoring a pond due to damage that occurred over a two-to-three-year period); *Fay v Commr, 120 F2d 253 (2nd Cir 1941)* , *affg per curiam 42 BTA 206 (1940)* ; *Durden v Commr, 3 TC 1 (1944)* .
- (n24)Footnote 146.4. *Rosenberg v Commr, 198 F2d 46 (8th Cir 1952)* .
- (n25)Footnote 146.5. *Black v Commr, TC Memo 1977-337, 36 TCM 1347* .
- (n26)Footnote 146.6. *Grant v Commr, 30 BTA 1028 (1934)* .
- (n27)Footnote 146.7. *Abrams et al v Commr, TC Memo 1981-231* .
- (n28)Footnote 147. *IRC § 165(c)(1), (2)*.
- (n29)Footnote 148. *IRC § 165(h)(1)*.
- (n30)Footnote 149. *IRC § 165(h)(2); Kay, Sr v Commr, TC Memo 2002-197* .
- (n31)Footnote 149.1. *IRC § 165(a); Lewis v Commr, TC Memo 2000-249* ; *Katz v Commr, TC Memo 1983-8* .
- (n32)Footnote 150. *Treas Reg § 1.165-1(d)(2)(i); Julicher v Commr, TC Memo 2002-55* .
- (n33)Footnote 151. *Seidenfeld v Commr, TC Memo 1995-61* ; *Allied Furriers Corp v Commr, 24 BTA 457 (1931)* .

(n34)Footnote 152. *Treas Reg § 1.469-2(d)(2)(xi)*.

(n35)Footnote 152.1. *Kemper v Commr*, 30 TC 546 (1958) , *affd* 269 F2d 184 (8th Cir 1959) ; *Godwin et al v Commr*, TC Memo 2003-289 , *affd per curiam* 143 Fed Appx 303 (11th Cir 2005) (deduction for alleged earthquake damage to house denied because although the taxpayers submitted pictures of cracks to the exterior, they failed to offer expert opinion or independent evidence that seismic activity caused them. There was no evidence that the cracks could not have been caused by a structural flaw in the residence or other non-casualty cause); *Abrams et al v Commr*, TC Memo 1981-231 (cracks in a building were shown to have resulted from earthquake activity, so casualty loss was allowed).

(n36)Footnote 153. See *Treas Reg § 1.165-7(a)(2)*; *Lamphere v Commr*, 70 TC 391 (1978) ; *Fast v Commr*, TC Memo 1998-272 ; *Godwin et al v Commr*, TC Memo 2003-289 , *affd per curiam* 143 Fed Appx 303 (11th Cir 2005) ; *Sykes v Commr*, TC Memo 2010-84 (2010) (no casualty loss deduction allowed from water damage to home from bursting pipe. Insurance company's repair estimate was just over \$6,000, but taxpayers claimed \$45,000 loss based on vague and incomplete appraisal of home after sustaining the water damage).

(n37)Footnote 154. *Treas Reg § 1.165-7(a)(2)(ii)*; *Hagerty v Commr*, TC Memo 1975-66 .

(n38)Footnote 154.1. *Kay, Sr. v Commr*, TC Memo 2002-197 ; *Ashley v Commr*, TC Memo 2000-376 ; see *Lamphere v Commr*, 70 TC 391 (1978) ; *Farber v Commr*, 57 TC 714 (1972)

(n39)Footnote 154.1.1. See *Austin v Commr*, 74 TC 1334 (1980) .

(n40)Footnote 154.1.2. *Godwin et al v Commr*, TC Memo 2003-289 , *affd per curiam* 143 Fed Appx 303 (11th Cir 2005) .

(n41)Footnote 155. *Philmon v US*, 99-2 USTC P 50,832 (MD Fla 1999) (no deduction allowed for alleged reduction in value of citrus groves that were subject to freezing; reduction resulted from buyer resistance to the purchase of freeze-prone citrus grove land); *Lund v US*, 2000-1 USTC P 50,234 (D Utah 2000) (casualty loss deduction denied because claim was based on avalanche risk and lower market value due to temporary buyer resistance); *Thornton v Commr*, 47 TC 1 (1966) ; *Peterson v Commr*, 30 TC 660 (1958) ; *Pulvers v Commr*, 407 F2d 838 (9th Cir 1969) , *aff'g* 48 TC 245 (1967) ; see *Finkbohner v US*, 788 F2d 723 (11th Cir 1986) (deduction allowed when flood caused permanent reduction in value of properties due to diminished attractiveness of neighborhood and the loss of privacy).

(n42)Footnote 155.1. *Finkboner v US*, 788 F2d 723 (11th Cir 1986) .

(n43)Footnote 155.2. *Caan v US*, 1999 US Dist LEXIS 6886 (CD Ca 1999) and *Chamales v Commr*, TC Memo 2000-33 (both cases denying loss based on reduction in market value to property near location of OJ Simpson's former home resulting from media frenzy after the murders).

(n44)Footnote 156. *Weyerhaeuser Company and Subs v US*, 96-2 USTC P 50,420 (Fed Cir 1996), *on remand* 97-2 USTC P 50,880 (US Ct of Fed Cls 1997); *International Paper Company and Consolidated Subsidiaries v US*, 97-2 USTC P 50,911 (US Ct of Fed Cls 1997).

(n45)Footnote 156.1. *Treas Reg § 1.165-7(b)(1)*; *Westvaco Corp v US*, 639 F2d 700 (Ct Cl 1980) ; see *FSA 200229007* .

(n46)Footnote 157. See *IRC § 165(c)(1), (2)*; see *Taylor v Commr*, TC Memo 1998-351 (loss denied because property not held with profit motive).

(n47)Footnote 158. See *Treas Reg §§ 1.167(a)-8, 1.167(a)-9*; see Chapter 5 for a discussion of depreciation.

(n48)Footnote 159. *Treas Reg § 1.165-7(b)(1)*. See *McClune v Commr*, TC Memo 2005-47 (limitation of

deductible loss to adjusted basis applies when determining loss to remainder interest in property).

(n49)Footnote 160. *Id.*

(n50)Footnote 161. *IRC § 165(a).*

(n51)Footnote 162. *Treas Reg § 1.165-7(b)(2)(i); Keefer v Commr, 63 TC 596 (1975) ; Cziraki v Commr, TC Memo 1998-439 , affd 2001-1 USTC P 50,141 (9th Cir 2000); Trinity Meadows Raceway, Inc v Commr, TC Memo 1998-79 , affd 99-2 USTC P 50,754 (6th Cir 1999).*

(n52)Footnote 163. *Cziraki v Commr, TC Memo 1998-439 , affd 2001-1 USTC P 50,141 (9th Cir 2000); Trinity Meadows Raceway, Inc v Commr, TC Memo 1998-79 , affd 99-2 USTC P 50,754 (6th Cir 1999).*

(n53)Footnote 164. *See IRC § 165(h)(1).*

(n54)Footnote 165. *See IRC § 165(h)(2).*

(n55)Footnote 166. *See Treas Reg § 1.165-7(b)(4)(iv).*

(n56)Footnote 167. *IRC § 165(c)(3).* See, eg, *Beyer v Commr, TC Memo 1993-313* (although Tax Court denied casualty loss deduction, court acknowledged that storm damage to beach, without damage to buildings or other improvements, may be basis of casualty loss if it reduces the value of the property below its fair market value before the casualty).

(n57)Footnote 167.1. *Farber v Commr, 57 TC 714 (1972) .*

(n58)Footnote 168. *Orozco v Commr, TC Memo 1994-407 , affd 67 F3d 314 (11th Cir 1995) ; Billman v Commr, 73 TC 139 (1979) ; White v Commr, 48 TC 430 (1967) ; Popa v Commr, 73 TC 130 (1979) .*

(n59)Footnote 169. *Marx v Commr, TC Memo 1991-598 .*

(n60)Footnote 170. *Orozco v Commr, TC Memo 1994-407 , affd 67 F3d 314 (11th Cir 1995) ; White v Commr, 48 TC 430 (1967) .*

(n61)Footnote 171. *Treas Reg § 1.165-7(b)(1); McClune v Commr, TC Memo 2005-47* (adjusted basis limitation applied to taxpayer's partial remainder interest in damaged property).

(n62)Footnote 171.1. *Lafavre v Commr, TC Memo 2000-297 ; see Treas Reg § 1.165-7(b)(1).*

(n63)Footnote 172. *IRC § 165(h)(1).*

(n64)Footnote 173. *IRC § 165(h)(2); Daniel v Commr, TC Memo 1997-328 .*

(n65)Footnote 174. *Treas Reg § 1.165-7(b)(2)(ii); Strutz v Commr, TC Memo 1980-274 ; Beyer v Commr, TC Memo 1993-313 .*

(n66)Footnote 175. *IRC § 165(h)(5)(E).*

(n67)Footnote 176. *IRC § 165(i).*

(n68)Footnote 177. *IRC § 63(c)(1)(D).*

(n69)Footnote 178. *IRC § 172(b)(1)(J), (j).*

(n70)Footnote 179. *IRC § 198A.*

(n71)Footnote 180-181. *IRC § 143(k)(12).*

(n72)Footnote 182. *IRC § 280B.*

(n73)Footnote 183. *IRC § 280B(a)(2); Gates v US, 98-1 USTC P 50,353 (MD Pa 1998), aff'd 98-2 USTC P 50,814 (3rd Cir 1998).*

(n74)Footnote 184. *See IRC § 280B.*

(n75)Footnote 185. *Treas Reg §§ 1.48-1(e), 1.280B-1(b).*

(n76)Footnote 186. *See IRC § 168(i)(8).*

(n77)Footnote 187. *IRC § 280B(a)(1); Conf Com Rpt to Pub L No 104-188, § 1121(a).*

(n78)Footnote 188. *See Treas Reg § 1.165-3.*

(n79)Footnote 191. *Rev Proc 95-27, 1995-1 CB 704 .*

(n80)Footnote 192. *See IRC §§ 162, 168, 263, 263A.*

(n81)Footnote 193. *Rev Proc 95-27, 1995-1 CB 704 .*

(n82)Footnote 194. *See IRC § 47(c)(3).*

(n83)Footnote 195. *Rev Proc 95-27, 1995-1 CB 704 ; see IRC § 47(c)(2)(C).*

(n84)Footnote 196. *IRC § 1016(a)(1).*

(n85)Footnote 197. *IRC § 168.*

(n86)Footnote 198. *IRC § 47.*

(n87)Footnote 199. *See IRC §§ 47, 168.*

(n88)Footnote 200. *Rev Rul 59-121, 1959-1 CB 212 .; Rev Rul 68-291, 1968-1 CB 351 .*

(n89)Footnote 201. *Conway v US, 31 AFTR2d 73-1028 (D Ky 1973) .*

(n90)Footnote 202. *Rev Rul 68-291, 1968-1 CB 351 .*

(n91)Footnote 203. *Rev Rul 73-161, 1973-1 CB 336 .*

(n92)Footnote 204. *Inaja Land Co v Commr, 9 TC 727 (1947) , acq 1948-1 CB 2 .*



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Federal Taxes Affecting Real Estate

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CHAPTER 6 Dispositions of Real Estate by Sale, Abandonment and Casualty

1-6 Federal Taxes Affecting Real Estate § 6.05

§ 6.05 Charitable Contributions of Real Property

[1] In General

Charitable contributions of real estate can provide valuable deductions for both income tax and estate planning purposes. Subject to annual percentage limits that restrict the amount of deduction in a given year and limitations based on the characteristics of the donee organization, n205 a taxpayer making a charitable contribution of capital gain property held for more than one year is entitled to a deduction equal to the fair market value of the property at the time of the contribution. By making a contribution of appreciated real estate, a taxpayer may thereby take a deduction equal to the fair market value of the property and at the same time avoid recognizing any gain resulting from the appreciation. n206 There must, of course, be a bona fide transfer of property in order for a valid contribution to exist. n206.1 This requirement is not usually in issue. n206.2

The "fair market value" standard in valuing a charitable contribution of property contemplates a hypothetical seller and buyer, and precludes consideration of specific characteristics of any buyer or seller. That a property may have a value to a particular recipient that exceeds the fair market value does not permit a charitable deduction above the fair market value of the property on the open market. n207

If the real estate contributed has not been held long enough to qualify for long-term capital gain treatment if it were sold (more than one year), n208 then the amount of the charitable contribution deduction must be reduced by the amount of gain that would have not been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value. n209

Any amount not deductible in the year of contribution because of the annual percentage limitations may be carried over to the next five years. n210 Qualified conservation contributions of real property are entitled to a 15-year carryover period. n210.1

In general, no deduction is allowed for gifts of partial interests in property, other than certain transfers in trust. n211 There are three exceptions to this rule. A deduction is allowed for a charitable contribution of the following partial interests in real estate: n212

- (1) the remainder interest in a personal residence or farm; n213

(2) an undivided portion of the taxpayer's entire interest in property (such as a percentage interest in real estate); n214 and

(3) a qualified conservation easement. n215

If the rights in the contributed property retained by the donor are so insubstantial that the donor has, in substance, transferred his or her entire interest in the property, the partial interest limitations do not apply and the charitable deduction is allowed. n215.1

If a donor retains a purchase option on property donated to charity and the possibility that the option will be exercised is not remote, then the donation is not considered to be made until the option expires, and the value of the donation is determined at that time. n216

A contribution of a right to use property is treated as a contribution of less than the taxpayer's entire interest in the property. n217 As a result, the conveyance of rent-free use and occupancy of real property does not qualify as a deductible charitable contribution. n218 A taxpayer may, however, claim a charitable deduction for expenses incurred with respect to real property that is being used by a charitable organization. To do so, the taxpayer must substantiate any "contribution" of the expenses that exceed \$250 with a written acknowledgment from the charitable organization. n218.1

Charitable contribution deductions are allowed for donations of all types of properties. Deductions have been permitted for donations of grave sites, n219 oil and gas wells, speculative property rights in land submerged in a man-made canal, n220 and even air space easements. n221 The waiver of a federal grazing permit back to the federal government when an underlying ranch is sold, however, is ineligible for a charitable deduction because under federal law, the permit holder does not have a transferable interest that can be sold or transferred. n221.1

The fair market value of donated property is the most frequently litigated issue in charitable contribution cases. The issue is a question of fact to be determined from all relevant evidence in the record. n222 Valuation of real property in general is discussed in detail in Chapter 20, "Valuation of Real Property." One specific rule regarding valuation comes into play for charitable contributions of remainder interests in real property, and should be noted here. In determining the value of a remainder interest in real property for purposes of computing a charitable deduction for income tax purposes, depreciation (using the straight line method) and depletion (using the cost depletion method) of the property must be taken into account. n222.1 The value of the remainder interest must also be discounted at a rate of 6 percent per year unless the Secretary provides a different rate by regulations. n222.2

NOTE:

Depreciation is not taken into account in computing the valuation of the remainder for gift tax purposes. Therefore, the value of the charitable remainder interest will be higher for gift tax purposes than for purposes of computing the income tax deduction. n222.3

[2] Donative Intent

For a charitable deduction to be allowed when property is contributed, the taxpayer must have the requisite donative intent to make a gift. n223 To satisfy this criterion, the donation must be made with a detached and disinterested generosity, and without any expectation of something in return. n224 Both the subjective attitude of the grantor and the benefits which the grantor expects to directly or indirectly receive as a result of the transaction are considered. The question of whether a taxpayer makes a gift or has transferred property in return for receipt of economic benefits is one of fact. n225

For an estate to claim a charitable deduction, the decedent's will must provide evidence of a charitable intent. The transfer of real property to a charity by estate trustees or the executor does not entitle the estate to a charitable contribution deduction unless there is a clear direction from the decedent that a charitable transfer is intended. n226

A transfer that is motivated primarily by the anticipation of an economic benefit or is in fact an exchange in the form of a *quid pro quo* does not qualify as a charitable contribution. Charitable deductions have been denied where taxpayers transferred property:

- pursuant to a contractual obligation or local ordinance;
- in exchange for a zoning change or variance or permit; or
- in exchange for a promise by a city to construct schools or widen roads. n227

The IRS has also questioned a deduction for a donation of rights of way under the Rails to Trails program, finding the donation to be an attempt to gain a substantial economic benefit, i.e., avoid the cost and burden of maintaining unused rights-of-way but retain the right to reactivate service (a valuable asset) in the future should it become economically advantageous. n227.1

In at least one case, the IRS made a blanket assertion that taxpayers who donate conservation easements cannot have the requisite donative intent to make a gift because their primary motivation is to maintain property values and obtain a deduction. The court rejected that argument. n228 Indeed, courts can be fairly liberal in finding donative intent, notwithstanding the reservation of rights in the property, if something of value is in fact given. In one case, a deduction was permitted for the donation of a scenic easement even though the taxpayers reserved rights to subdivide the easement property, build four new family residences and roads, cut timber, and farm portions of the property. The court granted a partial deduction because the easement did impose restrictions on commercial activity, construction and various mining and other activities. The court found that the transfer of these restrictions was a transfer of something of value for which the taxpayers were entitled to a charitable deduction, notwithstanding their retention of other rights in the property. n229

In at least one ruling, however, the IRS has given a caveat that an conservation easement deduction may be lost, even without a *quid pro quo* arrangement or exchange if property retained by the taxpayer would increase as a result of the easement. n229.1

[3] Qualified Conservation Contributions; Scenic and Conservation Easements

[a] Overview of Requirements for Charitable Deduction

A charitable contribution deduction is allowed for a qualified conservation contribution. n230

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization made exclusively for conservation purposes. n231 In addition, to be eligible for a deduction, the conservation purpose must be protected in perpetuity. n232

[b] Qualified Real Property Interest and Qualified Donee Requirements

The requirements of a qualified real property interest n233 and a qualified donee organization n234 are straightforward and seldom litigated. It is probably prudent, however, to restrict donations to established, well-known groups whose dedication to conservation purposes is unquestioned. Even then, the IRS may require restrictions in the deed regarding later transfers of that property by the initial donee. As a condition to granting a favorable ruling on an easement

donation, the IRS in rulings has required the taxpayer to add to the deed a restriction that the donee could transfer the easement only to a transferee that had a commitment to protect the conservation purposes of the donation and the resources to enforce the restrictions of the deed. n234.1 A contribution to a government entity or agency, such as a county, would also qualify. n234.2

A qualified real property interest includes the following: n235

- (1) an entire interest of the donor, other than a qualified mineral interest;
- (2) a remainder interest; and
- (3) a restriction granted in perpetuity on the use which may be made of the real property.

Scenic and conservation easements are included in the third category. A scenic easement is a negative easement--one that prevents certain activities on property. Typically, a scenic easement protects the public's right to sunlight or a view of landscape or sky. It may also bar an owner from erecting certain obstructive structures. A conservation easement is an affirmative easement that preserves or gives access to property to people who do not own or lease it.

[c] Qualified Conservation Purposes

In general, a contribution is for a conservation purpose if it does any of the following: n236

- Preserves land for outdoor recreation by, or the education of, the general public;
- Protects a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
- Preserves open space for the scenic enjoyment of the general public or pursuant to a federal, state, or local governmental conservation policy, and this preservation will yield a significant public benefit; or
- Preserves a historically important land area or a certified historic structure.

Each of the above four prongs is a conservation purpose in and of itself, and a taxpayer's satisfaction of one of these prongs suffices to establish the requisite conservation purpose. n236.1 Uses that satisfy the open space requirement usually involve the preservation of the natural state of land. Legislative history gives the following as qualifying examples: n236.2

- Preservation of land as a public garden;
- Preservation of farmland pursuant to a State program for flood prevention and control;
- Preservation of a unique natural land formation for the enjoyment of the general public;
- Preservation of woodland along a Federal highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway; and
- Preservation of a stretch of undeveloped oceanfront property located between a public highway and the ocean so as to maintain the scenic ocean view from the highway.

In one case, a taxpayer was denied a charitable contribution for a deed to the county that limited development of a specified property to 30 lots, rather than the 62 lots it was supposedly entitled to. The "open space" requirement was not

met because there were no restrictions placed on open space within the buildable area, nor did anything in the deed limit the size of homes that could be built, so as to protect the view from a nearby historical area, or prevent the owner from later seeking rezoning to a denser development classification. n236.3 The same case also held that the attempted easement did not satisfy the historic preservation requirement prong. The property being developed did not contain any historical structure to preserve, and the proposed limitation on development of land did nothing to protect historical structures on nearby land that the taxpayer did not own. n236.4

It is not usually difficult to satisfy the "conservation purpose" requirement, n236.5 but the IRS can take a surprisingly hard line at times. In one significant case, the full Tax Court rejected the IRS position, and held that an easement that restricted the development of Lake Michigan property in order to protect habitat for two endangered plant species and preserve a roosting spot for bald eagles satisfied the second prong in protecting a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem. n236.6 The Sixth Circuit affirmed. n236.7

A problem with respect to conservation purposes can arise if a donation achieves one of the required conservation purposes, but would permit destruction of some other significant conservation interest. In that case, a deduction is prohibited. n237

[d] Perpetuity Requirement

As noted above, a contribution of a qualified real property interest may be exclusively for conservation purposes only if it is protected in perpetuity. n237.1 With respect to the perpetuity requirement, regulations require legally enforceable restrictions against property retained by the donor, and that the donor agree in writing to various donee rights to assist enforcement of the easement. n238 For donated property that is subject to a mortgage, the mortgagee must subordinate its rights in the property to the rights of the qualified organization to enforce the conservation purposes of the gift. n239 If a donation of property may be defeated by the performance of some act or by a subsequent event, a deduction is permitted only if the possibility of the occurrence of such an act or event on the date of the gift is so remote as to be negligible. n240 The term "so remote as to be negligible" has been defined in various ways. n241 To avoid problems over whether the possibility of a defeating event in the future is sufficiently remote, a donor should obtain a statement signed by the donee as a condition to the gift of property. The statement should indicate the donee's future plans with respect to the property, as well as the remoteness of the danger of a reversion.

If a subsequent unexpected change in the conditions surrounding the property that is the subject of a conservation easement donation can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution. n241.01 For this use-of-proceeds requirement to be met, the donor, at the time of the gift, must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that, at the time of the gift, is at least equal to the proportionate value that the perpetual conservation restriction bears to the value of the property as a whole. That proportionate value of the donee's property rights must remain constant. Thus, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction. This requirement need not be met, however, if state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction. n241.02

NOTE:

A simple mortgage may cause this "use-of-proceeds" requirement to be unmet and lead to a denial of a charitable deduction. In one case, the taxpayers were denied a deduction for the donation of a facade easement on a property on which they had a mortgage. The lending bank retained a "prior claim" to all

proceeds of condemnation and to all insurance proceeds as a result of any casualty on the property. The bank retained its preference for these proceeds (over the charitable donee) until such time as the mortgage was satisfied and discharged. As a result of this priority, the court found that the facade easement donation was not protected in perpetuity, and it denied a charitable deduction. n241.03

As part of satisfying the perpetuity requirement, any deed to the qualified organization should also require that any transferee to whom the donee might transfer the easement also have a commitment to protect the conservation purposes of the easement and the resources to enforce easement restrictions. n241.1

A charitable deduction may be taken for a contribution of a permanent conservation easement where a mineral interest has been retained and surface mining is possible, as long as the probability of surface mining is so remote as to be negligible. n242

[e] Effect of Incidental Benefit to Donor

The existence of donative intent may be questioned if a taxpayer receives something other than an incidental benefit as a result of the grant of conservation restrictions where the easement limits the uses to which the taxpayer's property may be put. n243 The IRS has even indicated that a *quid pro quo* arrangement or exchange isn't necessary for an improper benefit to be present. In one ruling it suggested that a deduction for a conservation easement donation would be lost if property retained by the taxpayer would increase as a result of the donation. n243.1

[f] Valuation Issues

The most frequently litigated issue with respect to contributions of conservation and scenic easements is valuation. The fair market value of a restrictive conservation easement may be determined on the basis of comparable sales of similar easements. n243.2 Because sales of similar easements are usually unavailable for comparison, however, the value of the easement is ordinarily determined by applying a "before and after" approach with respect to the value of the burdened land. The value of the property before the contribution is compared to the value of the property after the contribution. The difference in the values is used as the fair market value of the easement. n244 The "before and after" method will not be applied mechanically, however, when other reliable indicators of market value are available. n245 The fair market value of an easement must be based on the highest and best use of the property on the valuation date. n246 Valuation of real property in general, including a discussion of highest and best use, is discussed in detail in Chapter 20, "Valuation of Real Property."

If the granting of a perpetual conservation restriction increases the value of any other property owned by the grantor or a related person, the amount of the deduction must be reduced by the amount of the increase in the value of that other property. The reduction is required whether or not the other property is contiguous to the donated property. n247

If the donor or related person receives or can expect to receive a substantial economic benefit as a result of the donation that is greater than benefits that will inure to the public as a result of the donation, no charitable contribution deduction is permitted. If the donor or related party receives a substantial benefit as a result of the donation, but the benefit is less than the amount of the transfer, a deduction is allowable for the excess of the value of the easement transferred over the amount of the benefit received or reasonably expected to be received by the donor or related person. n248

To meet the statutory exclusivity requirement, n249 a qualified conservation contribution must contain a prohibition on the right to extract minerals by any surface mining method, when a "qualified mineral interest" has been retained by the grantor. n250 A qualified mineral interest includes subsurface oil, gas or other minerals, and the right of access to them. n251 Sand and gravel have also been held to be "subsurface" minerals. n252

[g] Trust as Donor

If a trust is the donor of an otherwise qualified conservation contribution under *IRC Section 170(h)*, the IRS has ruled that no charitable or distribution deduction may be taken unless the contribution is from trust income. If the contribution is of trust principal, no deduction is permitted. n252.1 In the ruling, a complex trust contributed a perpetual conservation easement to a qualified charity with respect to a 20-acre parcel it owned. In the year of the contribution, the trust's gross income exceeded the value of the easement, and no distributions were made to trust beneficiaries. The governing instrument of the trust authorized the trustee to make charitable contributions, including contributions of trust income. The Service's rationale for denying a charitable deduction was that an estate or trust can take charitable deductions only as provided by *IRC Section 642(c)*, and under that provision, a charitable deduction is available only if the source of the contribution is gross income. The contribution, however, had been made with respect to trust principal. The IRS also disallowed a distribution deduction for the contribution because a deduction for amounts paid, permanently set aside, or to be used for charitable purposes are deductible by trusts only as provided in *IRC Section 642(c)*. n252.2

In a separate case, a trust conveyed conservation easements to property and allocated the charitable contribution to the sole income beneficiary, who then claimed the deduction (and carryovers of the deduction for later years) on his joint return. The Tax Court denied the deduction because although the taxpayer was treated as the owner of the income portion of the trust, he failed to prove that the conservation easements were made from the income portion of the trust. The mere fact that petitioner failed to withdraw trust income that he was due did not cause him to be treated as the owner of the corpus. The court also held that the taxpayer did not prove that the trust's distributions to charity were deemed distributions to him, followed by his contribution of the easements to charity. n252.3

COMMENT:

The Tax Court didn't mention *Revenue Ruling 2003-123* in *Goldsby*, since the trust was not claiming the deduction. Because a conservation easement necessarily relates to property, however, it is hard to imagine when a conservation easement ever could be made from the income portion, rather than the corpus, of a trust. Thus, it appears that the only way a conservation easement charitable contribution deduction can be taken for property held in a trust is for the trust to distribute the property to a beneficiary, who may then make the contribution of the easement.

[h] Percentage Limitations and Carryover Rules for Qualified Conservation Contributions

Separate percentage limitation and carryover rules apply with respect to the charitable deduction allowed for qualified conservation contributions, effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2010. n252.4 *Notice 2007-50* provides detailed guidance regarding the statutory percentage limitations on qualified conservation contributions made by individuals. n252.4.1 The usual 30-percent contribution base limitation on contributions of capital gain property by individuals n252.4.2 does not apply to qualified conservation contributions. n252.5 Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in *IRC Section 170(b)(1)(A)* (i.e. public charities, private foundations other than private non-operating foundations, and certain governmental units) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. n252.6 These contributions are not taken into account in determining the amount of other allowable charitable contributions. n252.7 Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. n252.8

Example:

Tom, an individual, has a contribution base of \$100,000. He makes a qualified conservation contribution of property with a fair market value of \$80,000 and makes other charitable contributions subject to the 50-percent limitation of \$60,000. Tom is allowed a deduction of \$50,000 in the current taxable year for the non-conservation contributions (50 percent of his \$100,000 contribution base) and is

allowed to carry over the excess \$10,000 for up to 5 years. n252.9 No current deduction is allowed for the qualified conservation contribution, n252.10 but the entire \$80,000 qualified conservation contribution may be carried forward for up to 15 years. n252.11

Even more lenient deduction limitations apply to qualified conservation contributions by qualified farmers and ranchers. A qualified farmer or rancher for this purpose means a taxpayer whose gross income from the trade or business of farming n252.12 is greater than 50 percent of the taxpayer's gross income for the taxable year. n252.13 In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions. n252.14

Example:

Mary, an individual, is a qualified farmer. She has a contribution base of \$100,000. She makes a qualified conservation contribution of property with a fair market value of \$80,000 and makes other charitable contributions subject to the 50-percent limitation of \$60,000. Mary is allowed a deduction of \$50,000 in the current taxable year for the non-conservation contributions (50 percent of her \$100,000 contribution base) and is allowed to carry over the excess \$10,000 for up to 5 years. n252.15 She may also deduct an additional \$50,000 for the qualified conservation contribution. n252.16 The remaining \$30,000 of the qualified conservation contribution may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation. n252.17

NOTE:

If a qualified conservation contribution is made by a pass-through entity such as a partnership or S corporation, the determination as to whether an individual who is a partner or shareholder is a qualified farmer or rancher for the taxable year of the contribution is made at the partner or shareholder level. n252.17.1

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, n252.18 any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income n252.19 over the amount of all other allowable charitable contributions. n252.20 Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation. n252.21 An additional condition applies for certain corporate contributions of property that is used in or is available for use in agriculture or livestock production. The 100-percent limitation applies for contributions of this property only if the property is subject to a condition that it remain available for that use. This condition applies only for contributions made after August 17, 2006; it does not apply to contributions made before that date. n252.22

[i] Reduced Deduction if Rehabilitation Credits Taken

For any qualified conservation contribution, the amount of the charitable deduction is reduced by an amount that bears the same ratio to the fair market value of the contribution as the sum of the rehabilitation credits n252.23 for the preceding five taxable years with respect to a building that is part of the contribution bears to the fair market value of the building on the date of the contribution. n252.24

Example:

Jim makes a qualified conservation contribution with respect to a building. The fair market value of the building with respect to which the contribution is made is \$1,000,000. In the five years before the year of the contribution is made, Jim has claimed rehabilitation credits with respect to the building

totaling \$100,000. He must therefore reduce the amount of the contribution by 10 percent, or \$100,000 (\$100,000/\$1,000,000). n252.25

[j] IRS Approaches to Challenging Conservation Contribution Deductions

The IRS has announced closer scrutiny of charitable deductions claimed in connection with charitable transfers of conservation easements, its key concerns being deductions claimed for that do not qualify as qualified conservation contributions, or deductions claimed for amounts that exceed the fair market value of the donated easement. It will challenge inappropriate transactions using various approaches: n252.26

- Disallowing improper deductions and imposing accuracy-related penalties for negligence and/or substantial valuation misstatements. n252.27
- Imposing a variety of penalties on promoters, appraisers, and other persons involved in these transactions. These penalties may include those imposed for promoting abusive tax shelters, n252.28 those imposed on income tax return preparers for understating tax liability, n252.29 and penalties for aiding and abetting the understatement of tax liability. n252.30
- Challenging the tax-exempt status of the charitable organization, based on the organization's operation for a substantial nonexempt purpose or impermissible private benefit.
- Assessing the tax on excess benefit transactions n252.31 against any disqualified person who receives an excess benefit from a conservation easement transaction, and against any organization manager who knowingly participates in the transaction.
- Reviewing promotions of transactions involving improper deductions for conservation easements.

NOTE:

Many feel that the IRS is taking an overly strict view of conservation easement donations, often asserting zero valuations for them. Some practitioners have claimed the IRS treats any claimed conservation easement deduction as a tax shelter, and that any claim of a conservation easement deduction will automatically trigger an audit. The IRS seems to give especially close scrutiny if the donation benefits the taxpayer in any way. n252.32

[4] Facade Easements

[a] In General

A facade easement is intended to preserve the exteriors of historic structures. n253 Charitable deductions for donations of facade easements are generally determined under the same rules that apply to scenic and conservation easements. n254 The easement is usually granted by a property owner to a governmental agency or nonprofit institution entrusted with responsibility for preserving historic structures. Typical facade easements bar the owner's modification, remodeling, demolition or extension of the facade or structure without the prior written consent of the recipient of the easement and generally require the owner to maintain the facade in good condition. n255

As with scenic and conservation easements, the usual issue regarding the charitable donation of a facade easement is one of valuation. The donor's qualified appraisal must identify the method of valuation and the specific basis for the valuation of the easement. n255.1 Due to the general absence of a market for the sale of them, the fair market value of a facade easement is ordinarily determined in the same manner as for other conservation easements--by comparing the value of the total property before and after the grant of the easement. The difference in value is the fair market value of the easement. n256 As with other charitable contributions, deductions for donations of facade easements may be denied

if statutory requirements related to acknowledgment, record-keeping, or appraisal are not followed. n256.1

The grant of a facade easement is a disposition that may result in recapture of the rehabilitation tax credit. n257

[b] Special Rules for Buildings in Registered Historic Districts

Special rules apply to charitable contributions of facade easements on the exterior of buildings that are located in a registered historic district. A charitable deduction is allowable with respect to those buildings, but only if the qualified real property interest transferred that relates to the exterior of the building preserves the entire exterior of the building, including the space above the building, the sides, the rear, and the front of the building. n257.1 In addition, the qualified real property interest must provide that no portion of the exterior of the building may be changed in a manner inconsistent with the historical character of the exterior. n257.2 These requirements would prevent a contribution of a restriction on air rights or unused development rights alone from qualifying for a deduction with respect to a certified historic structure. n257.2.1 The donor and the donee must also enter into a written agreement certifying, under penalty of perjury, that the donee is a qualified organization, with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and that the donee has the resources to manage and enforce the restriction and a commitment to do so. n257.3

For any contribution relating to a registered historic district made after August 17, 2006, taxpayers must include with the return for the taxable year of the contribution a qualified appraisal of the qualified real property interest (irrespective of the claimed value of that interest) and attach the appraisal with the taxpayer's return, photographs of the entire exterior of the building, n257.4 and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information will result in disallowance of the deduction. n257.5

Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district in excess of \$10,000 must pay a \$500 fee to the IRS, or the deduction is not allowed. n257.6

[5] Bargain Sales

A taxpayer may make a charitable contribution through a bargain sale of property. To qualify for a charitable deduction:

- (1) the sale of property must be to a qualifying organization;
- (2) it must be accompanied by a donative intent; and
- (3) the selling price must be less than the fair market value of the property. n258

The fair market value of the property is measured on the date of the contribution. n259 The amount of the charitable contribution is the difference between the fair market value of the property at the time of contribution and the sales price. n260 The restrictions that apply to charitable donations of real property generally also apply to bargain sales that qualify for a charitable deduction. n261

If a taxpayer is allowed a charitable deduction by reason of a bargain sale, then the adjusted basis for determining the gain from that sale is the portion of the adjusted basis of the property which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property. n261.1 This rule prevents a taxpayer from subtracting the full adjusted basis of the property from the amount received. Instead, a taxpayer may deduct only the amount of the adjusted basis proportional to the amount realized in the part sale over the fair market value of the entire property.

n261.2

Example:

T Corporation owns property with a fair market value of \$1 million and an adjusted basis of \$200,000. *T* makes a bargain sale of the property to a qualified charitable organization for \$500,000. *T*'s adjusted basis for determining gain on the sale is \$100,000 [$\$200,000 \times \$500,000 / \$1,000,000$]. *T* therefore recognizes \$400,000 gain on the sale, and is allowed a \$500,000 charitable contribution deduction.

n261.3

NOTE:

The IRS has announced closer scrutiny of charitable deductions claimed in connection with bargain sales when in order to determine whether part of the stated purchase price is inappropriately categorized as a charitable contribution. One scenario that has occurred is for the charitable organization to purchase the property and place a conservation easement on it. Then, the charitable organization sells the property subject to the easement to a buyer for a price that is substantially less than the price paid by the charitable organization for the property. As part of the sale, the buyer makes a second payment, designated as a charitable contribution, to the charitable organization. The total of the payments from the buyer to the charitable organization fully reimburses the charitable organization for the cost of the property. The IRS will use a "substance over form" rationale to recharacterize the above transactions. It may therefore treat the total of the buyer's payments to the charitable organization as the purchase price paid by the buyer for the property. It may also impose a variety of penalties and seek to challenge the tax-exempt status of the charitable organization, based on the organization's operation for a substantial nonexempt purpose or impermissible private benefit.

[6] Acknowledgment by Donee

In order to claim a charitable deduction for contributed real estate, the donor must generally substantiate the contribution by a contemporaneous written acknowledgment of the contribution by the donee. n263 The acknowledgment must describe the property, state whether the donee provided goods or services in consideration for the property or any part of it, and estimate the value of those goods or services. If the goods or services are solely intangible religious benefits, a statement to that effect must be included. n264 Regulations detail further requirements with respect to the acknowledgment. n264.1 Failure to obtain an acknowledgement that complies with statutory and regulatory requirements may cause deductions to be disallowed. n264.2

The acknowledgement is not required if the donee organization files a return including specified information about the contribution. n265-266

[7] Reporting and Return Requirements**[a] In General**

In general, if the total charitable deduction claimed for non-cash property exceeds \$500, a taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS that describes the property. n267 C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds \$5,000.

[b] Returns for Dispositions of Donated Property by Donee

A donee of charitable deduction property that disposes of it within three years of its receipt must make a return (Form 8282, Donee Information Return), showing the following: n267.1

- the name, address, and TIN of the donor;
- a description of the property;
- the date of the contribution;
- the amount received on the disposition;
- the date of the disposition;
- a description of the donee's use of the property; and
- a statement indicating whether the use of the property was related to the purpose or function constituting the basis of the donee's tax exemption. n267.2

For purposes of the return requirement, "charitable deduction property" includes property (other than publicly traded securities) for which the donor claimed a charitable contribution deduction, if the claimed value of that property (plus the claimed value of similar items of property donated by the donor to one or more donees) exceeds \$5,000. n267.3

[c] Reporting "Transactions of Interest"

The IRS has issued a notice regarding reporting requirements with respect to charitable contributions of successor member interests in entities holding real estate, when the taxpayer claims a deduction for the contribution that is significantly higher than the amount the taxpayer paid to acquire the interest. The notice identifies various transactions as "transactions of interest," n267.4 and alerts persons involved with the transactions to certain reporting responsibilities relating to that involvement. n267.5

The notice describes a fact pattern involving an LLC that owns real property subject to a long-term lease. An Advisor owns all of the membership interests in the LLC, and enters into an agreement under which the Advisor continues to own the membership interests in LLC for a term of years (the Initial Member Interest). A taxpayer purchases the successor member interest in LLC (the Successor Member Interest), which entitles the taxpayer to own all of the membership interests in LLC upon the expiration of the term of years. In some variations of the transaction, the taxpayer may hold the Successor Member Interest through another entity, such as a single-member LLC. Further, the agreement may refer to the Successor Member Interest as a remainder interest. After holding the Successor Member Interest for more than one year (in order to treat the interest as long-term capital gain property), the taxpayer transfers the Successor Member Interest to a charitable organization. The taxpayer claims the value of the Successor Member Interest to be an amount that is significantly higher than the taxpayer's purchase price (for example, an amount that is a multiple of taxpayer's purchase price and a price that exceeds normal appreciation). The taxpayer claims a charitable contribution deduction based on this higher amount, determining the value by taking into account an appraisal obtained by or on behalf of Advisor or taxpayer of the fee interest in the underlying real property and the *IRC Section 7520* valuation tables. n267.6

Transactions that are the same as, or substantially similar to, the above transactions are treated by the IRS as "transactions of interest" for purposes of various reporting requirements. n267.7 Persons entering into those transactions must disclose them, in accordance with regulations. n267.8 Similarly, material advisors who make a tax statement with respect to them also have disclosure and list maintenance obligations. n267.9

The notice also explains which parties will be treated as participants in the transaction, n267.10 the time of required disclosure, n267.11 and the material advisor threshold amount. n267.12

Persons required to disclose these transactions under regulations n267.13 who fail to do so may be subject to the penalty under *IRC Section 6707A*. Persons required to disclose these transactions as a "reportable transaction" n267.14 who fail to do so may be subject to the penalty under *IRC Section 6707(a)*. Persons required to maintain lists of advisees n267.15 who fail to do so (or who fail to provide those lists when requested by the IRS) may be subject to the penalty under *IRC Section 6708(a)*. In addition, the Service may impose other penalties on persons involved in these transactions or substantially similar transactions, including accuracy-related penalties. n267.16

[8] Appraisal Requirements

All C corporations, individuals, closely-held corporations, personal service corporations, partnerships, and S corporations must obtain a qualified appraisal of contributed real property if the amount of the deduction claimed exceeds \$5,000. n268 In addition, if the amount of the contribution of property other than cash, inventory, or publicly traded securities exceeds \$500,000, then the donor (whether an individual, partnership, or corporation) must attach the qualified appraisal to the donor's tax return. n269 For purposes of these dollar thresholds, property and all similar items of property donated to one or more donees are treated as one property. n270 A donor that fails to properly substantiate a charitable contribution of property may be denied charitable contribution deduction. n271 If the donor is a partnership or S corporation, the deduction is denied at the partner or shareholder level. n272 The denial of the deduction does not apply if it is shown that the failure to substantiate is due to reasonable cause and not to willful neglect. n273 Pursuant to statutory authority, n274 the IRS has issued regulations imposing various recordkeeping, return, and appraisal requirements with respect to charitable contribution deductions. n274.1 Courts have ruled that substantial compliance with the regulations will suffice to allow deductions. n274.2

A qualified appraisal is one that is treated as a qualified appraisal under regulations or other guidance provided by the Secretary, and which is conducted by a qualified appraiser in accordance with generally accepted appraisal standards and regulations or other guidance provided by the Secretary. n275 The appraisal, as well as the Declaration of Appraiser of Form 8283, must be signed by an individual, not by an appraisal firm. n275.1 If someone other than the person(s) who conducted the appraisal is signing the appraisal, the appraisal is not a qualified appraisal, and the claimed deduction may be disallowed. This is regardless of whether the person signing is or is not an appraiser. n275.2 If two or more appraisers contribute to an appraisal, each appraiser must sign the appraisal. n275.3

A qualified appraiser is an individual who: n276

- has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations;
- regularly performs appraisals for which he or she receives compensation;
- can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed;
- has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and
- meets other requirements as may be provided under applicable Treasury regulations.

NOTE:

A civil penalty is imposed on any person who prepares an appraisal that is to be used to support a tax position if the appraisal results in a substantial or gross valuation misstatement, or a substantial estate or gift tax valuation understatement. n277 The penalty is equal to the greater of \$1,000 or 10 percent of the

understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. n278 The penalty does not apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct. n279 The penalty is in addition to any other penalties that may be imposed. n280

[9] Contributions to Donor Advised Funds

[a] Overview

Donor advised funds and contributions of appreciated real estate to them have proliferated in recent years. Many financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as "commercial" donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including "commercial" donor advised funds, as *IRC Section 501(c)(3)* public charities.

Donor advised funds are typically accounts to which donors may contribute real estate or other assets and thereafter provide non-binding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution, n281 but if the sponsor of the fund does not have control over the assets (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction. In the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

The Code provides a statutory framework for evaluating charitable contributions to donor advised funds, and several strict penalties intended to prevent donor control over assets contributed to those funds. Provisions include the following:

- a detailed statutory definition of a donor advised fund; n282
- denial of a charitable deduction for certain contributions to maintain a donor advised fund; n283
- application of the excess business holdings tax to donor advised funds. n284
- imposition of the excess benefits transactions taxes to various payments from a donor advised fund to certain disqualified individuals; n285
- imposition of a 20-percent tax on taxable distributions from a donor advised fund, and a 5-percent tax (not to exceed \$10,000) on managers who knowingly approve a taxable distribution; n286
- imposition of a 125-percent tax if certain parties connected with a donor advised fund provide advice as to a distribution that results those parties receiving a more than incidental benefit, and a 10-percent tax (not to exceed \$10,000) on managers who knowingly agree to the distribution; n287 and
- reporting and disclosure requirements for sponsoring organizations of donor advised funds. n288

[b] Definition of "Donor Advised Fund" and "Sponsoring Organization"

Subject to several exceptions, discussed below, a "donor advised fund" is a fund or account that is: (1) separately identified by reference to contributions of a donor or donors (2) owned and controlled by a sponsoring organization and (3) with respect to which a donor (or any person appointed or designated by a donor (a "donor advisor")) has, or

reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor. All three prongs of the definition must be met in order for a fund or account to be treated as a donor advised fund. n289 A "sponsoring organization" is an organization that: (1) is a qualifying charitable organization under *IRC Section 170(c)* (other than a governmental entity n290 and without regard to any requirement that the organization be organized in the United States); (2) is not a private foundation; n291 and (3) maintains one or more donor advised funds. n292

NOTE:

The Joint Committee conference report accompanying the legislation elaborates extensively on the definition of "donor advised fund" and how and when various relationships between a donor and the receiving entity will cause a fund to fall within or outside of that definition. Each of the three prongs of the definition is discussed at length. The first prong of the definition requires that a donor advised fund be separately identified by reference to contributions of a donor or donors. n293 The conference report elaborates on this requirement at some length. It states that a distinct fund or account of a sponsoring organization does not meet this prong of the definition unless the fund or account refers to contributions of a donor or donors, such as by naming the fund after a donor, or by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors. Although a sponsoring organization's general fund is a "fund or account," a general fund will not usually be treated as a donor advised fund because the general funds of an organization typically are not separately identified by reference to contributions of a specific donor or donors; rather contributions are pooled anonymously within the general fund. Similarly, a fund or account of a sponsoring organization that is distinct from the organization's general fund and that pools contributions of multiple donors generally will not meet the first prong of the definition unless the contributions of specific donors are in some manner tracked and accounted for within the fund. Accordingly, if a sponsoring organization establishes a fund dedicated to the relief of poverty within a specific community, or a scholarship fund, and the fund attracts contributions from several donors but does not separately identify or refer to contributions of a donor or donors, the fund is not a donor advised fund even if a donor has advisory privileges with respect to the fund. However, a fund or account may not avoid treatment as a donor advised fund even though there is no formal recognition of separate contributions on the books of the sponsoring organization if the fund or account operates as if contributions of a donor or donors are separately identified. The Secretary has the authority to look to the substance of an arrangement, and not merely its form. In addition, a fund or account may be treated as identified by reference to contributions of a donor or donors if the reference is to persons related to a donor. For example, if a husband made contributions to a fund or account that in turn is named after the husband's wife, the fund is treated as being separately identified by reference to contributions of a donor. n294

As to the second prong of the definition--that the fund be owned and controlled by a sponsoring organization n295--the conference report notes that to the extent that a donor or person other than the sponsoring organization owns or controls amounts deposited to a sponsoring organization, a fund or account is not a donor advised fund. Furthermore, in cases where a donor retains control of an amount provided to a sponsoring organization, there may not be a completed gift for purposes of the charitable contribution deduction. n296

The third prong of the definition provides that with respect to a fund or account of a sponsoring organization, a donor or donor advisor has or reasonably expects to have advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of a donor's status as a donor. n297 The conference report notes that advisory privileges are distinct from a legal right or obligation. For example, if a donor executes a gift agreement with a sponsoring organization that specifies certain enforceable rights of the donor with respect to a gift, the donor will not be treated as

having "advisory privileges" due to those enforceable rights for purposes of the donor advised fund definition. The presence of an advisory privilege may be evident through a written document that describes an arrangement between the donor or donor adviser and the sponsoring organization whereby a donor or donor adviser may provide advice to the sponsoring organization about the investment or distribution of amounts held by a sponsoring organization, even if those privileges are not exercised. The presence of an advisory privilege also may be evident through the conduct of a donor or donor adviser and the sponsoring organization. For example, even in the absence of a writing, if a donor regularly provides advice to a sponsoring organization and the sponsoring organization regularly considers that advice, the donor has advisory privileges under the provision. Even if advisory privileges do not exist at the time of a contribution, later acts by the donor (through the provision of advice) and by the sponsoring organization (through the regular consideration of advice) may establish advisory privileges subsequent to the time of the contribution. For example, if a past donor of a building or land later notifies a sponsoring organization that he would like the organization to distribute \$10,000 to a specific charitable organization n298 although the mere act of providing advice does not establish an advisory privilege, if the sponsoring organization distributed the \$10,000 to the organization specified by the donor in consideration of the donor's advice, and reinforced the donor in some manner that future advice similarly would be considered, advisory privileges (or the reasonable expectation thereof) might be established. However, the mere provision of advice by a donor or donor adviser does not mean the donor or donor adviser has advisory privileges. For example, a donor's singular belief that he or she has advisory privileges with respect to the contribution does not establish an advisory privilege; there must be some reciprocity on the part of the sponsoring organization. n299

The conference report states that a person reasonably expects to have advisory privileges if both the donor or donor adviser and the sponsoring organization have reason to believe that the donor or donor adviser will provide advice and that the sponsoring organization generally will consider it. Thus, a person reasonably may expect to have advisory privileges even in the absence of the actual provision of advice. However, a donor's expectation of advisory privileges is not reasonable unless it is reinforced in some manner by the conduct of the sponsoring organization. If, at the time of the contribution, the sponsoring organization had no knowledge that the donor had an expectation of advisory privileges, or no intention of considering any advice provided by the donor, then the donor does not have a reasonable expectation of advisory privileges. Ultimately, the presence or absence of advisory privileges (or a reasonable expectation thereof) depends upon the facts and circumstances, which in turn depend upon the conduct (including any agreement) of both the donor or donor adviser and the sponsoring organization with respect to the making and consideration of advice. n300

A further requirement of the third prong is that the reasonable expectation of advisory privileges is by reason of the donor's status as a donor. n301 The conference report states that, under this requirement, if a donor's reasonable expectation of advisory privileges is due solely to the donor's service to the organization--as by reason of the donor's position as an officer, employee, or director of the sponsoring organization--then the third prong of the definition is not satisfied. For instance, in general, a donor who is a member of the board of directors of the sponsoring organization may provide advice in his or her capacity as a board member with respect to the distribution or investment of amounts in a fund to which the board member contributed. However, if by reason of that donor's contribution to the fund, the donor secured an appointment on a committee of the sponsoring organization that advises how to distribute or invest amounts in that fund, the donor may have a reasonable expectation of advisory privileges, notwithstanding that the donor is an officer, employee, or director of the sponsoring organization. n302

The committee report notes that the third prong of the definition is applicable to a donor or any person appointed or designated by that donor (the donor adviser). For purposes of this prong, a person appointed or designated by a donor adviser is treated as being appointed or designated by a donor. In addition, for

purposes of any exception to the definition of a donor advised fund, to the extent a donor recommends to a sponsoring organization the selection of members of a committee that will advise as to distributions or investments of amounts in a fund or account of the sponsoring organization, those members are not treated as appointed or designated by the donor if the recommendation of those members by the donor is based on objective criteria related to the expertise of the member. For example, if a donor recommends that a committee of a sponsoring organization that will provide advice regarding scholarship grants for the advancement of science at local secondary schools should consist of persons who are the heads of the science departments of those schools, then the donor generally would not be considered to have appointed or designated those persons, and they would not be treated as donor advisors. n303

There are several exceptions to the definition of a donor advised fund. n304 The term does not include a fund or account that makes distributions only to a single identified organization or governmental entity. n305 The conference report elaborates on this exception. It notes that an endowment fund owned and controlled by a sponsoring organization that is held exclusively to for the benefit of that sponsoring organization is not a donor advised fund even if the fund is named after its principal donor and the donor has advisory privileges with respect to the distribution of amounts held in the fund to the sponsoring organization. Accordingly, a donor that contributes to a university for purposes of establishing a fund named after the donor that exclusively supports the activities of the university is not a donor advised fund even if the donor has advisory privileges regarding the distribution or investment of amounts in the fund. n306

A donor advised fund also does not include a fund or account with respect to which a donor or donor advisor provides advice as to which individuals receive grants for travel, study, or other similar purposes, provided that (1) the donor's or donor advisor's advisory privileges are performed exclusively by that donor or donor advisor in that person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization, (2) no combination of a donor or donor advisor or persons related to them, control, directly or indirectly, that committee, and (3) all grants from the fund or account are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, and that procedure is designed to ensure that all such grants meet statutory requirements concerning grants to individuals by private foundations. n307

In addition, the Secretary may exempt a fund or account from treatment as a donor advised fund if it is advised by a committee not directly or indirectly controlled by a donor, donor advisor, or persons related to a donor or donor advisor. n308 The conference report indicates that it is intended that indirect control includes the ability to exercise effective control. For example, if a donor, a donor advisor, and an attorney hired by the donor to provide advice regarding the donor's contributions constitute three of the five members of an advising committee, the committee would be treated as being controlled indirectly by the donor under the exception. Board membership alone does not establish direct or indirect control. In general, under this authority, the Secretary may establish rules regarding committee advised funds generally that, if followed, would result in the fund not being treated as a donor advised fund. The Secretary also may establish rules excepting certain types of committee-advised funds, such as a fund established exclusively for disaster relief, from the donor advised fund definition. n309 Finally, the Secretary may exempt a fund or account from treatment as a donor advised fund if it benefits a single identified charitable purpose. n310

[c] Denial of Charitable Deduction for Contributions to Maintain Donor Advised Fund

Contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is a veterans organization, n311 a fraternal society, n312 or a cemetery company. n313 For gift tax purposes, a contribution to a sponsoring organization for maintenance in a donor advised fund is not deductible if the sponsoring organization is a fraternal society n314 or a veterans' organization. n315 For estate tax purposes, the contribution to a sponsoring organization for maintenance in a donor advised fund is not deductible if the sponsoring organization is a fraternal society n316 or a veterans' organization. n317

In addition, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a

charitable deduction for income, gift, or estate tax purposes if the sponsoring organization is a Type III supporting organization (other than a functionally integrated Type III supporting organization). n318 A functionally integrated Type III supporting organization is a Type III supporting organization that is not required under regulations established by the Secretary n319 to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, those supported organizations. n320

Even if the above restrictions do not preclude a deduction, a donation to a donor advised fund is deductible only if statutory substantiation requirements are met n321 and if the donor obtains, with respect to each charitable contribution to a sponsoring organization to be maintained in a donor advised fund, a contemporaneous written acknowledgment n322 from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed. n323

[d] Excess Business Holdings Tax Applies to Donor Advised Funds

The excess business holdings tax applies to donor advised funds. n324 Thus, a 10 percent tax is imposed on the excess business holdings of a donor advised fund n325, with a 200 percent additional tax imposed if the donor advised fund has excess business holdings in a business enterprise at the close of the taxable period with respect to those holdings. n326 The taxes may be abated in certain cases. n327

In applying the excess business holdings rules to donor advised funds, a "disqualified person" with respect to a donor advised fund is a donor, donor advisor, a member of the family of a donor or donor advisor, or a 35-percent controlled entity of any such person. n328 Complex transition rules apply to the holdings that a donor advised fund has on August 17, 2006. n329

[e] Taxes on Excess Benefit Transactions

Any grant, loan, compensation, or other similar payment from a donor advised fund to a person that with respect to that fund is a donor, donor advisor, or a person related to a donor or donor advisor automatically is treated as an excess benefit transaction. n330 The entire amount paid to any such person is treated as the amount of the excess benefit n331 upon which the excess benefits transactions taxes are based. n332 The taxes may be abated in certain cases. n333

NOTE:

The conference report accompanying the legislation clarifies that "other similar payments" that can be treated as an excess benefit transaction include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. "Other similar payments," however, do not include payments pursuant to bona fide sale or lease of property, which instead are subject to the general rules of *IRC Section 4958* under the special disqualified person rule described below. Also as described below, payment by a sponsoring organization of, for example, compensation to a person who both is a donor with respect to a donor advised fund of the sponsoring organization and a service provider with respect to the sponsoring organization generally, will not be subject to the automatic excess benefit transaction rule unless the payment (of a grant, loan, compensation, or other similar payment) properly is viewed as a payment from the donor advised fund and not from the sponsoring organization. n334

For purposes of the taxes on excess benefits transactions, donors and donor advisors with respect to a donor advised fund (as well as persons related to a donor or donor advisor) are treated as disqualified persons with respect to transactions with that donor advised fund (though not necessarily with respect to transactions with the sponsoring organization more generally). n335 For example, if a donor to a donor advised fund purchased real estate from the fund, the purchase is subject to the excess benefits transaction rules because the donor is a disqualified person with respect to the fund. Thus, if as a result of the purchase, the donor receives an excess benefit n336 then the donor is subject to tax.

n337 If the purchase was of real estate that was contributed by the donor, a factor that may indicate the presence of an excess benefit is if the amount paid by the donor to acquire the property is less than the amount the donor claimed the property was worth for purposes of any charitable contribution deduction of the donor. In addition, if a donor advised fund distributes property to the sponsoring organization of the fund prior to purchase by the donor, consideration should be given to whether the distribution to the sponsoring organization prior to the purchase was intended to circumvent the disqualified person rule of *IRC Section 4958*. If so, the distribution may be disregarded, with the result that the purchase is treated as being made from the donor advised fund and not from the sponsoring organization. n338

A person who is a donor to a donor advised fund and thus a disqualified person with respect to the fund n339 also may be a service provider with respect to the sponsoring organization. In general the sponsoring organization's transactions with the service provider are not subject to *IRC Section 4958* unless the service provider is a disqualified person with respect to the sponsoring organization (e.g., if the service provider serves on the board of directors of the sponsoring organization), or unless the transaction is not properly viewed as a transaction with the sponsoring organization but in substance is a transaction with the service provider's donor advised fund. n340 If the transaction properly is viewed as a transaction with the donor advised fund of a sponsoring organization, then the transaction is subject to *IRC Section 4958*, and, as described above, if the transaction involves payment of a grant, loan, compensation, or other similar payment, then the transaction is subject to the special automatic excess benefit transaction rule. n341

The conference report gives an example to explain the above rules. For example, if a sponsoring organization pays an amount as part of a service contract to a service provider (a bank, for example) who also is a donor to a donor advised fund of the sponsoring organization, and those amounts reasonably are charged uniformly in whole or in part as routine fees to all of the sponsoring organization's donor advised funds, the transaction generally is considered to be between the sponsoring organization and the service provider in that service provider's capacity as a service provider. The transaction is not considered to be a transaction between a donor advised fund and the service provider even though an amount paid under the contract was charged to a donor advised fund of the service provider. n342

An investment advisor (as well as persons related to the investment advisor) is treated as a disqualified person with respect to the sponsoring organization under the excess benefits transactions rules. n343 A "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds (including pools of assets all or part of which are attributed to donor advised funds) owned by the sponsoring organization. n344

[f] Tax Imposed on Distributions from Donor Advised Funds

A 20-percent tax is imposed on taxable distributions from a donor advised fund. The tax is imposed on the sponsoring organization. n345 In addition, an excise tax equal to five percent of the amount of the distribution is imposed against any manager of the sponsoring organization who knowingly approved the distribution, not to exceed \$10,000 with respect to any one taxable distribution. n346 The taxes are subject to abatement if the event triggering the tax was due to reasonable cause and not willful neglect, and is corrected. n347 The taxes are effective for tax years beginning after August 17, 2006. n348

A "taxable distribution" is generally any distribution from a donor advised fund to the following: n349

- to any natural person;
- to any other person for any purpose other than one specified in *IRC Section 170(c)(2)(B)* (generally, a charitable purpose); or
- to any other person, if the sponsoring organization does not exercise expenditure responsibility with

respect to the distribution in accordance with statutory standards. n350

A taxable distribution does not, however, include any a distribution to from a donor advised fund to the following:
n351

- an organization described in *IRC Section 170(b)(1)(A)* (other than to a disqualified supporting organization); n352
- the sponsoring organization of the donor advised fund making the distribution; or
- another donor advised fund.

NOTE:

The conference report accompanying the donor advised fund legislation clarifies the meaning of the requirement that a distribution be "to" an organization described in *IRC Section 170(b)(1)(A)* in order to avoid being a taxable distribution. n353 Rules similar to those in *Treasury Regulation Section 53.4945-5(a)(5)* are to apply. Thus, if a sponsoring organization makes a good faith determination (under standards similar to those currently applicable for private foundations) that a distributee organization is an organization described in *IRC Section 170(b)(1)(A)* (other than a disqualified supporting organization), then a distribution to the organization is not considered a taxable distribution. n354

[g] Tax on Prohibited Benefits from Donor Advised Funds

If a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund provides advice as to a distribution that results in any such person receiving, directly or indirectly, a more than incidental benefit, an excise tax equal to 125 percent of the amount of that benefit is imposed against the person who advised as to the distribution, and against the recipient of the benefit. n355 Persons subject to the tax are jointly and severally liable for the tax. n356 In addition, if a manager of the sponsoring organization agreed to the making of the distribution, knowing that the distribution would confer a more than incidental benefit on a donor, a donor advisor, or a person related to a donor or donor advisor, the manager is subject to an excise tax equal to 10 percent of the amount of that benefit, not to exceed \$10,000. n357 The taxes are subject to abatement if the event triggering the tax was due to reasonable cause and not willful neglect, and is corrected. n358 The taxes are effective for tax years beginning after August 17, 2006. n359

The committee report accompanying the legislation indicates that there is a more than incidental benefit if, as a result of a distribution from a donor advised fund, a donor, donor advisor, or related person with respect to that fund receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit was received as part of the contribution to the sponsoring organization. n360

[h] Reporting and Disclosure Requirements

Each sponsoring organization must disclose on its information return (Form 990, Return of Organization Exempt from Tax) the following information: n361

- the total number of donor advised funds it owns;
- the aggregate value of assets held in those funds at the end of the organization's taxable year; and
- the aggregate contributions to and grants made from those funds during the year.

In addition, when seeking recognition of its tax-exempt status (Form 1023, Application for Recognition of Exemption Under *Section 501(c)(3) of the Internal Revenue Code*), a sponsoring organization must disclose whether it intends to maintain donor advised funds. n362 It is intended that the organization must provide information regarding its planned operation of those funds, including, for example, a description of procedures it intends to use to: (1) communicate to donors and donor advisors that assets held in donor advised funds are the property of the sponsoring organization; and (2) ensure that distributions from donor advised funds do not result in more than incidental benefit to any person. n363

FOOTNOTES:

(n1)Footnote 205. See *IRC §§ 170(b), (e)*.

(n2)Footnote 206. *IRC § 170(e)(1); Treas Reg § 1.170A-1(c)*; see *IRC § 1222(3)* (definition of long-term capital gain).

(n3)Footnote 206.1. See *IRC § 170(a)(1)*.

(n4)Footnote 206.2. But see *Kaplan et al v Commr, TC Memo 2006-16* (taxpayer failed to make bona fide transfer of legal title to donee).

(n5)Footnote 207. *Arbor Towers Associates, Ltd v Commr, TC Memo 1999-213*.

(n6)Footnote 208. See *IRC § 1222(3)*.

(n7)Footnote 209. *IRC § 170(e); Treas Reg § 1.170A-4(a); Strasburg v Commr, TC Memo 2000-94*.

(n8)Footnote 210. *IRC § 170(d)*.

(n9)Footnote 210.1. *IRC § 170(b)(1)(E)(ii)*, effective for contributions made in tax years beginning after Dec 31, 2005, and before Jan 1, 2010 [*IRC § 170(b)(1)(E)(vi)*]; see Pub L 109-280, § 1206(a)(1). See § 6.05[3][h], below, for a discussion.

(n10)Footnote 211. *IRC §§ 170(f)(2), (3)(A)*. The retention of an easement over donated property does not necessarily make the transfer one of a partial interest in property, although it may reduce the value of the donation. *Ltr Rul 9728016*; *Ltr Rul 9729024*.

(n11)Footnote 212. *IRC § 170(f)(3)(B), (4)*.

(n12)Footnote 213. See *Rev Rul 78-303, 1978-2 CB 122*; *Ltr Rul 9714017*; *Ltr Rul 9329017* (deduction allowed for contribution of remainder interest in farm).

(n13)Footnote 214. *Douglas v Commr, TC Memo 1989-592*; *Treas Reg § 1.170A-7(b)(1)*.

(n14)Footnote 215. See [3], below.

(n15)Footnote 215.1. *Treas Reg § 1.170A-7(b)(1)(i)*; *Stark v Commr, 86 TC 243 (1986)*; see *Rev Rul 76-331, 1976-2 CB 52* (no charitable deduction allowed when donor retained mineral rights in the property or a lifetime interest in payments due under a 60-year timber lease); *Rev Rul 75-66, 1975-1 CB 85* (deduction allowed for contribution of 800 acres when taxpayer retained only the right during his life to train his personal hunting dog on trails extending over the entire property, and to maintain paths and lanes relating to this reserved use).

(n16)Footnote 216. *TAM 9828001*; see *Treas Reg § 1.170A-1(e)*.

(n17)Footnote 217. *IRC § 170(f)(3)(A)*.

(n18)Footnote 218. *Treas Reg § 1.170A-7(a)(1)*; see *Logan v Commr, TC Memo 1994-445* .

(n19)Footnote 218.1. *Stussy v Commr, TC Memo 2003-232* (charitable contribution denied for expenses paid with respect to a personal residence, part of which was used by a charitable foundation, because the foundation did not provide a written acknowledgment); see *IRC § 170(f)(8)(A)*.

(n20)Footnote 219. *Klavan v Commr, TC Memo 1993-299* .

(n21)Footnote 220. *Kellahan, Jr v Commr, TC Memo 1999-210* .

(n22)Footnote 221. *Fair v Commr, 27 TC 866 (1957)* , *acq 1957-2 CB 4* .

(n23)Footnote 221.1. *Bischel et ux v US, No 2:04-cv-1537 (D Nev 2006)*.

(n24)Footnote 222. *Jarre v Commr, 64 TC 183 (1975)* ; *Kaplan v Commr, 43 TC 663 (1965)* ; *Van Zelst v Commr, 100 F3d 1259 (7th Cir 1996)* ; *Forte, Jr v Commr, TC Memo 1991-36, 61 TCM 1754* ; *Glick v Commr, TC Memo 1997-65* ; *Johnston, III et al v Commr, TC Memo 1997-475* ; *Browning Jr v Commr, 109 TC 303 (1997)* ; *Crocker FKA et al v Commr, TC Memo 1998-204* ; *Talkington v Commr, TC Memo 1998-412* ; *Kellahan, Jr v Commr, TC Memo 1999-210* ; *Wortmann et al v Commr, TC Memo 2005-227* ; *Terrene Invs, Ltd v Commr, TC Memo 2007-218* (valuation of property depended on value of recoverable sand and gravel deposits).

(n25)Footnote 222.1. *IRC § 170(f)(4)*; *Treas Reg § 1.170A-12(a)(1)*.

(n26)Footnote 222.2. *IRC § 170(f)(4)*; see *Rev Rul 76-473, 1976-2 CB 306* .

(n27)Footnote 222.3. *Rev Rul 76-473, 1976-2 CB 306* . See *IRC §§ 170(f)(4), 2522(c)*.

(n28)Footnote 223. *DeJong v Commr, 36 TC 896 (1961)* , *affd 309 F2d 373 (9th Cir 1962)* ; *Frazee v US, 2004-1 USTC P 50,253 (DC Md 2004)*.

(n29)Footnote 224. *Commr v Duberstein, 362 US 278 (1960)* ; *Perlmutter v Commr, 45 TC 311 (1965)* ; *Allen v US, 541 F2d 786 (9th Cir 1976)* ; *Stubbs v US, 428 F2d 885 (9th Cir 1970)* ; *Petit v Commr, 61 TC 634 (1974)* ; *Morton, Jr v Commr, TC Memo 1979-484, 39 TCM 621* .

(n30)Footnote 225. *Consol Investors Group v Commr, TC Memo 2009-290 (2009)* (donative intent found based on credibility of taxpayer at trial); *Saba v Commr, TC Memo 1980-189, 40 TCM 446* ; *Grinslade v Commr, 59 TC 566 (1973)* ; *Stubbs v US, 428 F2d 885 (9th Cir 1970)* .

(n31)Footnote 226. *Lockett v Commr, TC Memo 1998-50* .

(n32)Footnote 227. *Signom, II v Commr, TC Memo 2000-175* (cancellation of lease and option to purchase was not a gift because it was made as part of a multiple property exchange transaction under which the taxpayer received and sold other properties); *McConnell v Commr, TC Memo 1988-307* , *affd without published opinion (3d Cir 1989)*; *Sutton v Commr, 57 TC 129 (1971)* (deduction denied for grant of easement that was given primarily to allow the taxpayer to develop other property); *Stubbs v US, 428 F2d 885 (9th Cir 1970)* (favorable zoning given for grant of land); *Perlmutter v Commr, 45 TC 311 (1965)* (donation in order to obtain approval of subdivision); *Petit v Commr, 61 TC 634 (1974)* (land granted in exchange for subdivision concession from local planning board); *Grinslade v Commr, 59 TC 566 (1973)* (land donated in exchange for money, other land for development purposes, and zoning variances); *US v Transamerica Corp, 392 F2d 522 (9th Cir 1968)* (no gift where taxpayer-corporation received relief from continued harassment, badgering and threats from the city, because donation was made under form of economic duress and threatened legal compulsion); *Wolfe v Commr, 54 TC 1707 (1970)* (no gift when taxpayers transferred their water and sewer lines because, in return, they received improved water and sewer systems operated by town and increased property values); *Forkan v Commr, TC Memo 1977-195* (donation of easement in exchange for approval to expand

trailer park); *Ottawa Silica Co v US*, 699 F2d 1124 (Fed Cir 1983) (deduction denied for donation of land for school site because roads built by local government as a result of the contribution increased value of other land owned by the taxpayer); see *Osborne v Commr*, 87 TC 575 (1986) (construction and transfer of easement to use drainage facilities qualified for deduction).

(n33)Footnote 227.1. TAM 200610017 .

(n34)Footnote 228. *McLennan v US*, 91-1 USTC P 50,230, 91-2 USTC P 50,447 (Cl Ct 1991), *affd* 994 F2d 839 (Fed Cir 1993) .

(n35)Footnote 229. *McLennan v US*, 91-1 USTC P 50,230, 91-2 USTC P 50,447 (Cl Ct 1991), *affd* 994 F2d 839 (Fed Cir 1993) ; see *Todd v US*, 617 F Supp 253 (WD Pa 1985) ; *Symington v Commr*, 87 TC 892 (1986) ; *Fannon v Commr*, TC Memo 1986-572 , modified and remanded on other grounds 842 F2d 1290 (4th Cir 1988) ; see *Fannon v Commr*, TC Memo 1989-136 .

(n36)Footnote 229.1. Ltr Rul 200208019 .

(n37)Footnote 230. IRC § 170(f)(3)(B)(iii).

(n38)Footnote 231. IRC § 170(h)(1); Treas Reg § 1.170A-14(a).

(n39)Footnote 232. IRC § 170(h)(5)(A); Treas Reg § 1.170A-14(a), (b)(2), (g).

(n40)Footnote 233. IRC § 170(h)(2); Treas Reg § 1.170A-14(b).

(n41)Footnote 234. IRC § 170(h)(3); Treas Reg § 1.170A-14(c); Ltr Rul 9927014 (school board was qualified organization).

(n42)Footnote 234.1. Ltr Ruls 200002020, 9952037.

(n43)Footnote 234.2. See *Turner v Commr*, 126 TC 299 (2006) .

(n44)Footnote 235. IRC § 170(h)(2).

(n45)Footnote 236. IRC § 170(h)(4)(A); Treas Reg § 1.170A-14(d)(1).

(n46)Footnote 236.1. *Glass v Commr*, 124 TC 258 (2005) , *affd* 471 F3rd 698 (6th Cir 2006).

(n47)Footnote 236.2. S Rept 96-1007 at 12, 1980), 1980-2 CB 599, 605 ; see *Turner v Commr*, 126 TC 299 (2006)

(n48)Footnote 236.3. *Turner v Commr*, 126 TC 299 (2006) .

(n49)Footnote 236.4. *Turner v Commr*, 126 TC 299 (2006) .

(n50)Footnote 236.5. See Ltr Rul 9952037 ; Ltr Rul 200002020 .

(n51)Footnote 236.6. *Glass v Commr*, 124 TC 258 (2005) .

(n52)Footnote 236.7. *Glass v Commr*, 471 F3rd 598 (6th Cir 2006) .

(n53)Footnote 237. Treas Reg § 1.170A-14(e)(2).

(n54)Footnote 237.1. IRC § 170(h)(5)(A).

(n55)Footnote 238. *Treas Reg § 1.170A-14(g)(1), (5); Great Northern Nekoosa Corp and Subs v US*, 97-2 USTC P 50,591 (*Fed Cl* 1997) (20-year restriction on mining activities failed to meet perpetuity requirement).

(n56)Footnote 239. *Treas Reg § 1.170A-14(g)(2)*.

(n57)Footnote 240. *Treas Reg § 1.170A-14(g)(3); 885 Investment Co v Commr*, 95 TC 156 (1990) .

(n58)Footnote 241. *885 Investment Co v Commr*, 95 TC 156 (1990) . "The phrase 'so remote as to be negligible' has been defined as 'a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction,' *United States v Dean*, 224 F2d 26, 29 (1st Cir 1955) , and 'a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance,' *Briggs v Commissioner*, 72 TC 646, 657 (1979) , *affd without published opinion* 665 F2d 1051 (9th Cir 1981) ."

(n59)Footnote 241.01. *Treas Reg § 1.170A-14(g)(6)(i)*.

(n60)Footnote 241.02. *Treas Reg § 1.170A-14(g)(6)(ii)*

(n61)Footnote 241.03. *Kaufman v Commr*, 134 TC No 9 (2010) .

(n62)Footnote 241.1. See *Ltr Rul 9952037 ; Ltr Rul 200002020* .

(n63)Footnote 242. *IRC § 170(h)(5)(B)(ii)*, applicable to easements granted after December 31, 1997, *added by Pub L No 105-34*.

(n64)Footnote 243. See *Treas Reg § 1.170A-14(e)(1)*; see [2], above.

(n65)Footnote 243.1. *Ltr Rul 200208019* . A benefit to the donor may also affect the valuation of the donation, as discussed in § 6.05[3][f], below.

(n66)Footnote 243.2. See *Strasburg v Commr*, *TC Memo 2000-94* .

(n67)Footnote 244. *Treas Reg § 1.170A-14(h)(3)(i); Hughes v Commr*, *TC Memo 2009-94* ; *Kiva Dunes Conservation LLC v Commr*, *TC Memo 2009-145* (easement restricting golf course property to use as golf course, park, or farmland valued at \$28.6 million; taxpayer initially claimed \$30.6 million deduction); *Browning v Commr*, 109 TC 303 (1997) ; *Johnston v Commr*, *TC Memo 1997-475* ; *Symington v Commr*, 87 TC 892 (1986) and cases cited therein; *Dorsey, Jr v Commr*, *TC Memo 1990-242* ; *Schapiro v Commr*, *TC Memo 1991-128* , rejected by IRS in AOD 1991-023 ; *Rev Rul 73-339*, 1973-2 CB 68 , *clarified by Rev Rul 76-376*, 1976-2 CB 53 .

(n68)Footnote 245. *Treas Reg § 1.170A-14(h)(3)(i); Higgins v Commr*, *TC Memo 1990-103* .

(n69)Footnote 246. *Treas Reg § 1.170A-14(h)(3)(ii); Schapiro v Commr*, *TC Memo 1991-128* .

(n70)Footnote 247. *Treas Reg § 1.170A-14(h)(3)(i); Rev Rul 67-246*, 1967-2 CB 104 ; *Kiva Dunes Conservation LLC v Commr*, *TC Memo 2009-145* ; see *Ltr Ruls 9952037, 200002020*.

(n71)Footnote 248. *Treas Reg § 1.170A-14(h)(3)(i); Ltr Rul 9736016* (value of release from obligation to repair dam reduced amount of charitable deduction).

(n72)Footnote 249. *IRC § 170(h)(1)(C)*.

(n73)Footnote 250. *IRC § 170(h)(5)(B)(i)*.

(n74)Footnote 251. *IRC § 170(h)(6)*.

(n75)Footnote 252. *Great Northern Nekoosa Corp and Subs v US*, 97-2 USTC P 50,591 (US Ct of Fed Cls 1997).

(n76)Footnote 252.1. *Rev Rul 2003-123*, 2003-2 CB 1200 .

(n77)Footnote 252.2. *Rev Rul 2003-123*, 2003-2 CB 1200 , citing *Treas Reg § 1.663(a)-2*; *US Trust Co v IRS*, 803 F2d 1363 (5th Cir 1986) .

(n78)Footnote 252.3. *Goldsby v Commr*, TC Memo 2006-274 .

(n79)Footnote 252.4. *IRC § 170(b)(1)(E)*, *170(b)(2)(B)*; see Pub Law No 109-280, § 1206(c).

(n80)Footnote 252.4.1. *Notice 2007-50*, 2007-25 IRB 1430 ; see *IRC § 170(b)(1)(E)*.

(n81)Footnote 252.4.2. See *IRC § 170(b)(1)(C)(i)*.

(n82)Footnote 252.5. *IRC § 170(b)(1)(E)(iii)*.

(n83)Footnote 252.6. *IRC § 170(b)(1)(E)(i)*.

(n84)Footnote 252.7. *IRC § 170(b)(1)(D)(iii)*.

(n85)Footnote 252.8. *IRC § 170(b)(1)(E)(ii)*.

(n86)Footnote 252.9. *IRC § 170(b)(1)(B)*.

(n87)Footnote 252.10. *IRC § 170(b)(1)(E)(i)*.

(n88)Footnote 252.11. *IRC § 170(b)(1)(E)(ii)*.

(n89)Footnote 252.12. See *IRC § 2032A(e)(5)*.

(n90)Footnote 252.13. *IRC § 170(b)(1)(E)(v)*. *Notice 2007-50*, 2007-25 IRB 1430 provides guidance as to what items are included in gross income from the trade or business of farming for purposes of the definition of "qualified farmer or rancher."

(n91)Footnote 252.14. *IRC § 170(b)(1)(E)(iv)(I)*.

(n92)Footnote 252.15. *IRC § 170(b)(1)(B)*.

(n93)Footnote 252.16. *IRC § 170(b)(1)(E)(iv)*.

(n94)Footnote 252.17. *IRC § 170(b)(1)(E)(ii)*.

(n95)Footnote 252.17.1. *Notice 2007-50*, 2007-25 IRB 1430 .

(n96)Footnote 252.18. *IRC § 170(b)(2)(B)(i)(I)*.

(n97)Footnote 252.19. See *IRC § 170(b)(2)(C)*.

(n98)Footnote 252.20. *IRC § 170(b)(2)(B)(i)*. The deduction is allowed for contributions made in tax years beginning after Dec 31, 2005 and before Jan 1, 2010 [see *IRC § 170(b)(2)(B)(iii)*].

(n99)Footnote 252.21. *IRC § 170(b)(2)(B)(ii)*.

(n100)Footnote 252.22. *IRC § 170(b)(2)(B)(i)(II)*. *Notice 2007-50*, 2007-25 IRB 1430 , provides guidance on what

parts of property will qualify as being used for agriculture or livestock production, and what steps must be taken to assure that the property will remain available for that use so as to qualify for the deduction.

(n101)Footnote 252.23. See *IRC* § 47.

(n102)Footnote 252.24. *IRC* § 170(f)(14), effective for contributions made after Aug 17, 2006.

(n103)Footnote 252.25. *IRC* § 170(f)(14).

(n104)Footnote 252.26. *Notice 2004-41, 2004-28 IRB 31.*

(n105)Footnote 252.27. See *IRC* § 6662.

(n106)Footnote 252.28. See *IRC* § 6700.

(n107)Footnote 252.29. See *IRC* § 6694.

(n108)Footnote 252.30. See *IRC* § 6701.

(n109)Footnote 252.31. See *IRC* § 4958.

(n110)Footnote 252.32. See D McClure, S Hollingworth and N Brown, "Courts to IRS: Ease Up on Conservation Easement Valuations," *124 Tax Notes* 551 (Aug 10, 2009); W. Elmore, "IRS Official Defends Audit Strategy on Conservation Easements," *125 Tax Notes* 61 (Oct 5, 2009).

(n111)Footnote 253. See *IRC* § 170(h)(4)(A)(iv), (C); *Treas Reg* § 1.170A-14(d)(5).

(n112)Footnote 254. *IRC* § 170(h); see [3], above.

(n113)Footnote 255. See *Rome I, Limited v Commr*, 96 TC 697 (1991) ; *Ltr Rul* 199933029 (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

(n114)Footnote 255.1. *Treas Reg* § 1.170A-13(c)(3)(ii)(J), (K). See CCA 201014056 (April 9, 2010) .

(n115)Footnote 256. *Treas Reg* § 1.170A-14(h)(3)(i); *Simmons v Commr*, *TC Memo* 2009-208 (court allowed 5 % reduction in values of two properties due to facade easements; the taxpayer claimed 11 and 13 % reductions); *Whitehouse Hotel Limited Partnership v Commr*, 131 TC No 10 (2008) (facade easement value determined under comparable sales approach to be \$1.8 million rather than the \$7.5 million claimed by the taxpayer); *Hillborn v Commissioner*, 85 TC 677 (1985) ; *Dorsey, Jr v Commr*, *TC Memo* 1990-242, 59 TCM 592 ; *Griffin v Commr*, *TC Memo* 1989-130, 56 TCM 1560 , *affd* 911 F2d 1124 (5th Cir 1990) ; *Nicoladis v Commr*, 55 TCM 624, *TC Memo* 1988-163 .

(n116)Footnote 256.1. *Bruzewicz v US*, 604 FSupp 2nd1197 (DC Ill 2009) (deduction for facade easement disallowed because no satisfactory acknowledgment by donee obtained; the easement appraisal was also faulty in several respects).

(n117)Footnote 257. *Rome I, Limited v Commr*, 96 TC 697 (1991) ; *Rev Rul* 89-90, 1989-2 CB 3 .

(n118)Footnote 257.1. *IRC* § 170(h)(4)(B)(i)(I).

(n119)Footnote 257.2. *IRC* § 170(h)(4)(B)(i)(II).

(n120)Footnote 257.2.1. See *Herman v Commr*, *TC Memo* 2009-205 . See, however, *Dorsey v Commr*, *TC Memo*

1990-242 (contribution of both facade and air rights easements together may support a charitable deduction).

(n121)Footnote 257.3. *IRC § 170(h)(4)(B)(ii)*. The restrictions apply for contributions made after July 25, 2006 [Pub Law 109-280, § 1213(e)(1)].

(n122)Footnote 257.4. Committee reports accompanying the legislation indicate that photographs of the entire exterior of the building are required only to the extent practicable. For example, if the building is a skyscraper, aerial photographs of the roof would not be required, but photographs sufficient to establish the existing exterior would still have to be submitted. See Joint Committee on Taxation report JCX-38-06 (Aug 3, 2006), at 291.

(n123)Footnote 257.5. *IRC § 170(h)(4)(B)(iii)*; see Joint Committee on Taxation report JCX-38-06 (Aug 3, 2006), at 291.

(n124)Footnote 257.6. *IRC § 170(f)(13)(A), 170(f)(13)(B)*, effective for contributions on or after Feb 14, 2007 [Pub Law 109-280, § 1213(e)(3)]. Amounts paid are used to enforce qualified conservation contributions [*IRC § 170(f)(13)(C)*].

(n125)Footnote 258. *Arbor Towers Associates, Ltd v Commr, TC Memo 1999-213* ; see *US v American Bar Endowment*, 477 US 105 (1986) ; *Stark v Commr*, 86 TC 243 (1986) ; *Waller v Commr*, 39 TC 665 (1963) ; *Musgrave v Commr, TC Memo 2000-285* (entry into contract for deed to Texas real property with a charitable organization constituted completed gift); see *Treas Reg § 1.170A-1(h)(2)*.

(n126)Footnote 259. *Arbor Towers Associates, Ltd v Commr, TC Memo 1999-213* ; *Estate of Proios v Commr, TC Memo 1994-442* ; *Thornton v Commr, TC Memo 1998-479* , *affd without published opin* 908 F2d 977 (9th Cir 1990) .

(n127)Footnote 260. *Consol Investors Group v Commr, TC Memo 2009-290 (2009)* ; *Klauer v Commr, TC Memo 2010-65 (2010)* (court found that the taxpayer made several bargain sales with respect to real property and was therefore entitled to charitable deduction); *Stark v Commr*, 86 TC 243 (1986) ; *Arbor Towers Associates, Ltd v Commr, TC Memo 1999-213* .

(n128)Footnote 261. *IRC § 170(e)*; see [1], above, for a discussion.

(n129)Footnote 261.1. *IRC § 1011(b)*.

(n130)Footnote 261.2. *Consol Investors Group v Commr, TC Memo 2009-290 (2009)* .

(n131)Footnote 261.3. *IRC §§ 170, 1001(a), 1011(b)*; *Consol Investors Group v Commr, TC Memo 2009-290 (2009)* .

(n132)Footnote 262. *Notice 2004-41, 2004-2 CB 31* .

(n133)Footnote 263. *IRC § 170(f)(8)(A), (C)*.

(n134)Footnote 264. *IRC § 170(f)(8)(B)*.

(n135)Footnote 264.1. *Treas Reg § 1.170A-13(f)(2)*.

(n136)Footnote 264.2. *Bruzewicz v US*, 604 F Supp 2d 1197 (DC Ill 2009) (deduction for facade easement disallowed because no acknowledgment obtained).

(n137)Footnote 265-266. *IRC § 170(f)(8)(D)*.

(n138)Footnote 267. *IRC § 170(f)(11)(B)*.

(n139)Footnote 267.1. *IRC § 6050L(a)*.

(n140)Footnote 267.2. For certain tangible personal property, a certification of use must also be submitted; see *IRC § 6050L(a)(1)*.

(n141)Footnote 267.3. *IRC § 6050L(a)(2)(A)*.

(n142)Footnote 267.4. See *IRC §§ 6111, 6112; Treas Reg § 1.6011-4(b)(6)*.

(n143)Footnote 267.5. *Notice 2007-72, 2007-36 IRB 544* .

(n144)Footnote 267.6. *Notice 2007-72, 2007-36 IRB 544* .

(n145)Footnote 267.7. See *Treas Reg § 1.6011-4(b)(6); IRC §§ 6111 and 6112*, effective Aug 14, 2007.

(n146)Footnote 267.8. See *Treas Reg § 1.6011-4*, effective for transactions entered into on or after Nov 11, 2006.

(n147)Footnote 267.9. *Notice 2007-72, 2007-36 IRB 544* . See *IRC §§ 6111, 6112; Treas Reg §§ 1.6011-4(h), 301.6111-3(i), 301.6112-1(g)*, effective for transactions entered into on or after Nov 11, 2006.

(n148)Footnote 267.10. See *Treas Reg § 1.6011-4(c)(3)(i)(E)*.

(n149)Footnote 267.11. See *Treas Reg §§ 1.6011-4(e), 301.6111-3(e)*.

(n150)Footnote 267.12. *Notice 2007-72, 2007-36 IRB 544* . See *Treas Reg § 301.6111-3(b)(3)(i)(B)*.

(n151)Footnote 267.13. See *Treas Reg § 1.6011-4*.

(n152)Footnote 267.14. See *IRC § 6111*.

(n153)Footnote 267.15. See *IRC § 6112*.

(n154)Footnote 267.16. *Notice 2007-72, 2007-36 IRB 544* ; see *IRC §§ 6662, 6662A*.

(n155)Footnote 268. *IRC § 170(f)(11)(C)*; C corporations were not subject to this requirement for contributions made before June 4, 2004. The requirement has long been required of other taxpayers (Pub L No 98-369, §§ 155(a)(1)-(6)).

(n156)Footnote 269. *IRC § 170(f)(11)(D)*.

(n157)Footnote 270. *IRC § 170(f)(11)(F)*.

(n158)Footnote 271. *IRC § 170(f)(11)(A)(i)*.

(n159)Footnote 272. *IRC § 170(f)(11)(G)*.

(n160)Footnote 273. *IRC § 170(f)(11)(A)(ii)(II)*.

(n161)Footnote 274. See *IRC § 170(f)(11)(H)*.

(n162)Footnote 274.1. *Treas Reg § 1.170A-13*.

(n163)Footnote 274.2. *Consol Investors Group v Commr, TC Memo 2009-290 (2009)* (substantial compliance found even though appraisal report was untimely and it lacked the date the contribution of property was made, a statement that the appraisal was prepared for income tax purposes, and the fair market value of the property as of the

date of contribution); *Bond v Commr*, 100 TC 32 (1993) (substantial compliance found even though qualifications of appraiser were omitted); *Simmons v Commr*, TC Memo 2009-208 (2009) (substantial compliance found although appraisals did not contain explicit statement that they were prepared for income tax purposes); *Hewitt v Commr*, 109 TC 258 (1997), *affd without published opinion* 166 F3d 332 (4th Cir 1998) (no substantial compliance found because nearly all information required on Form 8283 was not provided).

(n164)Footnote 275. IRC § 170(f)(11)(E)(i); see Notice 2006-96, 2006-2 CB 902 (transitional guidance relating to the new definition of "qualified appraisal").

(n165)Footnote 275.1. CCA 201022021 .

(n166)Footnote 275.2. CCA 201024065 .

(n167)Footnote 275.3. *Treas Reg* § 1.170A-13(c)(5)(iii).

(n168)Footnote 276. IRC §§ 170(f)(11)(E)(ii), 170(f)(11)(E)(iii); see Notice 2006-96, 2006-2 CB 902 (transitional guidance relating to the new definition of "qualified appraiser").

(n169)Footnote 277. IRC § 6695A(a), generally effective for appraisals prepared with respect to returns or submissions filed after 8/17/06 [Pub Law No 109-280, § 1219(e)(2)]. See IRC § 6662(e), (g), (h).

(n170)Footnote 278. IRC § 6695A(b); see Notice 2006-96, 2006-2 CB 902 (transitional guidance relating to the new IRC § 6695A regarding substantial or gross valuation).

(n171)Footnote 279. IRC § 6695A(c).

(n172)Footnote 280. IRC § 6696(a).

(n173)Footnote 281. See IRC § 170.

(n174)Footnote 282. IRC § 4966(d)(2); see § 6.05[9][b], below, for a discussion.

(n175)Footnote 283. See IRC §§ 170(f)(18)(A)(ii), 2055(e)(5)(A)(ii), 2522(c)(5)(A)(ii); see § 6.05[9][c], below, for a discussion.

(n176)Footnote 284. IRC § 4943(e); see § 6.05[9][d], below, for a discussion.

(n177)Footnote 285. IRC § 4958(a), (b), (c)(2); see § 6.05[9][e], below, for a discussion.

(n178)Footnote 286. IRC § 4966(a); see § 6.05[9][f], below, for a discussion.

(n179)Footnote 287. IRC § 4967(a), (c); see § 6.05[9][g], below, for a discussion.

(n180)Footnote 288. IRC §§ 508(f), 6033(k); see § 6.05[9][h], below, for a discussion.

(n181)Footnote 289. IRC § 4966(d)(2)(A).

(n182)Footnote 290. See IRC § 170(c)(1).

(n183)Footnote 291. See IRC § 509(a).

(n184)Footnote 292. IRC § 4966(d)(1).

(n185)Footnote 293. IRC § 4966(d)(2)(A)(i).

- (n186)Footnote 294. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n187)Footnote 295. See *IRC* § 4966(d)(2)(A)(ii).
- (n188)Footnote 296. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n189)Footnote 297. See *IRC* § 4966(d)(2)(A)(iii).
- (n190)Footnote 298. See *IRC* § 170(b)(1)(A).
- (n191)Footnote 299. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n192)Footnote 300. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n193)Footnote 301. *IRC* § 4966(d)(2)(A)(iii).
- (n194)Footnote 302. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n195)Footnote 303. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n196)Footnote 304. *IRC* § 4966(d)(2)(B).
- (n197)Footnote 305. *IRC* § 4966(d)(2)(B)(i).
- (n198)Footnote 306. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006). *IRC* § 4966(d)(2)(B).
- (n199)Footnote 307. *IRC* § 4966(d)(2)(B)(ii); see *IRC* § 4945(g)(1),(2),(3).
- (n200)Footnote 308. *IRC* § 4966(d)(2)(C)(i).
- (n201)Footnote 309. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n202)Footnote 310. *IRC* § 4966(d)(2)(C)(ii).
- (n203)Footnote 311. See *IRC* § 170(c)(3).
- (n204)Footnote 312. See *IRC* § 170(c)(4).
- (n205)Footnote 313. *IRC* § 170(f)(18)(A)(i); see *IRC* § 170(c)(5).
- (n206)Footnote 314. See *IRC* § 2522(a)(3).
- (n207)Footnote 315. *IRC* § 2522(c)(5)(A)(i); see *IRC* § 2522(a)(4).
- (n208)Footnote 316. See *IRC* § 2055(a)(3).
- (n209)Footnote 317. *IRC* § 2055(e)(5)(A)(i); see *IRC* § 2055(a)(4).
- (n210)Footnote 318. *IRC* §§ 170(f)(18)(A)(ii), 2055(e)(5)(A)(ii), 2522(c)(5)(A)(ii); see *IRC* § 4943(f)(5)(A) (definition of Type III supporting organization).
- (n211)Footnote 319. See *Treas Reg* § 1.509(a)-4(i)(3)(ii).
- (n212)Footnote 320. *IRC* § 4943(f)(5)(B).

- (n213)Footnote 321. See *IRC* § 170(f).
- (n214)Footnote 322. See *IRC* § 170(f)(8)(C) for requirements of a written acknowledgment
- (n215)Footnote 323. *IRC* §§ 170(f)(18)(B), 2055(e)(5)(B), 2522(c)(5)(B).
- (n216)Footnote 324. *IRC* § 4943(e)(1).
- (n217)Footnote 325. *IRC* § 4943(a)(1).
- (n218)Footnote 326. *IRC* § 4943(b).
- (n219)Footnote 327. *IRC* §§ 4961, 4962, 4963.
- (n220)Footnote 328. *IRC* § 4943(e)(2).
- (n221)Footnote 329. *IRC* § 4943(e)(3); see *IRC* § 4943(c)(4),(5),(6).
- (n222)Footnote 330. *IRC* § 4958(c)(2)(A).
- (n223)Footnote 331. *IRC* § 4958(c)(2)(B).
- (n224)Footnote 332. See *IRC* § 4958(a), (b).
- (n225)Footnote 333. *IRC* §§ 4961, 4962, 4963.
- (n226)Footnote 334. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n227)Footnote 335. *IRC* § 4958(f)(1)(D), (E).
- (n228)Footnote 336. See *IRC* § 4958(c)(1)(B).
- (n229)Footnote 337. *IRC* § 4958(a)(1).
- (n230)Footnote 338. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n231)Footnote 339. See *IRC* § 4958(f)(1)(E).
- (n232)Footnote 340. See *IRC* § 4958(a), (f)(1)(D),(E).
- (n233)Footnote 341. *IRC* § 4958(a)(1), (c)(2).
- (n234)Footnote 342. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).
- (n235)Footnote 343. *IRC* § 4958(f)(1)(F), (8)(A).
- (n236)Footnote 344. *IRC* § 4958(f)(8)(B).
- (n237)Footnote 345. *IRC* § 4966(a)(1).
- (n238)Footnote 346. *IRC* § 4966(a)(2), (b)(2).
- (n239)Footnote 347. *IRC* §§ 4962(a), 4963(a), (c), (d).
- (n240)Footnote 348. Pub Law No 109-280, § 1231(c).

(n241)Footnote 349. *IRC § 4966(c)(1)*:

(n242)Footnote 350. See *IRC § 4945(h)* (these standards generally require that an organization exert all reasonable efforts and establish adequate procedures to see that the distribution is spent solely for the purposes for which made, to obtain full and complete reports from the distributee on how the funds are spent, and to make full and detailed reports with respect to those expenditures to the Secretary).

(n243)Footnote 351. *IRC § 4966(c)(2)*.

(n244)Footnote 352. See *IRC § 4966(d)(4)* (definition of "disqualified supporting organization").

(n245)Footnote 353. See *IRC § 4966(c)(2)(A)*.

(n246)Footnote 354. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).

(n247)Footnote 355. *IRC § 4967(a)(1)*.

(n248)Footnote 356. *IRC § 4967(c)(1)*.

(n249)Footnote 357. *IRC § 4967(a)(2), (c)(2)*.

(n250)Footnote 358. *IRC §§ 4962(a), 4963(a), (c), (d)*.

(n251)Footnote 359. Pub Law No 109-280, § 1231(c).

(n252)Footnote 360. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006); see *Rev Rul 80-77, 1980-1 CB 56 ; Rev Proc 90-12, 1990-1 CB 471* .

(n253)Footnote 361. *IRC § 6033(k)*.

(n254)Footnote 362. *IRC § 508(f)*.

(n255)Footnote 363. See Joint Committee Conference Report JCX-38-06 (Aug 3, 2006).



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Federal Taxes Affecting Real Estate

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CHAPTER 7 Installment Sales

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Federal Taxes Affecting Real Estate

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CHAPTER 7 Installment Sales

1-7 Federal Taxes Affecting Real Estate § 7.01

§ 7.01 Statutory Framework and Benefits

Many real estate sales result in the seller receiving some or all of the purchase price after the year of sale. If the sale produces a gain, general tax accounting rules would typically require the seller to recognize the full amount of the gain in the year of sale. This could result in a significant tax liability, even though the seller does not receive most of the sale proceeds until several years hence.

Congress recognized that the tax liability might pose a serious cashflow problem for the seller if he could not match the payment of tax with the receipt of cash from the buyer. Consequently, the Code provides specific installment sale tax rules to allow a seller, under certain circumstances, to spread out tax payments over an extended period of time. n1

The installment sale rules provide yet another benefit: Because tax rates are graduated upward, it is generally less expensive to report the receipt of a substantial amount of income over a period of years rather than to bunch it all up in one year--particularly if the gain is taxed as ordinary income, rather than as capital gain. The primary downside, however, is that a taxpayer who defers the recognition of gain assumes the risk of an increase in tax rates in later years: Subsequent installment payments are taxed at the rates in effect in the year collected, rather than the rates in effect in the year of sale. n1.1

The bulk of the installment sale rules appear in *IRC Section 453*. This section allows most real estate sellers to use the installment method, with one main exception--the installment method cannot be used for dealer dispositions, unless the property being sold is farm property or certain timeshares and residential lots. n2 Real estate investors who make significant installment sales will typically be subject to additional rules under *IRC Section 453A*. That section generally requires these sellers to pay interest on income taxes they defer by using the installment method. Finally, *IRC Section 453B* provides rules that apply to sellers who sell property on the installment basis, receiving an installment obligation from the buyer, but dispose of the obligation before it has been paid in full.

Note:

Federal legislation enacted in 1999 precluded accrual method taxpayers from using the installment method. This legislation caused an immediate uproar and was retroactively repealed in December 2000. The installment sale statutory provisions are to be applied and administered as if the 1999 legislation had not been enacted. n2.1

The retroactive repeal allows accrual method taxpayers who sold real estate or had other transactions that may be reported on the installment method to file an amended return for 1999 (for sales occurring during 1999 when the now-repealed provisions were effective), or file a claim for refund for estimated tax payments for payments made with respect to sales that took place in 2000. The repealed provision may be ignored in preparing income tax returns for 2000 calendar and tax year returns.

The IRS has issued a notice providing guidance regarding the interplay of the repealing legislation and the election out provision in the installment method rules. n2.2 The installment method does not apply to any disposition for which the taxpayer elects out of the installment method. n2.3 A taxpayer who reports an amount realized equal to the selling price on the tax return filed for the taxable year in which an installment sale occurs is considered to have made an election out of the installment method. n2.4 An election out of the installment method may be revoked only with the consent of the Secretary, n2.5 and any revocation is retroactive. n2.6 In the notice, the IRS states that an accrual method taxpayer that entered into an installment sale on or after December 17, 1999, and filed a federal income tax return by April 16, 2001, reporting the sale on an accrual method (and, thus, an amount realized equal to the selling price) has the consent of the Secretary to revoke its effective election out of the installment method. The consent is effective only if the taxpayer files timely amended federal income tax return(s) for the taxable year in which the installment sale occurred, and for any other affected taxable year, reporting the gain on the installment method. Thus, a taxpayer may not revoke its effective election out of the installment method if the taxable year in which any payment on the installment obligation was received has closed. n2.7

One point worth noting at the outset is that the Code's definition of an installment sale varies from that phrase's meaning in common parlance. Though most installment sales call for multiple payments over an extended period of time, the Code merely requires that the buyer make at least one payment following the year of sale. n3 In addition, the installment sale rules apply only to sales that produce a gain. n4 Subject only to general tax rules limiting loss deductions, a seller recognizes the full amount of the loss on property in the year of sale--even if the sales price is paid over a number of years.

Finally, it should be noted that the installment method cannot be used for sales in which a taxpayer receives only indebtedness that is readily tradable, regardless of the nature of the issuer. The reason for this is that receipt of any readily tradable indebtedness is treated as "payment." Therefore, if a taxpayer sells property solely in exchange for readily tradable debt of a partnership, the partnership debt is treated as payment on the installment note, and the installment method is unavailable to the taxpayer. n4.1 For sales occurring before October 22, 2004, the installment method was not available if the taxpayer sold property in exchange for readily tradable evidence of indebtedness that was issued by a corporation or a government or political subdivision. Instead, the receipt of that indebtedness was treated as a receipt of payment. n4.2

FOOTNOTES:

(n1)Footnote 1. See *IRC* § 453.

(n2)Footnote 1.1. See, eg, *Sanford v Commr*, 76 AFTR2d P 95-5136 (5th Cir 1995) (an unpublished per curiam opinion which is also available electronically at 95 TNT 144-12), where the taxpayer sold property in 1986 using the installment method. The capital gains deduction under prior-law *IRC* § 1202 was available at the time of sale, but not when the taxpayer reported an installment payment in 1989. The Fifth Circuit, citing *Commr v So Tex Lumber Co*, 333 US 496 , 1948-2 USTC P 5929, 36 AFTR P 604 (1948), concluded that the taxpayer could not take the capital gains deduction for the 1989 payment.

(n3)Footnote 2. *IRC* § 453(b)(2)(A), (l). Whether a seller is a dealer is governed by general rules that consider the

level and nature of the seller's activities. See Ch 10. See also *Ltr Rul 9331013* , where the Service ruled that a partnership which purchased a high rise building and sold apartment units in the building through a direct marketing campaign, unit-by-unit, was not a dealer for purposes of *IRC § 453(l)(1)* and could, therefore, use the installment method to report the sales. Also see *Raymond v Commr, TC Memo 2001-96* , where the Tax Court held that the face amount of promissory notes received in the sales of 41 single family homes by a sole proprietor had to be included in gross income because the sales were dealer dispositions and not eligible for the installment method. The court found the homes to be held in the ordinary course of the taxpayer's business because the taxpayer had purchased land with the intent of subdividing it into residential lots and constructing single-family residences. He had made the improvements, listed the homes with an outside seller, and sold more than 58 homes in a 2-year period.

(n4)Footnote 2.1. *IRC § 453*; see Pub Law No 106-573.

(n5)Footnote 2.2. *Notice 2001-22, 2001-12 IRB 911* .

(n6)Footnote 2.3. *IRC § 453(d)(1)*.

(n7)Footnote 2.4. *Temp Treas Reg § 15a.453-1(d)(3)(i)*.

(n8)Footnote 2.5. *IRC § 453(d)(3)*.

(n9)Footnote 2.6. *Temp Treas Reg § 15a.453-1(d)(3)(i)*.

(n10)Footnote 2.7. *Notice 2001-22, 2001-12 IRB 911* .

(n11)Footnote 3. *IRC § 453(b)(1)*.

(n12)Footnote 4. See *IRC § 453(c)*, referring to "gross profit."

(n13)Footnote 4.1. *IRC § 453(f)(4)(B)*, effective for sales occurring on or after Oct 22, 2004.

(n14)Footnote 4.2. *IRC § 453(f)(3), (4)(B)*, before amendment by Pub L No 108-357.



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Federal Taxes Affecting Real Estate

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CHAPTER 7 Installment Sales

1-7 Federal Taxes Affecting Real Estate § 7.02

§ 7.02 The Installment Method

[1] Transactions Eligible For Installment Sale Treatment

Sales of real estate that are not sales to customers in the ordinary course of business (i.e., that are not dealer sales) are generally reportable on the installment basis if at least a portion of the payment is received after the year of sale. n5 Installment sale reporting may be combined with the *IRC Section 121* exclusion, to report gain in excess of the exclusion. n5.1 The installment method automatically applies to qualifying sales, unless the seller "elects out" and deliberately chooses to report the transaction as completed in the year of sale. The "election out" rules are located in *IRC Section 453(d)*.

Despite the general rule that dealer sales are ineligible for installment sale treatment, n6 there are certain dealer dispositions which may be reported under the installment method. These favored dispositions include the following:

- Installment sales of farm property described in *IRC § 2032A(e)(4)* or *(5)*; n6.1
- Dealer sales to an individual of a timeshare right to use a timeshare ownership interest in residential real estate, provided that the right to use the real property cannot exceed more than six weeks per year; n6.2
- Dealer sales to an individual of a timeshare right to use specified campgrounds for recreational purposes; n6.3 and
- Dealer sales to an individual n6.4 of any residential lot, but only if the taxpayer (or any related person) is not to make any improvements with respect to the lot. n6.5

Qualifying dealer dispositions of timeshares and residential lots may be reported on the installment method only if the dealer makes an election to pay interest on the tax liability that is deferred through the use of the installment method. n6.6 The election is available, however, only if the installment obligation is not guaranteed by any person other than an individual. n6.7

Note:

A dealer is not required to report any or all qualifying timeshare sales on the installment basis. Indeed, a dealer may report some sales on the installment basis and not others. n6.8

Whether property is residential real property or a residential lot for purposes of the above dealer dispositions is usually not in issue. n7 In one case, the Tax Court held that undeveloped real estate marketed as a speculative investment did not qualify as residential lots so as to entitle the taxpayers to the residential real estate exception for dealer dispositions. n7.1 The court found that temporary regulations under former *IRC Section 453C* n7.2 provided the best guidance for interpreting the term "residential lots" in *IRC Section 453(l)(2)(B)*. Those regs defined a residential lot as "a parcel of unimproved land on which the purchaser intends to construct (or intends to contract to have another person construct) a dwelling unit for use as a residence by the purchaser." Applying this definition, the Tax Court found that the land sold by the dealer-taxpayers was not residential property. Although the zoning for the lots permitted a buyer to construct a house on them, the land was marketed as a speculative investment. The offering materials exclusively focused on return on investment, capital preservation (safety), and tax considerations. The land was not represented to potential buyers as suitable for use as residential lots, and the overwhelming weight of evidence indicated that no buyer ever constructed a dwelling unit on the land. The court concluded that the taxpayers could not use the installment sales method for reporting gain because they failed to satisfy the residential real estate exception for dealer dispositions. n7.3

The majority of real estate installment sales involve nondealers, and many of these taxpayers must contend with *IRC Section 453A*. This provision imposes an interest charge on a seller's installment sale if the sales price of the property in question is greater than \$150,000 and if the sale took place in a year when the taxpayer made installment sales which gave rise to installment obligations which have a total outstanding face value exceeding \$5 million at year's end. n8

[2] Electing Out of Installment Sale Treatment

The law presumes that a taxpayer who can report on the installment basis will do so. Thus, the Code says that the installment sale rules apply automatically to eligible dispositions unless the taxpayer elects out of the special treatment. n9

The taxpayer who wants installment sale treatment reflects the sale on IRS Form 6252 (Installment Sale Income). To elect out, a taxpayer simply reports the entire gain from the transaction on whichever of these IRS Forms is appropriate: Form 1040 Schedule D (Capital Gains and Losses) or IRS Form 4797 (Sales of Business Property). Temporary regulations provide that the election must be made in the manner prescribed by the appropriate forms for the taxpayer's return in the year of sale. n10

A taxpayer interested in electing out of installment sale treatment must do so by the due date, including extensions, for the tax return for the sale year. n11 Revocation of the election out may be revoked only with the consent of the IRS. n12 The grounds for most consents is that the taxpayer's advisor made an error. n13 Taxpayers should not expect to receive consent when one purpose of revoking the election is to avoid federal income tax n14 or when the tax year in which any payment was received is now closed. n15

NOTE:

The IRS has issued a notice providing guidance regarding the interplay of the repeal of legislation that precluded accrual basis taxpayers from using the installment method n15.1 and the election out provision in the installment method rules. n15.2 The installment method does not apply to any disposition for which the taxpayer elects out of the installment method. n15.3 A taxpayer who reports an amount realized equal to the selling price on the tax return filed for the taxable year in which an installment sale occurs is considered to have made an election out of the installment method. n16 An election out of the installment method may be revoked only with the consent of the Secretary, n17 and any revocation is retroactive. n18 In the notice, the IRS states that an accrual method taxpayer that entered into an installment sale on or after December 17, 1999, and filed a federal income tax return by April 16, 2001,

reporting the sale on an accrual method (and, thus, an amount realized equal to the selling price) has the consent of the Secretary to revoke its effective election out of the installment method. The consent is effective only if the taxpayer files timely amended federal income tax return(s) for the taxable year in which the installment sale occurred, and for any other affected taxable year, reporting the gain on the installment method. Thus, a taxpayer may not revoke its effective election out of the installment method if the taxable year in which any payment on the installment obligation was received has closed. n19

[3] Alternative Minimum Tax Considerations

[a] Corporations

For C corporations not exempt under the small corporation exemption, n20 installment dispositions can be problematic because of the special AMT provision that applies to this type of taxpayer. The provision in question is the AMT adjustment for adjusted current earnings (the ACE adjustment). In somewhat simplistic terms, this adjustment is designed to penalize taxpayers that have significant economic income, but report comparatively smaller amounts of income for regular tax purposes. One way the ACE adjustment does this is by preventing a corporation from using the installment method for ACE purposes, except to the extent that the corporation pays interest on the deferred tax liability attributable to the applicable percentage of gain under *IRC Section 453A*. n21

Example:

XYZ Corp. sells an undeveloped parcel of real estate for \$4 million in Year 1, calling for four annual \$1 million payments beginning in Year 2, plus adequate stated interest. XYZ's adjusted basis in the property is \$500,000. XYZ is not a dealer, and this is the only sale it makes using the installment method in Year 1. Because the face amount of this obligation does not exceed \$5 million, *IRC Section 453A* does not apply to this disposition. In Year 1, XYZ recognizes none of its \$3.5 million gain (i.e., \$4,000,000 - \$500,000) for regular tax purposes. It must, however, recognize the full \$3.5 million gain for ACE adjustment purposes in Year 1. n22

[b] Non-Corporate Taxpayers

The maximum AMT rate on net capital gains of a noncorporate taxpayer cannot exceed the capital gains rate that applies for regular tax purposes. Thus, the regular tax capital gains tax rates also apply for AMT purposes. n22.1 The amounts of these net capital gains for AMT purposes are determined according to the principles used for regular tax purposes, although the AMT amounts can vary from the regular tax amounts because of AMT adjustments and preferences. n22.2

The manner in which the regular capital gains rates is applied for AMT purposes is by means of a statutory limitation that requires complex and convoluted computations that fill the second page of Form 6251. Under the limitation, the amount of AMT computed with the usual 26-and 28-percent AMT tax rates cannot exceed the sum of the following amounts: n22.3

- (1) The amount determined by applying the 26-and 28-percent rates on the amount of the taxable excess (i.e., alternative minimum taxable income less the applicable exemption amount), reduced by the lesser of (a) the net capital gain, or (b) the sum of (i) the adjusted net capital gain, plus (ii) the unrecaptured *IRC Section 1250* gain; plus
- (2) 5 percent (0 percent for tax years beginning after 2007) of so much of the adjusted net capital gain (or, if less, the taxable excess) as does not exceed an amount equal to the excess described in *IRC Section 1(h)(1)(B)*; plus
- (3) 15 percent of the adjusted net capital gain (or, if less, the taxable excess) in excess of the amount on

which a tax is determined using the 5 percent rate in step (2) above; plus

(4) 25 percent of the taxable excess in excess of the sum of the amounts on which tax is determined in steps (1) through (3), above.

Noncorporate taxpayers with significant capital gains from an installment sale will not solely by virtue of those gains become liable for the AMT. n22.4 Capital gains from an installment sale may, however, indirectly cause a noncorporate taxpayer to become liable for the AMT at the regular AMT rate if the gains cause the taxpayer's AMT income to exceed the AMT exemption amount. n22.5 A noncorporate taxpayer's AMT income include long-term capital gains. n22.6 Therefore, significant capital gains may cause a taxpayer's AMT exemption amount to be phased out. This, in turn, may trigger AMT taxation of other income at the 26 or 28 percent tax rate. n22.7

[4] Interaction with Other Code Sections

A taxpayer's decision to use the installment method does not necessarily preclude the use of other tax-favored Code provisions. For example, it is not uncommon for a taxpayer to use the installment sale rules in connection with the like-kind exchange provisions under *IRC Section 1031*. How these two provisions interact is discussed in Chapter 8.

The special rules relating to gain on the sale of a principal residence--provided in *IRC Section 121*--can also be used in conjunction with an installment sale. This subject is discussed in Chapter 9.

FOOTNOTES:

(n1)Footnote 5. *IRC § 453(a)*. Special rules apply to installment sales of depreciable property to controlled entities. This subject, which is beyond the scope of this treatise, is governed by *IRC § 453(g)*. See also Andrew R Henderson, "Using the Imputed Interest Safe Harbor for Intrafamily Installment Sales," 74 *J Tax'n* 100 (1991).

(n2)Footnote 5.1. See *IRC § 453*; see *Ltr Rul 200931001* (taxpayers allowed to revoke their election out of installment method on the sale of their principal residence when their return preparer erroneously told them they could not use installment method in connection with *IRC § 121* exclusion to report gain).

(n3)Footnote 6. *IRC § 453(b)(2)(A)*.

(n4)Footnote 6.1. *IRC § 453(l)(2)(A)*.

(n5)Footnote 6.2. *IRC § 453(l)(2)(B)(ii)(I)*.

(n6)Footnote 6.3. *IRC § 453(l)(2)(B)(ii)(I)*.

(n7)Footnote 6.4. See *Tietig v Commr, TC Memo 2001-190*, *affd per curiam 2003-1 USTC P 50,205 (11th Cir 2003)* (sale to partnership did not qualify, and taxpayer failed to prove the lots were residential lots).

(n8)Footnote 6.5. *IRC § 453(l)(2)(B)(ii)(II)*.

(n9)Footnote 6.6. *IRC § 453(l)(2)(B)(i), (3)*; see *TAM 9343007*. The interest computation is discussed at § 7.05[2], below.

(n10)Footnote 6.7. *IRC § 453(l)(2)(B)(i)*; see *TAM 9133002* (credit life insurance for timeshare purchasers is not considered a guarantee that precludes use of the election).

(n11)Footnote 6.8. See *TAM 9213001*.

(n12)Footnote 7. See *IRC § 453(l)(2)(B)(ii)*; but see *Tietig v Commr, TC Memo 2001-190*, *affd per curiam 2003-1*

USTC P 50,205 (11th Cir 2003) (taxpayer failed to prove lots were residential lots).

(n13)Footnote 7.1. *Wang v Commr, TC Memo 1998-127* ; see *IRC § 453(l)(2)(B)*.

(n14)Footnote 7.2. See *Temp Treas Reg § 1.453C-8T(4)*.

(n15)Footnote 7.3. *Wang v Commr, TC Memo 1998-127* .

(n16)Footnote 8. *IRC § 453A(a)(1), (b)*. This is discussed further in § 7.05[1], below.

(n17)Footnote 9. *IRC § 453(d)*. In one instance, the Service ruled that a dealer taxpayer was allowed to report the sale of residential lots using the installment method, even though the taxpayer failed to pay interest on the deferred tax, as required by *IRC § 453(l)(3)*. The Service's holding was based on the taxpayer's having made a proper and timely election. *TAM 9343007* . See § 7.09, below, for a discussion of the tax treatment that applies when a taxpayer elects not to have the installment sale rules apply.

(n18)Footnote 10. *Temp Treas Reg § 15A.453-1(d)(3)(i)*; see IRS Publication 537, p 4.

(n19)Footnote 11. *IRC § 453(d)(2)*. If a taxpayer inadvertently elects out of installment treatment and--before the return's due date--files a second return reporting the sale using the installment method, the Service will look to the second return and ignore the first for this purpose. *Ltr Rul 9446007* . The Service will allow an election to be made after the due date in those "rare circumstances" where "the taxpayer had good cause for failing to make a timely election." *Temp Treas Reg § 15A.453-1(d)(3)(ii)*. See also *Rev Rul 90-46, 1990-1 CB 107* (change in the taxpayer's circumstances, change in the law, and change of mind are all unacceptable reasons); *TAM 9243005* (estate denied right to make late election when motivation is tax savings resulting from changed circumstances); *Ltr Rul 9121044* (good cause not shown when taxpayers always intended to use the installment method but subsequently wanted to elect out when changed circumstances made the election advisable); *Ltr Rul 9130004* (tardy election not allowed where audit adjustments produce changed circumstances which make it desirable to elect out of installment sale treatment); *Ltr Rul 9023010* (taxpayer not allowed to elect out of installment sale treatment following an unanticipated resale of the installment property and a tax law change; the motivation was to produce a better tax result).

(n20)Footnote 12. *IRC § 453(d)(3)*; *Temp Treas Reg § 15A.453-1(d)*; *Hirahara v Commr, TC Memo 1997-16* ; *Ltr Rul 199924066* .

(n21)Footnote 13. See, eg, *Ltr Rul 201027025* (tax return preparer failed to take into account state income tax consequences of the election out); *Ltr Rul 201016034* (representative failed to follow taxpayer's instruction to report gain from the sale of real estate under installment method); *Ltr Rul 201007035* (error by taxpayer's accountant); *Ltr Rul 200931001* (taxpayers' return preparer erroneously told them they could not use installment method in connection with *IRC § 121* exclusion to report gain from sale of principal residence); *Ltr Rul 200404035* and *Ltr Rul 200308042* (error by taxpayers' accountant); *Ltr Rul 200305014* (error by taxpayers' accountant); *Ltr Rul 200230016* (partnership relied on accounting firm to submit returns that would minimize their taxes, and as to two sales, specifically requested that gain be reported on the installment method); *Ltr Rul 9419012* (the taxpayers' return was not ready for signature until April 15, when the taxpayers noticed that their CPA incorrectly elected them out of the installment method; unable to reach the return preparer that day, they filed their return and, six days later, had their preparer draft a letter revoking the election; held, taxpayers could revoke their election); *Ltr Rul 9233044* (taxpayers allowed to revoke election when they intended to use the installment method but their return preparer mistakenly made the election); *Ltr Rul 9218012* (taxpayer allowed to revoke election made because his CPA erroneously told him that he could not use the installment method); *TAM 9214005* (taxpayer elected out of installment treatment using a note attached to her return, rather than by using Form 1040, Schedule D; held, failure to use correct form does not invalidate the election, nor does it allow the taxpayer to revoke the election; this is so despite the terms of *IRC § 453(d)(2)*, requiring that elections "be made in the manner prescribed by regulations"); *TAM 9213003* (facts similar to *Ltr Rul 9218012*); *Ltr Rul 9141013* (facts similar to *Ltr Rul 9233044*); *Ltr Rul 9118013* (facts similar to *Ltr Rul 9233044*). But see *Ltr Rul 9533012* (taxpayers not allowed

to revoke election even though they desired the revocation due to their accountant's error and even though they always intended to use the installment method; the taxpayers failed to check on how the sale was reported on their return and they only discovered the problem when their return was audited).

(n22)Footnote 14. *Temp Treas Reg § 15A.453-1(d)(4)*; see also *Krause v Commr, TC Memo 2000-343* (court held that taxpayers couldn't revoke an election out based on a hindsight attempt to reduce their federal income taxes; the IRS had denied a *IRC § 179* expense deduction that had offset the gain from the sale the taxpayers now wanted to report on the installment method); *Ltr Rul 9452034* (after substantial delay, taxpayers determined that changed circumstances made use of the installment sale method desirable; held, election out of installment method could not be revoked); *Ltr Rul 9413019* (taxpayers' accountant reported all gain in year of sale; although the taxpayers questioned their large tax liability, they never indicated that they intended to use the installment method; when they subsequently hired a new accountant, that person suggested that they amend their prior returns to reflect the disposition as an installment sale; held, the taxpayers could not revoke their election under these circumstances, especially since a significant motivation for doing so was that it would allow them to make better use of a capital loss they had); *TAM 9230003* (taxpayer inadvertently reported gain from the same transactions in both Year 1 (when it elected out of installment sale treatment) and Year 2; held, taxpayer could not revoke its Year 1 election, since doing so would allow the taxpayer to shift income from Year 1 to Year 2 and to use net operating losses that it could not carry back to Year 1); *TAM 9214005* (discussed in the preceding note); "Installment Election Virtually Irrevocable," 45 *Tax'n for Accts* 35 (1990).

(n23)Footnote 15. *Temp Treas Reg § 15A.453-1(d)(4)*; see also *Ltr Rul 9218012*, discussed in N 13, above.

(n24)Footnote 15.1. See *IRC § 453(a)*, before amendment by Pub L 106-573, § 2(a).

(n25)Footnote 15.2. *Notice 2001-22, 2001-12 IRB 911*; see *IRC § 453(d)*.

(n26)Footnote 15.3. *IRC § 453(d)(1)*.

(n27)Footnote 16. *Temp Treas Reg § 15a.453-1(d)(3)(i)*.

(n28)Footnote 17. *IRC § 453(d)(3)*.

(n29)Footnote 18. *Temp Treas Reg § 15a.453-1(d)(3)(i)*.

(n30)Footnote 19. *Notice 2001-22, 2001-12 IRB 911*.

(n31)Footnote 20. See *IRC § 55(e)*. See Chapter 6 for a discussion of the small corporation exemption.

(n32)Footnote 21. *IRC § 56(g)(4)(D)(iv)*. The adjustment is 75% of the amount by which the corporation's ACE exceeds its pre-adjustment AMT income.

(n33)Footnote 22. Assuming XYZ's ACE exceeds its pre-adjustment AMT income before considering this sale, the sale will increase the corporation's AMT income by \$2,625,000 (75% x \$3,500,000). In subsequent years, XYZ's ACE will be reduced by the amount of gain the corporation reports for regular tax purposes, since XYZ fully reflected the gain for ACE adjustment purposes in the year of disposition.

(n34)Footnote 22.1. *IRC § 55(b)(3)*; see *IRC § 1(h)*.

(n35)Footnote 22.2. See *Notice 97-59, 1997-2 CB 309*.

(n36)Footnote 22.3. *IRC § 55(b)(3)*.

(n37)Footnote 22.4. *IRC § 55(b)(3)*.

(n38)Footnote 22.5. See *IRC* § 55(d)(3).

(n39)Footnote 22.6. *IRC* § 55(b)(2).

(n40)Footnote 22.7. See *IRC* § 55(b)(1)(A), (d). See Chapter 6 for a discussion of AMT exemption amounts.



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Federal Taxes Affecting Real Estate

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CHAPTER 7 Installment Sales

1-7 Federal Taxes Affecting Real Estate § 7.03

§ 7.03 Definitions

To understand the mechanics of the installment method of reporting income, it is necessary to understand the terms discussed below.

[1] Installment Sale

An installment sale is a disposition of property with at least one payment received after the close of the taxable year in which the disposition occurs. ⁿ²³ In fact, the seller need not receive any payment in the year of sale. Moreover, an installment sale is possible when the purchase price is satisfied with just one payment.

Example:

S sells a parcel of undeveloped real estate to P on December 1, Year 1. S's adjusted basis in the property is \$100,000 and the sales contract calls for P to pay S \$500,000 on January 15, Year 2. Unless S elects out, she must report her gain using the installment method. This is so even though P makes only one payment to S, rather than a series of payments, and even though P pays S nothing in the year of sale.

[2] Selling Price

The selling price is the total amount the purchaser must pay for the property. If the property is encumbered by a mortgage, the unpaid balance of the mortgage at the date of sale is included in the selling price, whether the purchaser assumes the mortgage or merely takes title subject to it. Selling expenses and commissions are not deducted in computing the selling price. Neither interest nor any original issue discount is included in the selling price. ⁿ²⁴

Example:

S, an individual investor, sells a parcel of undeveloped real estate to P on December 1, Year 1. S's adjusted basis in the property is \$100,000 and the sales contract calls for P to pay S \$500,000 on January 15, Year 2, and to assume a \$300,000 mortgage on the property. S pays X, a real estate broker, \$65,000, for his services. The property's selling price for installment sale purposes is \$800,000. This consists of the \$500,000 cash P pays, plus the \$300,000 mortgage P assumes. The broker's commission is not included in the selling price.

[3] Gross Profit

The gross profit on an installment sale is the excess of:

(1) the selling price over

(2) the seller's adjusted basis increased by--(a) selling expenses, if the seller is not a dealer; and (b) any *IRC Section 1245* and *IRC Section 1250* recapture income. n25

While the temporary regulations make clear that an investor increases his adjusted basis by selling expenses, they are silent about the effect of depreciation recapture income. n26 The explanation for the omission is simple: The regulations predate *IRC Section 453(i)*, which requires a taxpayer to recognize all recapture income in the year of sale. The legislative history, n27 as well as IRS documents, n28 clarify that a taxpayer increases his adjusted basis by recapture income when computing gross profit. The result also makes sense, since the seller recognizes the total recapture amount in the year of sale, even though he uses the installment method.

The treatment of selling expenses differs for investors and dealers. n29 (For this purpose, selling expenses include sales commissions, advertising, transfer taxes, stamp taxes and legal, escrow and recording fees.) An investor must add his selling expenses (other than state or local transfer taxes, which are treated as a reduction of the amount realized) to his basis to compute gain on the sale. n30 This requirement forces the investor to recover his selling expenses over the life of the installment contract; selling expenses cannot be deducted from the initial payment.

A dealer, however, deducts selling expenses as business expenses independent of the sale. n31 This permits the dealer to deduct the entire amount of these expenses in the year of sale, with the gain being postponed to the later years of the installment contract.

Example:

On January 15, Year 1, investor S sells an office building for \$1.1 million. This consists of a \$400,000 down payment, seven annual \$100,000 installments beginning in Year 2, plus adequate stated interest. S's adjusted basis is \$200,000. There is \$75,000 of recapture income and the sale expenses are \$20,000. S's gross profit is \$805,000, computed as follows:

Selling price	\$1,100,000
Less: adjusted basis.....\$200,000	
recapture income.....\$75,000	
selling expenses..... \$20,000	
	\$295,000
Gross profit (total gain on sale)	\$805,000

[4] Total Contract Price and Qualifying Indebtedness

The total contract price equals the:

"selling price reduced by that portion of any qualifying indebtedness...assumed or taken subject to by the buyer, which does not exceed the seller's basis in the property (adjusted... to reflect commissions and other selling expenses..." n32

For this purpose, "qualifying indebtedness" refers to:

"a mortgage or other indebtedness encumbering the property and indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property." n33

Example:

S, an investor, agrees to sell a parcel of land to P for \$1 million in 1998. S's adjusted basis in the land is \$400,000. There is a long-standing mortgage on the property of \$500,000, and S has \$20,000 of selling expenses. P pays for the property with a \$50,000 downpayment, and by assuming the \$500,000 mortgage and giving S a \$450,000 note. The note is payable in 3 equal annual installments of \$150,000, plus adequate stated interest, beginning in 1999. The total contract price is \$580,000, computed as follows:

1. Selling price		\$.....1,000,000
2. Qualifying indebtedness	\$.....500,000	
3. Seller's adjusted basis		
(\$400,000) plus selling		
expenses (\$20,000)	\$.....420,000	
4. Less: smaller of 2 or 3		\$.....420,000

		—
5. Total contract price		\$.....580,000

		—

		—

Debt that the seller puts on property in anticipation of the property's sale will not be considered "qualifying debt" when the purchaser assumes or takes the property subject to it. n34 A different rule could allow a seller to bail out part or all of his gain tax free, as the following two examples demonstrate.

Example (1):

S, an investor, owns an undeveloped real estate parcel which has a fair market value of \$100,000 and an adjusted basis of \$40,000. The property is not encumbered when P offers to purchase it for a \$30,000 downpayment and seven annual installments of \$10,000, beginning the following year. As discussed in *Section 7.04*, below, 60 percent of each payment—including the \$30,000 downpayment—will be taxable, since 60 percent of the sale price (\$60,000/\$100,000) represents profit.

Example (2):

Assume the same facts as in the preceding example, except that S takes out a \$30,000 mortgage from bank B immediately before sale, receiving \$30,000 cash. If P assumes the mortgage, and the mortgage were treated as qualifying debt, S would be able to avoid any tax on the first \$30,000 he received. n35

To prevent the result in the second example, the regulations preclude S from reducing the \$100,000 selling price by the \$30,000 mortgage. n36 In addition, P's assumption of the mortgage is treated as a \$30,000 payment, 60 percent of which is gain. n37

[5] Gross Profit Percentage

The seller's gross profit percentage is simply his gross profit divided by the contract price.

Example:

S has a gross profit of \$400,000 on the sale of real estate that has a contract price of \$1,000,000, plus adequate stated interest. S's gross profit percentage is 40 percent ($\$400,000/\$1,000,000$). This means that S will recognize gain on 40 percent of each installment payment he receives.

[6] Payment

The term "payment" is significant for installment sale purposes because the seller must receive "at least 1 payment" after the year of disposition. n38 Moreover, the amount of income which the seller recognizes each year is computed using "the payments received in that year..." n39

"Payment" includes cash or other property, including foreign currency and marketable securities. The most important exception is the purchaser's indebtedness. The evidence of indebtedness (usually an installment note) which the purchaser gives to the seller is not considered payment, unless the note is: (1) payable on demand; or (2) readily tradable. n40 An evidence of indebtedness is generally considered to be readily tradable if it is issued in a form designed to be readily tradable in an established securities market. n41

Example:

S, an investor, owns an undeveloped real estate parcel which has a fair market value of \$100,000 and an adjusted basis of \$40,000. S sells the property to P for a \$30,000 downpayment and seven annual installments of \$10,000, beginning following the sale year. The note evidencing the seven installments is not considered to be a payment, assuming it is not payable on demand or readily tradable. Thus, S is treated as receiving a payment of \$30,000 in the year of sale. Each subsequent year, when P pays an additional \$10,000, S is treated as receiving an additional payment of \$10,000.

[a] Third-Party Guarantees and Standby Letters of Credit

An installment sale allows a seller to defer tax on the sale's gain. The deferred payment arrangement which an installment sale requires, however, exposes the seller to the possibility that the purchaser will be unable to make all payments required by the installment obligation. To protect themselves from this risk, sellers have adopted a number of strategies.

In real estate installment sales, the most common, and obvious, form of protection is for the seller to take back a mortgage to cover the amount due under the installment obligation. Many sellers, however, look for more protection--especially in situations where the seller's mortgage is large and sits behind a pre-existing mortgage. In these cases, a drop in the fair market value of the property could effectively wipe out the value of the seller's mortgage.

The problem with some of the more aggressive protection strategies is that they may be treated for tax purposes as "payments" for installment sale purposes--thereby triggering taxable gain. n42

Two strategies that are *not* treated as payments are third-party guarantees and most standby letters of credit securing the

purchaser's payment. n43 A standby letter of credit is not treated as a payment if it is:

- (1) non-negotiable and nontransferable (except together with the note it secures);
- (2) issued by a bank or other financial institution; and
- (3) serves as a guarantee of the note which the letter of credit secures. n44

[b] Escrow and Trust Arrangements

Installment sellers like the security which an escrow or trust arrangement provides. The Service, however, takes the position that an installment obligation "which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment." n45

If the seller's access to escrow or trust funds is subject to a substantial restriction providing a benefit to the buyer, the funds are not considered to be a payment when the escrow or trust is first established. n46 A provision precluding the seller from receiving the funds if he competes with the buyer over a fixed period should be a sufficient restriction for these purposes. n47 On the other hand, a restriction that simply prevents the seller from obtaining the escrow or trust funds until the date they are payable under the terms of the installment obligation is not a substantial restriction. n48

[c] Assuming, or Taking Subject to, a Mortgage

If property being sold is encumbered by a mortgage that is "qualifying indebtedness," n49 and the buyer assumes, or takes the property subject to, the mortgage, the buyer's assumption or taking subject to the mortgage is generally not treated as a payment. The exception to this rule is where the mortgage exceeds the seller's adjusted basis (after adding the costs of the installment sale to the seller's adjusted basis). Then, the excess of the mortgage over the adjusted basis is considered a payment in the year of sale. n50

Example (1):

S, an investor, agrees to sell a parcel of land to P for \$1 million in 1998. S's adjusted basis in the land is \$400,000. There is a long-standing mortgage on the property of \$500,000 which S owes to Bank X, and S has expenses of \$20,000 relating to the sale. P pays for the property by assuming the \$500,000 mortgage and giving S a \$500,000 note, payable in 5 equal annual installments of \$100,000, plus adequate stated interest, beginning in 1999. Even though S receives no cash in the year of sale, she recognizes \$80,000 of income that year because P assumed her mortgage. The computation is as follows:

1. Qualifying Indebtedness	\$.....5 00,000
2. Less: S's adjusted basis	(\$.....4) 00,000
plus selling expenses (\$20,000)	\$.....4 20,000
3. Gain recognized in year of sale	\$.....8 0,000

[d] Wraparound Mortgages

One technique that sellers have used to prevent the assumption of a mortgage in excess of the seller's adjusted

basis--and to avoid the taxable income that results from it--is the "wraparound" mortgage. With this type of mortgage (discussed in Chapter 12), the buyer gives the seller one mortgage for the entire non-cash portion of the sales price--i.e., one that "wraps around" existing mortgages. The seller remains liable on the first mortgage, which may be at an interest rate lower than current mortgage rates, and the wraparound is subordinate to the first mortgage.

Example (2):

Assume the same facts as in the preceding Example (1), except that P does not assume S's mortgage liability to Bank X. Instead, S finances the whole \$1 million purchase price (the wraparound mortgage). Under the terms of the installment sale contract, P will pay S \$200,000 annually for five years, plus adequate stated interest, beginning in 1999. S remains liable on the \$500,000 underlying mortgage to Bank X.

In 1981, the Service issued temporary regulationsⁿ⁵¹ stating that property transferred using a wraparound mortgage is "deemed" to have been taken subject to the seller's first mortgage. The Service intended, with this regulation, to make wraparound transactions analogous to situations where the buyer either assumed the seller's mortgage or took the property subject to it.

Example (3):

Based on the rule enunciated in the temporary regulations, S's tax treatment in Example (2) would be the same as in Example (1); i.e., S would have \$80,000 of taxable income in 1998, even though P did not actually assume S's mortgage.

The Service's position flew in the face of several prior decisions which rejected the Service's approach--at least when it was evident that the underlying debt was still the seller's responsibility.ⁿ⁵² In 1987, the Tax Court held the temporary regulations invalid.ⁿ⁵³ Despite some unhappiness with the Tax Court's decision, the Service conceded the point by acquiescing.ⁿ⁵⁴

Example (4):

Under current law, S recognizes no taxable income in 1998 if the parties use the wraparound mortgage described in Example (2).

FOOTNOTES:

(n1)Footnote 23. *IRC § 453(b)(1)*.

(n2)Footnote 24. *Temp Treas Reg § 15A.453-1(b)(2)(ii)*.

(n3)Footnote 25. If the property being sold is the seller's principal residence, any gain excluded from gross income under *IRC § 121* further reduces the gross profit. See Ch 9.

(n4)Footnote 26. *Temp Treas Reg § 15A.453-1(b)(2)(v)*.

(n5)Footnote 27. S Rep No 169, 98th Cong, 2d Sess 466 (1984).

(n6)Footnote 28. IRS Pub 537(Installment Sale) p 2-3 (defining "installment sale basis" as "adjusted basis plus selling expenses and depreciation recapture income"); IRS Form 6252 (Installment Sale Income), lines 12 and 13. See also Stephen J White & Steven C Thompson, "Installment Reporting Offers Savings Through Tax Deferral," 54 *Tax'n for Accts* 12 (1995).

(n7)Footnote 29. Although dealers generally cannot use the installment method, dealers in farm property and

certain timeshares and residential lots generally can. See § 7.02[1], above.

(n8)Footnote 30. *Temp Treas Reg § 15A.453-1(b)(2)(v)*.

(n9)Footnote 31. *Treas Reg § 1.453-1(b)(1)*.

(n10)Footnote 32. *Temp Treas Reg § 15A.453-1(b)(2)(iii)*.

(n11)Footnote 33. *Temp Treas Reg § 15A.453-1(b)(2)(iv)*.

(n12)Footnote 34. *Id.*

(n13)Footnote 35. Subsequent payments would have a greater taxable component, but S's tack--if it worked--would produce a significant tax deferral.

(n14)Footnote 36. *Temp Treas Reg § 15A.453-1(b)(2)(iv)*.

(n15)Footnote 37. *Temp Treas Reg § 15A.453-1(b)(3)(i)*.

(n16)Footnote 38. *IRC § 453(b)(1)*.

(n17)Footnote 39. *IRC § 453(c)*.

(n18)Footnote 40. *IRC § 453(f)(3), (4)*, effective for sales occurring on or after Oct 22, 2004. For sales occurring prior to this date, a note was considered payment only if payable on demand, or if issued by a corporation or government entity and readily tradable (*IRC § 453(f)(4)(B)*, before amendment by Pub L No 108-357); *Temp Treas Reg § 15A.453-1(b)(3)(i)*. Evidence of indebtedness includes convertible debentures which will, nonetheless, be treated as payment if they are readily tradable (*Rev Rul 71-420, 1971-2 CB 221*), but not stock warrants (*Frizzelle Farms, Inc v Commr, 61 TC 737 (1974)* , *aff'd per curiam 511 F2d 1009* , 1975-1 USTC P 9312, 35 AFTR2d P 75-998 (4th Cir 1975); *Taylor v US, 1974-1 USTC P 9448, 33 AFTR2d 74-1317 (EDNC 1974)*) . If notes are treated as payment under these exceptions, the payment amount is determined using the seller's accounting method. *Temp Treas Reg § 15A.453-1(e)(2)*. So an accrual basis taxpayer generally includes the obligation at face; a cash basis taxpayer includes the obligation at its fair market value.

(n19)Footnote 41. *IRC § 453(f)(5)*.

(n20)Footnote 42. Taking back a mortgage is not considered to be a "payment." See § 7.03[6], above.

(n21)Footnote 43. *IRC § 453(f)(3); Temp Treas Reg § 15A.453-1(b)(3)(i), (iii)*.

(n22)Footnote 44. *Temp Treas Reg §§ 15A.453-1(b)(3)(iii) & 15A.453-1(b)(5)*, Ex. (7). See also *Korstad v Commr, TC Memo 1983-147, 45 TCM 1032 (1983)* (involving an irrevocable bank letter of credit provided as security for the payment of the buyer's debt).

(n23)Footnote 45. *Temp Treas Reg § 15A.453-1(b)(3)(i)*. See also TAMs 8622002 and 9238005.

(n24)Footnote 46. See *Rev Rul 77-294, 1977-2 CB 173* , amplified *Rev Rul 79-91, 1979-1 CB 179* ; *Stiles v Commr, 69 TC 558 (1978)* , acq 1978-2 CB 3 ; *Reed v Commr, 723 F2d 138, 1983-2 USTC P 9728, 53 AFTR2d P 84-335 (1st Cir 1983)* (escrow account not treated as payment when established if: (1) escrow is part of a bona fide, arm's-length agreement between the purchaser and seller calling for deferred payment; (2) the seller does not receive any present beneficial interest from the purchase price while the funds are in escrow; and (3) the escrowee cannot act under the exclusive authority of the seller).

(n25)Footnote 47. *Murray v Commr*, 28 BTA 624 (1933) , acq XII-2 CB 10.

(n26)Footnote 48. *Rev Rul 79-91*, 1979-1 CB 179 .

(n27)Footnote 49. See § 7.03[3], above, for a discussion of qualifying indebtedness.

(n28)Footnote 50. *Temp Treas Reg § 15A.453-1(b)(3)(i)*. But see *Joe Kelly Butler, Inc v Commr*, 87 TC 734 (1986) (in a sale of real estate and personal property, the excess of the mortgage on the real estate over its adjusted basis was not considered payment in the year of sale; the mortgage did not exceed the basis of the real estate plus the personal property being sold; because the contract did not allocate the sales price between the real estate and the personal property, the court held that, for this purpose, the contract was not divisible; only the excess, if any, of the mortgage over the basis of all the property sold, would be considered payment in the year of sale).

(n29)Footnote 51. *Temp Treas Reg § 15A.453-1(b)(3)(ii)*.

(n30)Footnote 52. See, eg, *Stonecrest Corp v Commr*, 24 TC 659 (1955) , *govt's app dismissed per stipulation* (9th Cir 1958), *nonacq* 1956-2 CB 10 .

(n31)Footnote 53. *Professional Equities, Inc v Commr*, 89 TC 165 (1987) . The Tax Court reiterated its position in *Webb v Comm'r*, *TC Memo 1987-451*, 54 TCM 443 (1987) .

(n32)Footnote 54. AOD 1988-2 CB 1 . See also 1994 IRS Pub 537 (Installment Sales), p 4. The Service will continue to challenge any wraparound mortgage that, based on a form-over-substance argument, is really an assumption of the seller's mortgage. See *Kline v Commr*, *TC Memo 1989-317*, 57 TCM 822 (1989) , *aff'd in an unpublished opin available electronically at 1991 US App LEXIS 10957 (9th Cir 1991)* . See also Ian J Redpath & Michael J Tucker, "Real Estate Installment Sales and Wraparound Mortgages," 20 *Tax Adv* 273 (1989).



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Federal Taxes Affecting Real Estate

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CHAPTER 7 Installment Sales

1-7 Federal Taxes Affecting Real Estate § 7.04

§ 7.04 Computation of Reportable Gain in Year of Sale and Subsequent Periods

[1] In General

To compute gain on an installment sale, a seller must take these six steps:

(1) *Compute the gross profit to be realized on the sale.* The seller does this by determining the excess of the selling price over his adjusted basis. If the seller is an investor, he increases his adjusted basis by selling expenses. *IRC Section 1245* and *IRC Section 1250* recapture are also added to the seller's adjusted basis for purposes of determining total gain. This is because the total recapture amount is currently recognized, despite the seller's use of the installment method. n55

(2) *Compute the contract price.* This is the selling price reduced by that portion of any qualifying indebtedness which the buyer assumes or takes subject to, provided it does not exceed the seller's basis in the property, adjusted to reflect commissions and other selling expenses. n56

(3) *Determine the ratio of total gain (Step 1) to total contract price (Step 2).* This is the gross profit percentage.

(4) *Determine payments received during the taxable year.*

(5) *Multiply the payments received during the taxable year (Step 4) by the gross profit percentage (Step 3).* The result is the gain to be recognized for the year. The tax treatment of this gain will depend on whether the asset is a capital asset in the seller's hands (producing capital gain) or an ordinary asset which may or may not be subject to *IRC Section 1231* treatment. n57

(6) *Increase Step 5 by any recapture income.* If the computation is for the year of sale and the sale resulted in depreciation recapture under *IRC Sections 1245* and *1250*, increase the amount computed in Step 5 by the recapture amount. The recapture amount will be accorded ordinary income treatment.

Example:

On January 15 of year 1 S, an investor, sells P an office building for \$1.1 million. The building is subject to a mortgage of \$150,000, which P assumes. P also makes a \$250,000 downpayment and gives S a \$700,000 note, providing for adequate stated interest. Sale expenses are \$20,000. After the sale, but

before the close of S's taxable year, he receives an additional payment of \$120,000 from P. S's adjusted basis is \$200,000. Assume that there is no recapture income. S's taxable gain in the year of sale is computed as follows:

Step 1 (Gross Profit):

Selling price	\$.....1,100,000
Less: adjusted basis	200,000
selling expenses	20,000
	220,000
Gross profit (total gain on sale)	\$.....880,000

Step 2 (Contract price):

Selling price	\$.....1,100,000
Less: mortgage debt assumed	150,000
Contract price	\$.....950,000

Step 3 (Gross Profit Percentage):

Ratio of gross profit (\$880,000) to contract price (\$950,000)	92.63%

Step 4 (Payments Received During Year):

Downpayment	\$.....250,000
Installment payment	\$.....120,000
Payments for year	\$.....370,000

Step 5 (Gain Recognized in sale year):

Gain taxable in year of sale (92.63% x \$370,000)	\$.....342,731

Step 6 (Additional Recapture Income):

No recapture	0
Income recognized for year 1	\$.....342,731

Example:

Assume the same facts as in the preceding example, except that the sale also produces \$30,000 of recapture income. S's income from the sale in year 1 is computed as follows:

Step 1 (Gross Profit):

Selling price	\$.....1,100,000	
Less: adjusted basis	\$.....200,000	
recapture income	\$.....30,000	
selling expenses	\$.....20,000	\$.....250,000
Gross profit (total gain on sale)		\$.....850,000

Step 2 (Contract price):

Selling price	\$.....1,100,000	
Less: mortgage debt assumed	\$.....150,000	
Contract price		\$.....950,000

Step 3 (Gross Profit Percentage):

Ratio of gross profit (\$850,000) to contract price (\$950,000)	89.47%

Step 4 (Payments Received During Year):

Downpayment	\$.....250,000	
Installment Payment	\$.....120,000	
Payments for year	\$.....370,000	

Step 5 (Gain Recognized in sale year):

Gain taxable in year of sale (89.47% x \$370,000)	\$.....331,039

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Step 6 (Additional Recapture Income):

Recapture Income	\$.....30, 000
Income recognized for year 1	\$.....361 ,039

In this example, \$30,000 of the income recognized in year 1 would be accorded ordinary income treatment. The balance would typically be treated as capital gain or taxed under *IRC Section 1231*.

Once the gross profit percentage has been determined, this figure is applied against all subsequent payments which the seller receives:

Example:

Assume the same facts as in the preceding example. In year 2, the year following the installment sale, S receives a principal payment of \$120,000 from P, plus applicable interest on the installment obligation. S reports \$107,364 of income on account of this payment, which is the gross profit percentage (89.47%) times the payment (\$120,000).

[2] Installment Sales of Depreciable Property Where Portion of Gain is Unrecaptured Section 1250 Gain

IRC Section 1(h) divides a taxpayer's net capital gain into several tax rate groups. A maximum marginal rate of 28 percent applies to the 28-percent rate gain. n58.1 A maximum marginal rate of 25 percent applies to unrecaptured Section 1250 gain (25-percent gain). n58.2 Unrecaptured Section 1250 gain is the amount of long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if *IRC Section 1250(b)(1)* included all depreciation and the applicable percentage under *IRC Section 1250(a)* were 100 percent, reduced by any net loss in the 28-percent rate category. n58.3 A maximum marginal rate of 15 percent applies to adjusted net capital gain (15/5 percent gain). n58.4 Adjusted net capital gain is the portion of net capital gain (determined without regard to any dividends taxed at capital gains rates) n58.4.1 that is not taxed at the 28-percent or 25-percent rates. n58.5 A reduced rate of 5 percent is applied to the portion of the taxpayer's adjusted net capital gain that would otherwise be taxed at the lowest regular income tax rate. n58.6

Special rules apply to determine the proper tax rate for various amounts with respect to capital gains from an installment sale of depreciable real property when the gain to be reported consists of both 25-percent gain and 15/5-percent gain. n58.7 If a portion of the capital gain from an installment sale of real depreciable property consists of 25-percent gain, and a portion consists of 15/5 percent gain, a taxpayer must take the 25-percent gain into account before the 15/5 percent gain, as payments are received. n58.8 Any *IRC Section 1231* gain from an installment sale that is recharacterized as ordinary gain under *IRC Section 1231(c)* (dealing with recapture of net ordinary losses) is deemed to consist first of 25-percent gain, and then 15/5 percent gain. n58.9 Consistent with this treatment and with the general rule that 25-percent gain is taken into account first, where there is installment gain that is characterized as ordinary gain under *IRC Section 1231(a)* because there is a net Section 1231 loss for the year, then the gain is treated as consisting of

25-percent gain first, before 15/5 percent gain, for purposes of determining how much 25-percent gain remains to be taken into account in later payments. n58.10

Several transitional rules related to changes in the capital gains tax rates can come into play. Uncodified transitional rules enacted with the reduction of the lowest capital gain rates from 20/10 percent to 15/5 percent in 2003 n58.10.1 require an allocation of the differential tax rates in tax years that included May 6, 2003, the effective date of the rate changes. The 15/5 tax rates apply only for sales and exchanges (and installment payments received) on or after May 6, 2003. n58.10.2 The regulations should be applied accordingly.

Similar transition rules in the regulations relate to 1997 legislation. The capital gain rates applicable to installment payments that are received on or after May 6, 1997 (the effective date of 1997 tax legislation) from sales taking place prior to May 6, 1997, are determined as if, for all payments received after the date of sale but before May 6, 1997, 25-percent gain had been taken into account before the 20/10-percent gain rate that became effective in 1997. n58.11

In the event that the cumulative amount of 25-percent gain actually reported in installment payments received during the period between May 6, 1997, and August 23, 1999 (the effective date of the final regulations) is less than the amount that would have been reported using the front-loaded allocation method of the regulations, then the amount of 25-percent gain actually reported, rather than an amount determined under a front-loaded allocation method, must be used in determining the amount of 25-percent gain that remains to be reported. n58.12

FOOTNOTES:

(n1)Footnote 55. See § 7.03[3], above.

(n2)Footnote 56. See § 7.03[4], above.

(n3)Footnote 57. The seller may also be required to pay interest on tax liability he can defer through use of the installment method. See § 7.05, below.

(n4)Footnote 58. If the mortgage debt assumed exceeded the seller's adjusted basis, the seller's contract price would be increased by the difference between these two amounts. See § 7.03[6][c], above.

(n5)Footnote 58.1. *IRC § 1(h)(1)(E).*

(n6)Footnote 58.2. *IRC § 1(h)(1)(D).*

(n7)Footnote 58.3. *IRC § 1(h)(b)(A).*

(n8)Footnote 58.4. *IRC § 1(h)(1)(C)*, effective for tax years beginning on or after May 6, 2003; for earlier tax years a 20/10 percent rate applied (*IRC § 1(h)(1)(B),(C)*, *before amendment by Pub Law No 108-27*).

(n9)Footnote 58.4.1. See *IRC § (h)(11)*.

(n10)Footnote 58.5. *IRC § 1(h)(3).*

(n11)Footnote 58.6. *IRC § 1(h)(1)(B)*, effective for tax years beginning on or after May 6, 2003; for earlier tax years a 10-percent rate applied (*IRC § 1(h)(1)(B)*, *before amendment by Pub Law No 108-27*). A 0-percent rate applies after for tax years beginning after Dec 31, 2007.

(n12)Footnote 58.7. *Treas Reg § 1.453-12.*

(n13)Footnote 58.8. *Treas Reg § 1.453-12(a).*

(n14)Footnote 58.9. *Treas Reg § 1.453-12(d)*, Example 3.

(n15)Footnote 58.10. *Treas Reg § 1.453-12(d)*, Example 4.

(n16)Footnote 58.10.1. *IRC § 1(h)(1)(B),(C)*.

(n17)Footnote 58.10.2. Pub Law No 108-27, § 301(c).

(n18)Footnote 58.11. *Treas Reg § 1.453-12(b)*.

(n19)Footnote 58.12. *Treas Reg § 1.453-12(c)*.



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CHAPTER 7 Installment Sales

1-7 Federal Taxes Affecting Real Estate § 7.05

§ 7.05 Interest Due on Tax Liabilities Deferred by an Installment Sale

In an effort to reduce the benefits of the installment method, Congress added provisions which, in some instances, require a taxpayer to pay interest on the tax liability he is able to defer by using the installment sale rules. n59 The interest rules, however, apply to only limited types of installment sales. For taxpayers selling real estate, there are two kinds of installment sales which may require the payment of interest:

(1) *Nondealer property.* IRC Section 453A provides rules for the payment of interest for installment sales of nondealer property. As discussed below, several types of nondealer property are excluded from the coverage of this provision. Moreover, the Section exempts many smaller transactions completely. Some larger transactions also fall outside of the provision because the taxpayer's total installment sales for the year do not exceed the annual threshold.

(2) *Dealer dispositions of certain timeshares and residential lots.* IRC Section 453(l)(3) provides a separate interest calculation rule for dealer dispositions of these kinds of real estate.

[1] Nondealer Property

[a] When Interest Rules Apply

The interest rules under IRC Section 453A apply only when these three requirements are satisfied:

- (1) the sale is of nondealer property sold for more than \$150,000 (but excluding personal use and farming property);
- (2) the obligation resulting from the installment sale is outstanding at the close of the seller's tax year; and
- (3) the face amount of these obligations which arose during the tax year, and are outstanding at the close of the year, exceeds \$5 million. n60

"Personal use property" is defined by reference to IRC Section 1275(b)(3), which describes this as "any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an

activity described in section 212."

A taxpayer who uses an installment sale to dispose of a timeshare or residential lot in the ordinary course of his trade or business will typically be subject to the interest provisions described in *Section 7.05[2], below*. The installment sale of a timeshare or residential lot could, however, be subject to *IRC Section 453A* if, for example, the taxpayer was not in the trade or business of selling such property and the three requirements described above were satisfied.

The operation of these three requirements can be seen by the following examples:

Example (1):

In Year 1, S, an individual investor, disposes of a building using the installment method. The sales price of the building is \$300,000. The total face amount of installment obligations resulting from sales which S makes in Year 1, and which are outstanding at the end of Year 1, is \$10 million. The interest rule in *IRC Section 453A* applies to the \$300,000 sale.

Example (2):

Assume the same facts as in Example (1), except that it is now Year 2. S sells another building for \$400,000 using the installment method, but makes no other installment sales in Year 2. Assume, also, that S has \$9 million of installment sales obligations outstanding at the end of Year 2. *IRC Section 453A* does not apply to the Year 2 sale, because S did not make new sales in Year 2 that gave rise to \$5 million of installment obligations outstanding at the end of Year 2. *IRC Section 453A*, however, continues to apply to the Year 1 sales.

If the \$5 million threshold is met, an entire year's interest is payable on applicable installment obligations that arise during the year and that are outstanding at year-end, regardless of the date of sale. For example, if an installment sale occurs December 30 of year 1, and the proceeds are collected January 2 of year 2, an entire year's interest is payable for year 1, if *IRC Section 453A* applies to the sale. (No interest is payable in year 2, since the obligation is not outstanding at year-end.)

[b] Computation of Interest

When an installment obligation to which *IRC Section 453A* applies is outstanding at the end of the taxable year, the interest equals the product of the applicable percentage of the deferred tax liability with respect to the obligation multiplied by the underpayment rate in effect under *IRC Section 6621(a)(2)* for the month with or within which the taxable year ends. n60.1 An IRS Chief Counsel Advice has ruled that the required interest charge arises as of the last day of the taxable year regardless of whether a sale occurs on the last day of the taxable year or any other day in the taxable year. (The advice assumed that the sales contract did not involve contingent payments.) The interest is computed by using the interest rate under *IRC Section 6621(a)* as of the close of the year, not by applying a weighted average of the interest rates. n60.2

The interest attributable to an obligation for a tax year is determined using this equation: n61

$$I = [(FA - \$5,000,000)/FA] \times [UR \times MTR] \times UPR$$

where

I = Interest on the deferred tax liability (which becomes the additional tax)

FA = Face amount of all obligations subject to *IRC Section 453A(b)(2)* which are outstanding at year end

UR = Unrecognized gain on an obligation, at the end of the taxpayer's tax year

MTR = Maximum tax rate applicable under either IRC Section 1 (for a non-corporate taxpayer) or 11 (for a corporation). If (1) the taxpayer is not a corporation, (2) the gain is capital, and (3) the taxpayer would use the 20 percent maximum tax rate provided in IRC Section 1(h) for any capital gain reported, then MTR will equal 20 percent. n62

UPR = IRC Section 6621(a)(2) underpayment rate in effect for the last month of the taxpayer's tax year.

Example:

Assume that on December 31 of year 1, S, an individual investor, has outstanding installment obligations with a face amount of \$20 million on which he is required to pay interest pursuant to *IRC Section 453A(b)(2)*. One of these obligations, which arose in year 1, has unrecognized gain of \$1 million at year end. Assume that this obligation qualifies for capital gain treatment and that S's maximum tax rate, pursuant to *IRC Section 1(h)*, is 15 percent. Assume, further, that the *IRC Section 6621(a)(2)* underpayment rate in effect for December of year 1 is 5 percent. The interest which S must pay on account of this obligation is computed as follows:

$$\begin{aligned}
 I &= [(FA - \$5,000,000)/FA] \times [UR \times MTR] \times UPR \\
 &= [(\$20,000,000 - \$5,000,000)/\$20,000,000] \times \\
 &\quad [\$1,000,000 \times 15\%] \times 5\% \\
 &= [75\%] \times \$150,000 \times 5\% \\
 &= \$7,500
 \end{aligned}$$

[c] Tax Treatment of Interest

IRC Section 453A(c)(1) says that interest paid under *IRC Section 453A(c)* is treated as an increase of the taxpayer's tax liability. *IRC Section 453A(c)(5)*, however, states that the interest is taken into account in computing the deduction the taxpayer is allowed for interest paid or accrued during the tax year. For an accrual taxpayer, the *tax year* refers to the year that the required addition to tax under *IRC Section 453A* is imposed, not to the subsequent year during which the interest is paid. n63

[2] Timeshares and Residential Lots

[a] When Interest Rules Apply

A dealer in qualified timeshares or residential lots may use the installment method only if he agrees (i.e., elects) to pay interest on the tax liability he defers through use of this method. n64 The interest rules then apply if the seller receives a payment on an obligation arising from such a sale during a tax year following the year of sale. Payments received in the year of sale are expressly excluded from the interest charge. n65

[b] Computation of Interest

Determining the interest due on a payment (other than a payment received in the year of sale) requires the seller to take these steps with respect to the payment: n66

(1) *Determine the gain recognized as a result of payments on the obligation during the year.*

(2) *Determine the tax attributable to the gain recognized during the year.* The Code is notably silent on how this is done. A 1991 Technical Advice Memorandum seems to take the approach that the tax attributable to the gain is the incremental tax which the taxpayer must pay as a result of the payments received, allocated pro rata among the payments. (This applies the taxpayer's highest marginal rates to

the payments.) n67

(3) *Compute the interest on the tax due.* This is based on the applicable Federal rate (AFR) under *IRC Section 1274* (without regard to *IRC Section 1274(d)(2)*) in effect on the sale date, compounded semiannually. n68 Although the Code does not say which AFR should apply, the Service has indicated that the short-term AFR should be used for an obligation that has a term of three or fewer years; the mid-term AFR for an obligation with a term of more than three, but fewer than nine, years; and the long-term rate for an obligation with a term of nine or more years. The relevant period for purposes of the interest computation is that between the sale date and the payment date.

Example:

S, a cash-basis, calendar-year individual whose business involves marketing undeveloped real estate, sells a qualifying residential lot on the installment basis on September 1, 1998, for \$30,000. P, the purchaser, makes a downpayment of \$10,000 on September 1, 1998, and agrees to pay an additional \$10,000 of principal on each of December 1, 1998, and March 1, 1999. Assume that 40 percent of each payment (i.e., \$4,000) represents taxable gain, and that the short-term AFR, based on the rate applicable at the time of sale, is 8 percent compounded semi-annually.

Neither the downpayment nor the December 1, 1998, installment payment is subject to an interest charge. This is because both payments were received in the year of sale. The situation is different for the March 1, 1999, payment. Assume that S is in the 36 percent marginal tax bracket, and that the \$4,000 of income which arises from the March 1, 1999 payment generates a tax liability of \$1,440 (\$4,000 x 36%). Since there are 182 days between the sale on September 1, 1998, and the March 1, 1999, payment, the interest attributable to this payment is computed as follows: n69

$$\begin{aligned}\text{Interest on tax} &= ((\$1,440 \times .08)/365) \times 182 \text{ days} \\ &= \$57.44\end{aligned}$$

[c] Tax Treatment of Interest

Even though the Code says that the interest on the tax is additional tax, n70 this additional payment is treated as interest for purposes of computing the taxpayer's allowable interest deductions. n71 This will typically be trade or business interest. It should be noted that S corporation shareholders may not deduct interest they pay as a result of tax incurred on installment sales of timeshares by their S corporation under *IRC Section 453(l)(3)(C)*. n71.1

FOOTNOTES:

(n1)Footnote 59. See generally Seago & Cornwall, "Interest on Taxes Deferred Through Installment Sales," 22 *Tax Adv* 532 (1991).

(n2)Footnote 60. *IRC § 453A(b)*. The \$5 million threshold is applied at the owner's level of a pass-through entity. *Notice 88-81, 1988-2 CB 397*.

(n3)Footnote 60.1. *IRC § 453A(c)(2)*.

(n4)Footnote 60.2. CCA 201021020.

(n5)Footnote 61. The equation comes from *IRC § 453A(c)*. $[(FA - \$5,000,000)/FA]$ produces the applicable percentage set forth in *IRC § 453A(c)(4)*. All *IRC § 453A(b)(2)* obligations arising during the same tax year will have the same applicable percentage. This percentage does not change in subsequent years as the purchaser makes payment on an obligation (or is treated as making payment under the pledging rule). HR Rep No 495, 100th Cong, 1st Sess 930 (1987). $[UR \times MTR]$ produces the deferred tax liability set forth in *IRC § 453A(c)(3)*.

(n6)Footnote 62. *IRC § 453A(c)(3)*(flush language) refers to *IRC § 1(h)* or *§ 1201* (providing a maximum capital gain rate for corporations). Based on the present rates under *IRC § 11*, *IRC § 1201* could not come into play.

(n7)Footnote 63. CCA 201021020 .

(n8)Footnote 64. *IRC § 453(l)(3)(A)*. For a discussion of the kinds of sales which qualify for the election, see § 7.02[1], above.

(n9)Footnote 65. *IRC § 453(l)(3)(B)(iii)*.

(n10)Footnote 66. These steps come from *IRC § 453(l)(3)(B)*.

(n11)Footnote 67. *TAM 9133002* . A taxpayer could presumably take the position that an average tax rate is appropriate in determining the tax attributable to the gain.

(n12)Footnote 68. But see *TAM 9133002* , where the Service did not use compound interest.

(n13)Footnote 69. Because of the short period between the sale and this payment, this formula does not need to take into account compounding of interest. As the preceding note indicates, the Service is not fond of this complication, which can be particularly unpleasant when the period between the payment and the sale date is not exactly divisible by six months. But the Code appears to require compounding.

(n14)Footnote 70. *IRC § 453(l)(3)(A)*.

(n15)Footnote 71. *IRC § 453(l)(3)(C)*.

(n16)Footnote 71.1. *Carlson v Commr*, 112 TC 240 (1999) .



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CHAPTER 7 Installment Sales

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§ 7.06 Dispositions and Pledges of Installment Obligations

Frequently, a seller wishes to raise additional cash after making an installment sale. One way to do this is to pledge or sell all or part of the installment obligation. In most cases the seller is looking for some form of tax nirvana--the receipt of cash without the payment of income tax.

In other cases, the seller may have a "purer" motive for disposing of the installment obligation. For example, the seller may wish to make a gift or charitable contribution of all or part of the obligation.

The Code provisions that deal with the seller's tax treatment in these situations are in *IRC Section 453B*, which relates to sales and other dispositions of an installment obligation, and *IRC Section 453A(d)*, dealing with the taxation of pledged obligations. As discussed in the materials that follow, these Code sections generally accelerate the income from the original installment sale when the seller disposes of or pledges the obligation.

While taxpayers are usually unhappy about having their installment gain accelerated, this is not always the case. A taxpayer might favor this result if he expected Congress to raise the rates applicable to his installment income. n72 Acceleration of the installment income might also be desirable if the taxpayer needs to generate income to use deductions which would otherwise produce no tax benefit.

The most efficient way to accelerate installment income is usually through a pledge of the obligation, assuming it arose from the sale of property described in *IRC Section 453A* (generally nondealer property sold for more than \$150,000, but excluding personal use property, farming property, and qualified timeshares and residential lots). As discussed in § 7.06[2][b], below, the amount of income accelerated is a function of the loan proceeds the taxpayer receives in connection with the pledge. This gives the taxpayer some flexibility in deciding how much income he wants to accelerate.

[1] Determining which Transactions Accelerate Income

[a] Transactions that Accelerate Income

The following are examples of transactions that accelerate income:

- (1) the sale or exchange (including the discounting) of an installment obligation; n73

- (2) the distribution of an installment obligation to a shareholder as a dividend;
- (3) making a gift of an installment obligation; n74
- (4) cancellation of the obligation, or its becoming unenforceable; n75
- (5) the pledge of an obligation arising from the sale of property described in *IRC Section 453A* (generally nondealer property sold for more than \$150,000, but excluding personal use property, farming property, and qualified timeshares and residential lots) (the "pledging rule").

This last category warrants additional attention. Most of *IRC Section 453A* provides rules requiring payment of interest on certain tax liabilities that are deferred through use of the installment method. These interest rules apply when the following requirements are satisfied:

- (1) The sale is of nondealer property sold for more than \$150,000 (but excluding personal use property, farming property, and qualified timeshares and residential lots).
- (2) The obligation resulting from the installment sale is outstanding at the close of the seller's tax year.
- (3) The face amount of these obligations, which arose during the tax year and are outstanding at the close of the year, exceeds \$5 million. n76

The pledging rule applies whenever the first of these three tests is satisfied. The second and third tests are relevant only for purposes of determining whether the taxpayer also owes interest. n77

Example:

In Year 1, S disposes of a building using the installment sale method. The sales price of the building is \$300,000. The total amount of installment sales which S makes in Year 1, and which are outstanding at the end of Year 1, is \$3 million. The pledging rule would apply to pledged obligations arising from the \$300,000 sale. The interest rule, however, does not apply, because the installment obligations which arose during the tax year and are outstanding at the close of the year do not exceed \$5 million.

[b] Transactions that Do Not Accelerate Income

These transactions do not produce taxable income: n78

- (1) The transfer of an installment obligation between spouses or a transfer between former spouses incident to a divorce. n79
- (2) The transfer of the obligation at death. n80 However, *IRC Section 691* governs the tax treatment of proceeds the estate or beneficiary receives as the obligation is paid off. n81 Note, also, that special rules apply to (a) an installment obligation which the decedent transfers to the installment obligor n82 and (b) any installment obligation which the decedent's estate uses to satisfy a pecuniary bequest. n83
- (3) Contribution of the obligation to a controlled corporation solely in exchange for stock pursuant to *IRC Section 351*. n84 If the transferor also receives boot (e.g., cash) in exchange for the obligation, some or all of the installment gain will be accelerated. n85

(4) Transfer of the obligation to a corporation under the reorganization rules of *IRC Section 361*. n86

(5) Contribution of the obligation to a partnership. n87

(6) Distribution of the obligation by a partnership to a partner, except as provided in *IRC Section 751*. n88

(7) Transfer of the obligation to a trust which the transferor is considered to own under the grantor trust rules. n89

In these types of dispositions, the transferee assumes the transferor's basis, and the transferee reports income as installments are received. n90

[2] Determining the Amount of Income Accelerated

[a] Sales and Other Dispositions

Computing the gain or loss on the disposition of an installment obligation typically requires two steps:

(1) Determine the taxpayer's basis in the installment obligation.

(2) Subtract the basis from the amount the taxpayer realizes. If, however, the obligation is not sold, exchanged, or satisfied at other than face value, the taxpayer subtracts the basis in the installment obligation from the fair market value of the obligation. n91

Obviously, the value assigned in Step 2 depends on whether there has been a sale or exchange or other satisfaction of the note. While it is usually clear whether this is the case, it is not always so. n92 The Code, however, expressly addresses the situation when an installment obligation is canceled or otherwise becomes unenforceable. These transactions are always treated as a disposition that is not a sale or exchange. Moreover, if the parties to the obligation are related within the meaning of *IRC Section 453(f)(1)*, the fair market value of the obligation cannot be treated as less than the obligation's face value. n93

The taxpayer's basis in an obligation equals its face value, less the income which the obligation would generate if it were paid in full. n94 This will typically equal the portion of the obligation which represents the return of the taxpayer's adjusted basis.

Example:

S, an investor, sells a parcel of undeveloped real estate using the installment method, and the installment obligation provides for adequate interest. S's adjusted basis in the property is \$100,000 and the sale price is \$400,000. The terms of sale call for the purchaser, P, to pay \$100,000 annually in each of the four years following the year of sale. Because S's gross profit percentage is 75%, each payment would produce \$75,000 of income for S. P has yet to make the last two payments due when S sells the installment obligation to a third party for \$190,000. S's gain on the sale of the obligation is computed as follows:

Computation of S's basis in the obligation

Remaining face value of obligation sold	\$.....20
	0,000

Less: Income the obligation would generate

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if paid in full	\$.....15 0,000

Basis in the obligation	\$.....50, 000

<i>Computation of S's gain on sale of the obligation</i>	
Amount realized	\$.....19 0,000
Less: basis in the obligation	\$.....50, 000

Gain on sale of the obligation	\$.....14 0,000

[b] Pledges

Another way for a seller to realize cash following an installment sale is to borrow, pledging the installment note as collateral. For example, a seller may pledge an installment contract or note to secure a loan from a third-party creditor.

If the pledged obligation arose from the sale of property described in *IRC Section 453A*, the net proceeds of the loan which the installment obligation secures is treated as payment received on the obligation. n95 The borrower is treated as receiving this payment when he provides the installment obligation as security or, if later, when he receives the loan proceeds. n95.1

Indebtedness is secured by an installment obligation under *IRC Section 453A* to the extent that the payment of principal or interest on that indebtedness is directly secured (under the terms of the indebtedness or any underlying arrangement) by any interest in that installment obligation. A payment is treated as directly secured by an interest in an installment obligation to the extent an arrangement allows the taxpayer to satisfy all or a portion of the indebtedness with the installment obligation. n95.2

Example:

T disposes of property in exchange for an installment note. The disposition is properly reported using the installment method. T only recognizes gain upon receiving deferred payments. If the installment note is pledged as security for a loan, however, T must treat the proceeds of the loan as a payment on the installment note and recognize the appropriate amount of gain. Similarly, if T has the right to "put" or

repay a loan by transferring the installment note to the creditor, T must treat the proceeds of the loan as payment on the installment note to that extent. n95.3

Once a taxpayer has pledged an installment obligation, special rules apply to subsequent payments received on the installment obligation. In particular, installment payments the taxpayer receives after recognizing the pledge income are not taxable until these payments exceed the income which the pledge accelerated. n95.4

Example:

S, an individual investor, sells undeveloped real estate using the installment method in 1998 for \$500,000. The payment terms call for P to pay S \$100,000 per year, plus adequate stated interest, for five years, with the first payment due in 1999. S's adjusted basis in the property is \$200,000. In 1999, before S receives the first \$100,000 payment, she pledges the installment obligation to X to secure a \$150,000 loan. S recognizes \$150,000 of income as a result of the pledge. However, when she receives \$100,000 from P later in 1999, she does not include any part of the payment in her 1999 income. n95.5

One question that sometimes arises in these contexts is whether the taxpayer pledged an installment obligation or, instead, actually sold it. The Service has ruled that pledging an installment obligation is a disposition if the loan is "substantially equal to the face amount of the obligation." n96 The Tax Court has held, however, that no disposition occurred when installment sales and other assets were pledged to secure a line of credit. n97

[3] Impact of Modification

The holder of an installment obligation may agree, as a result of changed circumstances, to a change in the terms of the obligation and a substitution of collateral. In other instances, the buyer of the real estate may turn around and resell the property. If this subsequent sale is made using the installment method, the original buyer may ask the original seller to accept the new buyer's note as a substitute for the original installment obligation. The issue in each of these cases is whether a change in the terms of the original installment obligation is treated as a disposition of that obligation. If it is, the original seller's gain may be accelerated as a result of the modification.

IRC Section 1001 and pronouncements relating to it provide general rules dealing with the types of modifications which are considered to result in the disposition of a debt instrument. n98 The Service, however, takes the position that the rules under *IRC Section 1001* do not apply to modifications of installment obligations. n99 This is fortunate for most owners of installment obligations because relatively minor modifications are sufficient to trigger a disposition for *IRC Section 1001* purposes, while a fairly significant modification is required under *IRC Section 453B*. n100

For example, the obligation holder's agreement to extend a maturity date or change an interest rate is not a taxable modification; n101 neither is substituting obligors; n102 suspending principal payments for a stated period; n103 modifying the price of the original sale; n104 changing the interest rate n105 or converting it from a variable rate to a flat rate; n106 or dividing one installment note into two, if the only effect of the division is to change the collateral. n107

FOOTNOTES:

(n1)Footnote 72. Similarly, an individual taxpayer may be in the 15 percent bracket in Year 1 and want to increase the amount of income taxed at that favorable rate.

(n2)Footnote 73. *IRC § 453B(a)*.

(n3)Footnote 74. See, eg, *Rev Rul 79-371, 1979-2 CB 294* ; *Rev Rul 72-264, 1972-1 CB 131* ; *Rev Rul 67-167, 1967-1 CB 107* . See also Jerome M Hesch, "Dispositions of Installment Obligations by Gift or Bequest," 16 *Tax Mgmt Est, Gifts & Tr J* 137 (1991). For a general discussion of the use of installment notes in estate planning, see Ch 18.

(n4)Footnote 75. *IRC § 453B(f)*. This provision does not prevent the taxpayer from taking a bad debt deduction should the installment obligation become worthless. See *American Offshore, Inc v Commr*, 97 TC 579 (1991) .

(n5)Footnote 76. *IRC § 453A(d)*. A more detailed description of the property described in *IRC § 453A* appears at § 7.05[1], above.

(n6)Footnote 77. *IRC § 453A(b)(2)* includes the second and third tests: "For purposes of subsection (a)(1)..." *IRC § 453A(c)* contains the interest rule, which is applied in *IRC § 453A(a)(1)*; the pledging rule appears in *IRC § 453A(d)* and applies in *IRC § 453A(a)(2)*. *IRC § 453A(b)(2)* is also captioned "Special Rule for Interest Payments."

(n7)Footnote 78. See also Patrick G Dooher, "Installment Notes: Nontaxable Dispositions and Purchase Price Reductions," 32 *Tax Mgmt Memo* 207 (1991).

(n8)Footnote 79. *IRC § 453B(g)*.

(n9)Footnote 80. *IRC § 453B(c)*. See also Hesch, N 72, above.

(n10)Footnote 81. *IRC § 691(a)(4)*.

(n11)Footnote 82. *IRC § 691(a)(5)*.

(n12)Footnote 83. *IRC § 691(a)(2)*. Eg, this provision would apply if the decedent's will provided a \$20,000 bequest to his nephew, Herbie, and the executor satisfied this bequest with an installment obligation the decedent owned. An estate's transfer of an installment obligation to a residuary beneficiary, or to a person to whom the obligation is specifically bequeathed, however, is not a taxable disposition unless the recipient is the obligor. *IRC § 691(a)(2)*, (4) and (5).

(n13)Footnote 84. *Treas Reg § 1.453-9(c)(2)* and (3).

(n14)Footnote 85. *Rev Rul 68-55, 1968-1 CB 140* , amplified *Rev Rul 85-164, 1985-2 CB 117* ; *Rev Rul 67-192, 1967-2 CB 140* ; *Treas Reg § 1.1245-4(c)*; see also *Easson v Commr*, 33 TC 963 (1960) , *rev'd on other issues 294 F2d 653, 1961-2 USTC P 9654, 8 AFTR2d P 5448 (9th Cir 1961)*. But see *Rev Rul 73-423, 1973-2 CB 161* , for the tax treatment of a transfer to the corporation that is the obligor on the obligation.

(n15)Footnote 86. *Treas Reg § 1.453-9(c)(2)*.

(n16)Footnote 87. *Treas Reg §§ 1.453-9(c)(2); 1.721-1(a)*. If the partnership is the obligor, the transfer should be taxable, using the rationale of *Rev Rul 73-423* , discussed in N 83, above.

(n17)Footnote 88. *Treas Reg § 1.453-9(c)(2)*. For a discussion of installment sales of partnership interests see Marc B Collier & Dan Hollingsworth, "Time After Time: Selling a Partnership Interest Under the Installment Method," 14 *Va Tax Rev* 725 (1995).

(n18)Footnote 89. *Ltr Rul 8521017* ; *Rev Rul 81-98, 1981-1 CB 40* ; *Rev Rul 74-613, 1974-2 CB 153* ; *Rev Rul 67-70, 1967-1 CB 106* .

(n19)Footnote 90. Examples of such dispositions are found in *Treas Reg § 1.453-9(c)(2)*. For character of any amount received, see *Treas Reg § 1.453-9(c)(3)*. For examples of basis, see, eg, *IRC § 358* and *§ 362* for corporations, and *IRC § 723* and *§ 732* for partnerships. For definitions related to basis, see *IRC § 7701(a)(42)*, (43) and (44).

(n20)Footnote 91. *IRC § 453B(a)*. Note that the gain on the sale of the *obligation* cannot be reported on the installment method. *Krist v Commr*, 231 F2d 548, 1956-1 USTC P 9424, 49 AFTR P 480 (9th Cir 1956) (interpreting prior law).

(n21)Footnote 92. See, eg, *Smith v Commr*, 56 TC 263 (1971) , acq 1972-2 CB 3 , interpreting a predecessor of IRC § 453B (parents' transfer of installment obligation to children in return for the children's providing the parents with lifetime annuities held to be a disposition, rather than a sale or exchange, so the determination of the parents' gain or loss was based on the obligation's fair market value); *Dessauer v Commr*, 449 F2d 562 , 1971-2 USTC P 9675, 28 AFTR2d P 71-5748 (8th Cir 1971) (installment obligations transferred to a finance company by a pledge agreement held to be a sale or exchange).

(n22)Footnote 93. IRC § 453B(f). See also *Rev Rul 86-72*, 1986-1 CB 253 . For a discussion of the tax treatment of obligations canceled as a result of the holder's death (or which the holder bequeaths to the obligee), see Ch 18.

(n23)Footnote 94. IRC § 453B(b).

(n24)Footnote 95. IRC § 453A(d). The net proceeds of the debt are the gross amount of the debt less the direct expenses of obtaining the debt. IRC § 453A(d)(2) provides rules which insure that the loan does not result in the borrower's reporting more income than is inherent in the installment obligation itself.

(n25)Footnote 95.1. IRC § 453A(d)(1).

(n26)Footnote 95.2. IRC § 453A(d)(4).

(n27)Footnote 95.3. IRC 453A(d)(4).

(n28)Footnote 95.4. IRC § 453A(d)(3).

(n29)Footnote 95.5. IRC § 453A(d)(3).

(n30)Footnote 96. *Rev Rul 65-185*, 1965-2 CB 153 ; but see *TAM 8711002* , suggesting that the IRS might reach a different conclusion if the facts of *Rev Rul 65-185* were again presented.

(n31)Footnote 97. *Town & Country Food Co v Commr*, 51 TC 1049 (1969) , acq 1969-2 CB xxv (pledge treated as such); *TAM 8711002* (see n 94); *Branham v Commr*, 51 TC 175 (1968) (pledge treated as sale); *United Surgical Steel v Commr*, 54 TC 1215 (1970) , acq 1971-2 CB 3 (pledge treated as such); *Yancey Bros v US*, 319 F Supp 441, 1970-2 USTC P 9619, 26 AFTR2d P 70-5564 (ND Ga 1970) (pledge treated as such). See also *GCM 37848* (Feb 5, 1979) ; *Sprague v US*, 627 F2d 1044, 1980-2 USTC P 9621, 46 AFTR2d P 80-5536 (10th Cir 1980); *In re JC Invs, Inc*, 1981-2 USTC P 9775, 49 AFTR2d 82-541 (US Bankr MD Fla 1981) ; *Korstad v Commr*, TC Memo 1983-147, 45 TCM 1032 (1983) ; *GCM 39584* (Oct 10, 1985) .

(n32)Footnote 98. The most significant recent pronouncements have been a Supreme Court decision, *Cottage Savings Assn v Comm'r*, 499 US 554 , 1991-1 USTC P 50,187, 67 AFTR2d P 91-808 (1991), and final regulations which the Service issued in response to this decision. *Treas Reg § 1.1001-3*.

(n33)Footnote 99. *GCM 39225* (Apr 27, 1984) .

(n34)Footnote 100. For an example where a disposition was held to occur under IRC § 453B, see *First Nat'l Bank in Albuquerque v Commr*, 921 F2d 1081 , 1991-1 USTC P 50,005, 67 AFTR2d P 91-381 (10th Cir 1990) (revenue bonds substituted for original installment obligation).

(n35)Footnote 101. *Rev Rul 68-419*, 1968-2 CB 196 , amplified *Rev Rul 72-570*, 1972-2 CB 241 ; *Rhombar Co, Inc v Commr*, 47 TC 75 (1966) , *aff'd on other grounds* 386 F2d 510, 1967-2 USTC P 9743, 20 AFTR2d P 5764 (2d Cir 1967) , and acq 1967-2 CB 3 .

(n36)Footnote 102. *Rev Rul 82-122*, 1982-1 CB 80 ; *Rev Rul 75-457*, 1975-2 CB 196 (which was amplified by *Rev Rul 82-122* , the preceding ruling). See also *Cunningham v Commr*, 44 TC 103 (1965) , acq 1966-2 CB 4 .

(n37)Footnote 103. See, eg, Ltr Ruls 9505011, 9505016, 9506018-20, 9506022, 8739045 and 8606052.

(n38)Footnote 104. *Rev Rul 72-570, 1972-2 CB 241* ; *Soter v Commr, TC Memo 1968-43, 27 TCM 194 (1968)* ; *Rev Rul 55-429, 1955-2 CB 252* (amplified by the preceding *Rev Rul 72-570*). See also Orefice, "Nontaxable Purchase-Price Reduction Versus Taxable Disposition--The Interplay Between Section 108(e)(5) and 453B(f)," *20 J Corp Tax'n* 43 (1993).

(n39)Footnote 105. *Rev Rul 82-122, 1982-1 CB 80* (also involved substitution of new obligor); *Rev Rul 68-419, 1968-2 CB 196* , amplified by *Rev Rul 72-570* , N 102, above.

(n40)Footnote 106. *Ltr Rul 8545010* .

(n41)Footnote 107. *Rev Rul 74-157, 1974-1 CB 115* ; *Kutsunai v Commr, TC Memo 1983-182, 45 TCM 1179 (1983)* ; *Ltr Rul 8848054* . For other authorities saying that a change in collateral is not a taxable modification, see *Rev Rul 55-5, 1955-1 CB 331* ; *TAM 9238005* .



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CHAPTER 7 Installment Sales

*1-7 Federal Taxes Affecting Real Estate § 7.07***§ 7.07 Repossession of Property Sold on the Installment Basis****[1] Computation of Gain on Repossession: General Rule**

IRC Section 1038 provides special treatment for repossessions of real property. n108 Instead of treating the repossession as a separate sale or disposition, the section looks to the original sale to determine whether the seller must recognize any gain on the repossession. In any event, the seller cannot recognize any loss upon repossession, and no bad debt deduction is allowed on reacquisition for worthlessness of any part of the purchaser's obligation. n109 *IRC Section 1038* may also apply to reacquisitions of oil, gas and mineral leases that are reacquired under a repurchase option. n109.1

The Section's "general rule" requires the seller to treat the purchaser's payments before default as if they consisted exclusively of gain. This general rule (which is subject to a significant limitation discussed below) obligates the seller to recognize gain upon repossession to the extent that the total collections received before the reacquisition exceed gain previously reported. For this purpose, the seller does not include in total collections interest (whether stated or unstated) and any note or other obligation of the purchaser. n110

Example (1):

Taxpayer sells a building in Year 1 for \$80,000. His adjusted basis in the building is \$60,000. The gain realized is \$20,000 (25 percent of the selling price). The downpayment is \$20,000, with six yearly installments of \$10,000, payable beginning in Year 2. The sale is reported using the installment method, and the seller includes 25 percent of each cash payment as taxable income. In Year 4, after the purchaser has made three installment payments, the buyer defaults and the taxpayer repossesses the property, which, at that time, has a fair market value of \$40,000. The costs associated with the repossession are \$500. The gain on repossession is determined under the *general* rule as follows:

Gain Based on General Rule

Total cash received in all years prior to repossession	\$50,000
Less: Portion of gain previously included in income (25% of \$50,000)	\$12,500

Gain based on the general rule	\$37,500

IRC Section 1038 does not come into play unless there is a sale and reacquisition of the same property. n111 If a taxpayer receives property in lieu of foreclosure of a loan and the underlying transaction was not a sale of that property, the taxpayer realizes ordinary income to the extent that the net fair market value of the property received exceeds the taxpayer's adjusted basis in the debt. n112

IRC Section 1038 applies without regard to any changes that may occur to the property between the time of sale and the reacquisition. n112.1 Furthermore, if the property has been damaged during that period, no loss is allowed. n112.2

[2] Limitation on Gain

The gain determined under the general rule is often limited. The limitation is designed to ensure that the taxpayer's gain on the repossession does not result in the recognition of more income than was realized when the property was initially sold. Thus, the additional gain resulting from the repossession cannot exceed: (1) the original gain (i.e., the amount by which the original sale price exceeded the property's adjusted basis at the time of the sale), reduced by (2) the gain previously reported (i.e., the amount of gain on the sale of the real property which is returned as income for periods prior to the acquisition) and the cost of repossession (i.e., the amount of money and the fair market value of other property paid or transferred by the seller in connection with the reacquisition). n113

Example (2):

Assume the same facts as in the preceding Example(1). Because of the limitation just described, the taxpayer will, in fact, recognize less than the \$37,500 which applies under the general rule:

Limitation--

Selling price of property	\$.....80,000
Less--Basis	\$.....60,000
Original gain	\$.....20,000
Less--Portion of gain previously included in income	\$.....12,500
Repossession costs	\$.....13,000

Gain under the limitation	\$.....	7,000
		0

This result makes sense: Although the general rule produced a \$37,500 figure, the taxpayer didn't have this great a gain from the sale. The limitation rule, in this case, ensures that the gain from the reacquisition is appropriate.

[3] Tax Treatment of Gain on Reacquisition and Holding Period

The tax treatment of the gain on reacquisition--whether ordinary or capital--is determined by the treatment that applied when the sale was initially made. n114 If the seller, in a tax year before the reacquisition, treated the purchaser's indebtedness in whole or in part as a bad debt, the seller, upon repossession, is considered to have received income equal to the bad debt previously deducted. n115 The income is treated as a recovery of a bad debt previously deducted as wholly or partially worthless. n116

The holding period of the property reacquired includes the period for which the seller held the property before the original sale, but not the period between the date of the original sale and the date of the reacquisition. n117 If, however, the purchaser made improvements on the repossessed property, a separate holding period will apply to the improvements. The holding period for the improvements starts with the reacquisition of the realty. n118

[4] Seller's Basis in Reacquired Property

Following reacquisition of the property, the seller takes a new basis. The basis equals the sum of these items:

- (1) the seller's adjusted basis in the *indebtedness* secured by the property;
- (2) gain that the seller recognizes on the acquisition; and
- (3) cash and any other property (other than the repossessed real estate and the purchaser's notes secured by the real estate) which the seller pays in connection with the reacquisition. This includes the seller's repossession costs. n119

The seller's adjusted basis in the indebtedness is increased by any portion of the indebtedness which the seller treated as worthless before the reacquisition. n120

Example (3):

In Example (1), above, the taxpayer's basis in the debt is 75 percent of the face value of the debt (which equals the taxpayer's adjusted basis in the property sold (\$60,000) divided by the sale price (\$80,000)). At the time of reacquisition, the taxpayer holds notes with a face value of \$30,000 and an adjusted basis of \$22,500 (75% x \$30,000). Thus, the taxpayer's adjusted basis in the reacquired property is \$30,000, computed as follows:

Taxpayer's adjusted basis in notes	\$22,500

Plus: gain recognized on reacquisition	7,000
repossession costs	500
Adjusted basis in reacquired property	\$30,000

[5] Repossession of Residence

Special rules may apply if a taxpayer sells his or her residence on the installment basis n121 and then repossesses the home. The rules are as follows: n122

- (1) If the taxpayer does not use *IRC Section 121* to reduce taxable gain on the installment sale, the regular rules of *IRC Section 1038* apply upon repossession.
- (2) If the taxpayer uses *IRC Section 121* on the installment sale, but waits *at least one year* before reselling the home, the regular rules of Section 1038 apply upon repossession.
- (3) If the taxpayer uses *IRC Section 121* on the installment sale, but waits *less than one year* before reselling the home, the taxpayer does not recognize any gain on the repossession and the resale is considered part of the original sale for purposes of applying the rules under *IRC Section 121*.

For sales and exchanges before May 7, 1997, the special rules above applied if the taxpayer used either former *IRC § 121* (relating to sales of principal residences by persons at least 55 years old) or former *IRC § 1034* (relating to rollover of gain from sale of principal residence). n123

[6] Reacquisition by Seller's Estate

The special rules set forth in *IRC Section 1038* are available to a decedent's estate. Thus, if the taxpayer sells property on the installment basis and dies prior to repossession of the property, his estate will be able to use the provisions of *IRC Section 1038* to mitigate the gain which the estate recognizes on repossession. n124

FOOTNOTES:

(n1)Footnote 108. The rules discussed here are not limited to installment sales but apply as well to any sale that meets the requirements of *IRC § 1038*. See *Treas Reg § 1.1038-1*.

(n2)Footnote 109. If both *IRC §§ 1038* and *453B* could apply, *IRC § 1038* takes precedence. See *IRC § 1038(b)(3)* and *Treas Reg § 1.453-5(b)*.

(n3)Footnote 109.1. *Ltr Rul 9833005* .

(n4)Footnote 110. *Treas Reg § 1.1038-1(b)*.

(n5)Footnote 111. *IRC § 1038(a)*.

(n6)Footnote 112. *Goldberg v Commr, TC Memo 1997-74* , *affd 2001-1 USTC P 20,155* (9[th] Cir 2000).

(n7)Footnote 112.1. *Hovhannissian v Commr, TC Memo 1997-444* ; *Connors v Commr, 88 TC 541* (1987) .

(n8)Footnote 112.2. *IRC § 1038(a)*; *Hovhannissian v Commr, TC Memo 1997-444* .

(n9)Footnote 113. *Treas Reg § 1.1038-1(c)*. Legal fees relating to the repossession are considered a cost of repossession. *Cramer v Commr, 55 TC 1125* (1971) , *acq on another point 1971-2 CB 2* .

(n10)Footnote 114. *Treas Reg § 1.1038-1(d)*. The result is the same as if the seller disposed of the underlying installment obligation. *Treas Reg § 1.453-9*.

(n11)Footnote 115. *IRC § 1038(d)*; *Treas Reg § 1.1038-1(f)(2)*.

(n12)Footnote 116. *Treas Reg § 1.1038-1(f)(2)(i)*. The amount treated as a recovery of a bad debt may be excluded from gross income to the extent the tax benefit recovery exclusion provisions of *Treas Reg § 1.111-1* apply to it. *Id.* See also *Rev Rul 80-56, 1980-1 CB 154* .

(n13)Footnote 117. *Treas Reg § 1.1038-1(g)(3)*.

(n14)Footnote 118. *Smith v Commr, 58 TC 874 (1972)* .

(n15)Footnote 119. *IRC § 1038(c)*; *Treas Reg § 1.1038-1(g)*. See also *Treas Reg § 1.1038-1(h)* for examples.

(n16)Footnote 120. *IRC § 1038(d)(2)*.

(n17)Footnote 121. The installment method may be used with the sale of a residence. *Rev Rul 53-75, 1953-1 CB 83* .

(n18)Footnote 122. *IRC § 1038(e)* and *Treas Reg § 1.1038-2*. See also *Treas Reg § 1.1038-2(h)* for examples.

(n19)Footnote 123. *IRC § 1038(e)*, *before amendment by Pub L No 105-34*.

(n20)Footnote 124. *IRC § 1038(g)*.



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CHAPTER 7 Installment Sales

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§ 7.08 Imputed Interest on Selling Price

Most installment sales provide that the purchaser will pay interest on the deferred principal payments. If, however, the installment obligation does not provide for interest, or the interest is below market rates, the Code will recharacterize some of the principal payments as interest. This approach is designed to deny sellers any tax advantage which might result from allowing them to treat installment payments as consisting solely of principal. n125

In most cases, the original issue discount (OID) rules under *IRC Section 1274* will apply to transactions where the installment obligation does not provide for "adequate stated interest" n126 and at least one payment under the obligation is due more than six months after the sale or exchange. n127 Interest is generally inadequate if it is less than the applicable Federal rate (AFR) for the period that the installment obligation is outstanding. The three AFRs described in *IRC Section 1274(d)* are the Federal short-term rate (for debt instruments with a term of three years or less); the Federal mid-term rate (for debt instruments with a term of three years, but not over nine years); and the Federal long-term rate (for debt instruments with a term of over nine years). n128 The Service revises these AFRs each month to reflect changes in market interest rates.

Several types of transactions which could involve real estate installment sales are excluded from the application of *IRC Section 1274*, namely: n129

- (1) farm sales by individuals, estates, testamentary trusts and small businesses when the sale price does not exceed \$1 million;
- (2) sales of principal residences;
- (3) sales involving total payments of \$250,000 or less;
- (4) certain land transfers for \$500,000 or less between related persons, if *IRC Section 483(e)* applies to the debt which arises from the transfer; and
- (5) cash method debt instruments with a stated amount of \$2 million or less (adjusted for inflation after 1989). n130

Obligations that are not subject to *IRC Section 1274* may, nonetheless, have imputed interest because of *IRC Section 483*. Section 483 applies to an installment obligation if the obligation is not subject to *IRC Section 1274*, n131 the sale or exchange that gives rise to the installment obligation has a price of more than \$3,000, n132 at least one payment is due more than one year after the sale or exchange, n133 and the obligation calls for no interest or an inadequate rate of interest. n134 Thus, *IRC Section 483* typically applies to the five types of transactions described above which are not subject to *IRC Section 1274*.

FOOTNOTES:

(n1)Footnote 125. The discussion of this complicated subject is, necessarily, just an overview. For detailed coverage, see, eg, David Garlock, ed, *Federal Income Taxation of Debt Instruments* (Prentice-Hall Law and Business 1994); McCawley, 333-4th TM, *Time Value of Money: OID and Imputed Interest* (BNA); Lawrence Lokken, "The Time Value of Money Rules," 42 *Tax L Rev* 1 (1986) (a 300-page article).

(n2)Footnote 126. *IRC § 1274(c)(1)*. For a definition of adequate stated interest, see *IRC § 1274(c)(2)*.

(n3)Footnote 127. *IRC § 1274(c)(1)(B)*.

(n4)Footnote 128. If a debt instrument given for property does not have a stated principal amount in excess of \$2.8 million, the AFR used to determine the issue price cannot exceed 9 percent. *IRC § 1274A(a), (b)*. The \$2.8 million figure is adjusted annually for inflation; the amount is \$3,885,500 for sales or exchanges in 1999 (*Rev Rul 98-58, 1998-2 CB 799*), \$3,960,100 for sales and exchanges in 2000 (*Rev Rul 99-50, 1999-2 CB 656*), \$4,085,900 for sales and exchanges in 2001 (*Rev Rul 2000-55, 2000-2 CB 595*), \$4,217,500 for sales and exchanges in 2002 (*Rev Rul 2001-65, 2001-2 CB 639*), \$4,280,500 for sales and exchanges in 2003 (*Rev Rul 2002-79, 2002-2 CB 908*), \$4,381,300 for sales and exchanges in 2004 (*Rev Rul 2003-119, 2003-2 CB 1094*), \$4,483,000 for sales and exchanges in 2005 (*Rev Rul 2004-107, 2004-2 CB 852*), \$4,630,300 for sales and exchanges in 2006, \$4,800,800 for sales and exchanges in 2007 (*Rev Rul 2007-4, 2007-4 IRB 351*), \$4,913,400 for sales and exchanges in 2008 (*Rev Rul 2008-3, 2008-2 IRB 249*), \$5,131,700 for sales and exchanges in 2009 (*Rev Rul 2008-52, 2008-49 IRB 1233*), and \$5,115,100 for sales and exchanges in 2010 (*Rev Rul 2010-2, 2010-3 IRB 272*).

(n5)Footnote 129. *IRC §§ 1274(c)(3), 1274A(c)(1)*.

(n6)Footnote 130. For transactions in 2001, the amount is \$2,918,500 (*Rev Rul 2000-55, 2000-2 CB 516*); for transactions in 2002, the amount is \$3,012,500 (*Rev Rul 2001-65, 2001-2 CB 639*); for transactions in 2003, the amount is \$3,057,700 (*Rev Rul 2002-79, 2002-2 CB 908*); for transactions in 2004, the amount is \$3,129,500 (*Rev Rul 2003-119, 2003-2 CB 1094*); for transactions in 2005, the amount is \$3,202,100 (*Rev Rul 2004-107, 2004-2 CB 852*); for transactions in 2006, the amount is \$3,307,400 (*Rev Rul 2007-4, 2007-4 IRB 351*); for transactions in 2007, the amount is \$3,429,100 (*Rev Rul 2007-4, 2007-4 IRB 351*); for transactions in 2008, the amount is \$3,509,600 (*Rev Rul 2008-3, 2008-2 IRB 249*); for transactions in 2009, the amount is \$3,665,500 (*Rev Rul 2008-52, 2008-49 IRB 1233*). For transactions in 2010, the amount is \$3,653,600 (*Rev Rul 2010-2, 2010-3 IRB 272*).

(n7)Footnote 131. *IRC § 483(d)(1)*.

(n8)Footnote 132. *IRC § 483(d)(2)*.

(n9)Footnote 133. *Cf IRC § 1274*, which applies if at least one payment is due more than six months after the sale or exchange.

(n10)Footnote 134. The determination of whether the interest is adequate is made pursuant to rules in *IRC § 483(b)*.



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CHAPTER 7 Installment Sales

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§ 7.09 Treatment of an Installment Sale When a Taxpayer Elects Not to Use the Installment Method

A taxpayer who elects not to report a qualified sale on the installment method must recognize gain on the sale in accordance with the taxpayer's overall accounting method. n135 For fixed amount obligations, an accrual-method taxpayer recognizes the total amount payable under the installment obligation. n136 A cash-method taxpayer, on the other hand, recognizes an amount equal to the fair market value of the obligation, which cannot be less than the sale price of the property sold, minus any other consideration the taxpayer receives on the sale. n137

In addition, the regulations provide that any provision of contract or local law restricting the transferability of the installment obligation must be disregarded in the determination of the fair market value. n138 Thus, a "nonnegotiable" note cannot be considered to have a reduced fair market value. The regulations reach all types of obligations, whether represented by a note, executory contract or even an oral promise enforceable under local law.

FOOTNOTES:

(n1)Footnote 135. *Temp Treas Reg § 15A.453-1(d)(2)*.

(n2)Footnote 136. *Temp Treas Reg § 15A.453-1(d)(2)(ii)*. For a discussion of the treatment of contingent payment obligations when the installment sale rules do not apply, see *Temp Treas Reg § 15A.453-1(d)(2)(iii)*.

(n3)Footnote 137. *Id.*

(n4)Footnote 138. *Temp Treas Reg § 15A.453-1(d)(2)(i)*.



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CHAPTER 7 Installment Sales

1-7 Federal Taxes Affecting Real Estate § 7.10

§ 7.10 Open-End or Contingent Selling Price

One type of sale that is used occasionally, particularly between a landowner and a subdivider, is the open-end or contingent price sales contract. With this type of sale, a landowner may not agree to a fixed price per acre but may want to tie the price to the ultimate success and value created by the development and sale of the property. A variation provides the seller with a fixed price per acre, with the buyer agreeing to pay an additional amount contingent upon the success of the ultimate sale of the property. A third approach is to establish a higher sales price with a provision that, if the buyer does not reach certain profit levels on resale, the sales price will be reduced. These transactions are the same in one respect--the seller does not know the final amount of the selling price.

IRC Section 453(j)(2) provides that installment method reporting is available under regulations prescribed by the Secretary in transactions when the gross profit or the total contract price (or both) cannot be readily ascertained. The temporary regulations n139 provide the rules for allocation of basis to payments received in three basic fact situations:

- (1) sales for which a maximum selling price is determinable;
- (2) sales for which a maximum selling price is not determinable, but the time period in which the payments will be received is determinable; or
- (3) sales for which neither a maximum selling price nor a definite payment term is determinable.

In a situation where the maximum selling price is determinable, such maximum price is treated as the "selling price" for purposes of making the usual installment method calculations. n140 When the maximum amount is subsequently reduced, the gross profit ratio is recomputed with respect to payments received in or after the taxable year in which the event requiring reduction occurs. n141

When a stated maximum selling price cannot be determined, but the maximum period over which the payments may be received is fixed, the seller generally allocates his adjusted basis equally among the years in which payment may be received. n142 If in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than the basis allocated to that taxable year, the seller cannot take a loss deduction unless the taxable year is the final payment year under the agreement. Instead of taking a loss deduction, the seller carries forward the unrecovered portion of the basis allocated to that taxable year to the next succeeding year. n143

If neither a maximum selling price nor fixed payment period is determinable, the Service will question whether a sale really has occurred or whether, in economic effect, the payments received are really in the nature of rent or royalty income or joint venture distributions. The regulations state that such arrangements will be closely scrutinized. However, if the arrangement is ultimately determined to qualify as a sale, the taxpayer's basis will be recovered in equal annual increments over a period of 15 years. n144

The general rule requiring the recovery of basis over 15 years does not apply if the taxpayer can establish to the Service's satisfaction that application of such a general rule would substantially and inappropriately defer the recovery of the taxpayer's basis. Conversely, if the Service determines that the 15-year period substantially and inappropriately accelerates recovery of the taxpayer's basis in early years of that 15-year term, the Service may require that the basis be reallocated within the 15-year term, but in no event will that basis be allocated over more than a 15-year period. n145

FOOTNOTES:

(n1)Footnote 139. *Temp Treas Reg § 15A.453-1(c)*.

(n2)Footnote 140. See *Temp Treas Reg § 15A.453-1(c)(2)(i)(B)*, Exs (1) & (2).

(n3)Footnote 141. *Temp Treas Reg §§ 15A.453-1(c)(2)(i)(A) & 15A.453-1(c)(2)(iii)*, Ex (5).

(n4)Footnote 142. *Temp Treas Reg §§ 15A.453-1(c)(3)(i) & 15A.453-1(c)(3)(ii)*, Ex. (1).

(n5)Footnote 143. *Temp Treas Reg §§ 15A.453-1(c)(3)(i) & 15A.453-1(c)(3)(ii)*, Ex. (2).

(n6)Footnote 144. *Temp Treas Reg § 15A.453-1(c)(4)*.

(n7)Footnote 145. *Id.*



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate Scope

Scope

SCOPE

This chapter discusses the requirements and operation of *Section 1031 of the Internal Revenue Code*, which provides for nonrecognition of gain or loss on qualifying exchanges of like-kind property. Included is a comprehensive review of the various requirements for complying with Section 1031 as it applies to real estate. Multiparty exchanges and deferred exchanges are also discussed in detail.



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

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§ 8.01 Overview of IRC Section 1031

[1] In General

A transferor generally realizes gain or loss on a sale or other disposition of real property. The amount of gain or loss is the difference between the adjusted basis of the property and the amount realized from the sale or other disposition. n1 Unless a statutory nonrecognition provision applies, any realized gain must also be recognized. n2 If realized gain or loss is subject to nonrecognition treatment under a Code provision, the gain is not included in gross income, nor is the loss deductible from gross income.

IRC Section 1031 is one of several nonrecognition provisions in the Internal Revenue Code. It provides that no gain or loss is recognized when there is a qualifying like-kind exchange of property. n3 Its underlying rationale is that recognition of gain or loss is not appropriate when a taxpayer essentially continues an investment in the same kind of property, notwithstanding the occurrence of an otherwise taxable transaction. The provision also recognizes that a taxpayer who receives only real estate in an exchange may not have cash available to pay tax on the realized gain. n4 *Internal Revenue Code Section 1031* generally permits taxpayers to exchange unwanted real estate and acquire other like-kind property without incurring immediate tax on the gain.

Nonrecognition is available, however, only if the taxpayer satisfies detailed statutory requirements. These requirements are discussed in the following parts of the chapter.

Complete nonrecognition of gain or loss is available for exchanges that consist solely of like-kind property. n5 If cash or other property in addition to like-kind property is received in an otherwise qualifying exchange, the transaction is not taken out of *IRC Section 1031*. Rather, gain, if any, must be recognized, but only to the extent of the money and fair market value of non like-kind property received by the taxpayer in the exchange. n6 Still, however, no loss can be recognized. Thus, if **any** like-kind property is received in an exchange, the transaction falls within the ambit of *IRC Section 1031*. A taxpayer wishing to recognize a loss in an exchange must therefore take care not to receive any like-kind property in the exchange. n7

[2] Nonrecognition Treatment Under IRC Section 1031 Not Elective

IRC Section 1031 is a non-elective provision. If a transaction falls within its ambit, nonrecognition of gain or loss automatically follows. n8

Planning Tip:

Ordinarily, tax planning around *IRC Section 1031* involves structuring and implementing transactions so as to meet statutory requirements and thereby qualify for nonrecognition. In appropriate situations, however, the opposite may be true--a taxpayer may want to assure that the requirements of *IRC Section 1031* are **not** met so that gain or loss may be recognized. For example, a taxpayer may wish to sell real estate in order to claim a loss, and reinvest the proceeds in like-kind property. A taxpayer may also wish to fully recognize taxable gain on the sale of property in order to obtain an increased basis for depreciation in the replacement property, take advantage of currently low capital gains rates, or offset another loss or loss carryover.

FOOTNOTES:

(n1)Footnote 1. *IRC § 1001(a)*.

(n2)Footnote 2. *IRC § 1001(c)*.

(n3)Footnote 3. *IRC § 1031(a)*.

(n4)Footnote 4. See *Jordan Marsh Company v Commr*, 269 F2d 453 (2d Cir 1959) ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) ; *Behrens v Commr*, TC Memo 1985-195 .

(n5)Footnote 5. *IRC § 1031(a)(1)*.

(n6)Footnote 6. *IRC § 1031(b)*; see § 8.20[2][a] for a detailed discussion.

(n7)Footnote 7. See *IRC § 1031(c)*; see § 8.20[2][b] for a detailed discussion.

(n8)Footnote 8. *IRC § 1031(a)(1)*; *United States v Vardine*, 305 F2d 60, 66 (2d Cir 1962) .

(n9)Footnote 9. See *IRC § 1(h)*.



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.02

§ 8.02 Reporting Requirements

[1] Income Tax Reporting Requirements

Section 1031 exchanges must be reported to the IRS, notwithstanding the nonrecognition of gain or loss. Form 8824, Like-Kind Exchanges, must be filed for each exchange of qualifying business or investment property for property of a like-kind. Multiple exchanges may be reported on separate Forms 8824, or one summary Form 8824 may be filed, with attached statements showing all the information requested on Form 8824 for each exchange. n10

Form 8824 must be filed in any tax year the taxpayer transfers property to another party in a like-kind exchange. The requested information must be provided in accordance with the instructions to the form. A Form 8824 must also be filed for the 2 years following the year of a related party exchange.

Any gain recognized on a like-kind exchange under *IRC Section 1031(b)* must also be reported on Schedule D to Form 1040 or Form 4797, Sales of Business Property, whichever applies.

[2] Broker Returns

The person(s) responsible for closing a like-kind exchange may be required to file a Form 1099-S, Proceeds from Real Estate Transactions, in accordance with the instructions to the form. The person responsible for closing the transaction is usually the person listed as the settlement agent on the Uniform Settlement Statement prescribed under the Real Estate Settlement Procedures Act of 1974 (RESPA). n11

If no one is responsible for closing, the person responsible for filing is one of the following (in the following order):
n12

- the mortgage lender;
- the transferor's broker;
- the transferee's broker; or
- the transferee.

Both parties to the exchange are treated as transferors for whom a Form 1099-S must be filed. The regulations provide an example of reporting requirements for gross proceeds in an exchange. n13

No information return is required with respect to a transferor that is a corporation, a governmental unit, or an exempt volume transferor, but if there is a non-exempt transferor, the reporting person must still file a Form 1099-S for the non-exempt transferor. n14 Sales and exchanges of certain property that are not related to the sale or exchange of reportable real estate are also exempt from the Form 1099-S reporting requirements, including sales and exchanges of interests in natural resources or crops, burial plots or vaults, or mobile homes. n15

[3] Withholding on Acquisitions of U.S. Real Property Interests Acquired from Foreign Persons

When a foreign person transfers a U.S. real property interest, the transferee is required to deduct and withhold a tax equal to 10 percent of the amount realized by the foreign person on the disposition. n16 Because the withholding amount is based on the amount *realized*, rather than the amount *recognized*, by the transferor, the transferee is subject to the withholding requirement even in a tax-free exchange. n17 The amount required to be withheld, however, cannot exceed the transferor's maximum tax liability. n18

It is the responsibility of a transferee to determine if a transferor is a foreign person. If the transferor is a foreign person, and the transferee fails to withhold, the transferee may be held liable for the tax. n19

Transferees must use Forms 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests, and 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests, to report and pay to the IRS any tax withheld on the acquisition of a U.S. real property interest. The forms must generally be filed and any tax withheld paid by the 20th day after the date of the transfer. n20

There are several exceptions under which withholding is not required. n21 The primary exception pertaining to like-kind exchanges is where the transferor is not required to recognize any gain or loss with respect to the transfer, and the requirements of *Regulation Section 1.1445-2(d)(2)* are met. That regulation sets forth requirements regarding the transferor's notice to the transferee that the transferor need not recognize any gain, and the transferee's timely providing of a copy of the notice to the IRS. n22

Withholding may also be reduced or eliminated pursuant to a withholding certificate issued by the IRS. n23 Procedures for obtaining a withholding certificate under *Regulations Sections 1.1445-3* and *1.1445-6* are set forth in *Revenue Procedure 2000-35*. n24 Details on withholding on dispositions of U.S. real property interests can be found in Publication 515.

FOOTNOTES:

(n1)Footnote 10. Instructions to Form 8824.

(n2)Footnote 11. *Treas Reg § 1.6045-4(e)(3)(i)*; see *12 USC § 2601 et seq.*

(n3)Footnote 12. *Treas Reg § 1.6045-4(e)(4)*.

(n4)Footnote 13. *Treas Reg § 1.6045-4(r)*, Ex (4).

(n5)Footnote 14. *Treas Reg § 1.6045-4(d)(1)*.

(n6)Footnote 15. *Treas Reg § 1.6045-4(c), (d)*.

(n7)Footnote 16. *IRC § 1445(a)*.

(n8)Footnote 17. See *IRC § 1445(a)*.

(n9)Footnote 18. *IRC § 1445(c)(1)*.

(n10)Footnote 19. *IRC § 1461; Treas Reg § 1.1445-1(e)*.

(n11)Footnote 20. *Treas Reg § 1.1445-1(c)(1)*.

(n12)Footnote 21. *IRC § 1445(b); Treas Reg § 1.1445-2*.

(n13)Footnote 22. *Treas Reg § 1.1445-2(d)(2)*. The IRS has issued a revenue procedure that provides a simplified method to request relief for late filings under the regulation [*Rev Proc 2008-27, 2008-21 IRB 1014*]. The procedure is in lieu of the private letter ruling request procedures and accompanying user fees that ordinarily apply to them [*Rev Proc 2008-27* , § 3, *2008-21 IRB 1014*].

(n14)Footnote 23. *Treas Reg §§ 1.1445-3, 1.1445-6*.

(n15)Footnote 24. *Rev Proc 2000-35, 2000-2 CB 211* .



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate §§ 8.03-8.09

[Reserved]

§§ 8.03-8.09[Reserved]



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.10

§ 8.10 Overview of Requirements

[1] In General

Under *IRC Section 1031(a)(1)*, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if that property is exchanged solely for property of like-kind which is also to be held for productive use in a trade or business or for investment. Thus, nonrecognition is available under *IRC Section 1031* only if the following requirements are met: n25

- there must be an "exchange" of property; the exchange requirement is discussed in § 8.11;
- both the property exchanged and the property received must be held for productive use in a trade or business or for investment; this is referred to as the "holding requirement", which is discussed in § 8.12; and
- the properties exchanged must be of like-kind; the "like-kind" requirement is discussed in § 8.13.

For deferred exchanges, a number of additional requirements must be met. n26 These are discussed in § 8.14.

[2] Excluded Property

[a] In General

Even if the requirements in [1] are met, certain property is specifically excluded from *IRC Section 1031*. The provision does not apply to any exchange of the following property: n27

- stock in trade or other property held primarily for sale; n28
- stocks, bonds, or notes; n29
- other securities or evidences of indebtedness or interest;
- interests in a partnership; n30

- certificates of trust or beneficial interest; or
- choses in action.

Thus, the exchange of these types of property, even if for other like-kind property, does not receive nonrecognition treatment under *IRC Section 1031*. The exceptions for stock in trade or other property held primarily for sale and partnership interests are discussed in further detail in [b] and [c], below. The remainder of the exceptions have less relevance to real estate, and are intended to exclude intangible property. n31

[b] Stock in Trade or Other Property Held Primarily for Sale

[i] Two Distinct Categories of Property

IRC Section 1031 does not apply to exchanges of stock in trade or other property that is held primarily for sale. n32 This exception refines the requirement that property be held for productive use in a trade or business or for investment. The major source of difficulty here is that property held for investment qualifies only if it is not held primarily for sale, but the very notion of investment implies holding property for future sale. The distinction between holding property primarily for sale and holding property for investment is further complicated by analogous statutory requirements in the capital gains area. Capital gain treatment is not allowed to property held by a taxpayer primarily for sale to customers in the ordinary course of a trade or business. n33

This exception under *IRC Section 1031* encompasses two distinct categories: n34

- stock in trade; and
- other property held primarily for sale.

[ii] "Stock in Trade" Category

The stock in trade category is intended to exclude real property that is inventory of a dealer. The primary issue that arises under this category is whether a particular taxpayer is a "dealer" in real estate. A considerable and confusing body of case law has developed to distinguish between dealers and nondealers (investors) in real estate. n35 Status as a "dealer" does not automatically preclude the use of *IRC Section 1031*. A dealer in real property may also acquire and hold real property for investment purposes, in other words, a taxpayer can be a dealer with respect to some properties, and an investor with respect to others. n36 When seeking to take advantage of *IRC Section 1031* with respect to a particular property, however, a dealer has the burden of proving that it is an investor with respect to that property. n37

To prove investor status with respect to particular property a dealer must generally show that the property was held for the production of income (whether presently or in the future). Property held for long-term appreciation cannot qualify. For a dealer, even holding property for many years does not establish an intent to hold it for investment rather than for sale. n38

In one pro-dealer case, the Tax Court found that an exchange of property qualified for nonrecognition under *IRC Section 1031* because the taxpayer--a real estate dealer--held the particular property in question as a capital asset and not primarily for sale. The case involved an exchange by the taxpayer's largest shareholder, who was liquidating the taxpayer's assets. n39

[iii] "Other Property Held Primarily for Sale" Category

The other category in the exception--"other property held primarily for sale"--is broader than the "stock in trade"

category. It encompasses *any* property held primarily for sale, whether or not that property is stock in trade or inventory. This category is also broader than the corresponding exclusion for capital asset property n40 because it does not require that the property be held for sale in the ordinary course of a trade or business. Rather, it requires only that the property be held primarily for sale. n41

For purposes of *IRC Section 1031*, "primarily" means "of first importance" or "principally." n42 Neither the Code nor the regulations define "held primarily for sale." The determination of whether property is held primarily for sale is a question of fact, and therefore requires an examination of the circumstances of each case. Courts look to several factors in determining whether property is held primarily for sale for purposes of *IRC Section 1031*, including the following: n43

- the purpose for which the property was initially acquired;
- the purpose for which the property was subsequently held; n44
- the ordinary business of the taxpayer, i.e., whether a taxpayer's real estate operations are limited to the properties in question or are engaged in as part of a general real estate business; n45
- whether the taxpayer makes improvements on the property; n46
- the extent of development or other activity with respect to the property; n47 and
- the extent of marketing of the property.

[c] Interests in a Partnership

[i] Applicability of Exception

IRC Section 1031 does not apply to any exchange of interests in a partnership. n48 Thus, a partnership as a taxpayer may exchange real estate for other like-kind property and take advantage of Section 1031. However, a partner may not exchange an interest in a real estate partnership for another partnership interest without triggering a taxable event. n49 The exception for exchanges of partnership interests applies regardless of whether the interests exchanged are general or limited partnership interests, or are interests in the same partnership or in different partnerships. n50

Note:

It should be noted that a conversion of a general partnership into a limited partnership or into an LLC is not considered an exchange and therefore does not fall within the scope of *IRC § 1031*. Generally, these conversions can be accomplished tax-free unless there is a shift in a partner's share of partnership liabilities. n51

If a partnership is used to hold real estate, careful attention must be paid to any attempts to avoid this limitation on Section 1031. For example, the distribution of an interest in real estate from a partnership to a partner, followed by that partner's exchange of the real estate in a Section 1031 transaction, may still be prohibited by Section 1031. The IRS may assert that the holding requirement has not been met or, applying the step transaction doctrine, may collapse the various steps and determine that the substance of the transactions is an exchange of partnership interests. n52

Planning Tip:

A common problem faced by taxpayers holding property in partnerships is how to dispose of the partnership property when not all of the partners want to continue in the partnership, but some of the

partners want to defer their gain through a *IRC Section 1031* exchange. Attempts to accomplish that goal often run afoul of the holding requirement or can be collapsed into an exchange of partnership interests. n53

It is not always clear whether an arrangement is a mere co-ownership or a partnership. A mere joint undertaking merely to share expenses is not a partnership, nor is mere co-ownership of property that is maintained, kept in repair, and rented or leased. Tenants in common may be partners, however, if they actively carry on a trade, business, financial operation or venture, and divide the profits. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or indirectly. n54

Note:

The IRS has specified the conditions under which it will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property) is not an interest in a business entity. n55

It is the degree of services that determine whether a partnership is present. Providing customary services of maintenance and repair will not render co-ownership a partnership, but the furnishing of additional services by the owners or through an agent will. Owners are not treated as providing services that are provided by an independent management company that is not an agent of the owners, provided the owners do not share the income earned from these additional services. n56 The temporary pooling of funds on a non-pro rata basis and the appointment of a tenant-in-common owner as a payment and/or communications agent because of the bankruptcy of the master tenant will not necessarily cause the tenants-in-common to become partners in a partnership if the arrangement was not a partnership prior to the temporary pooling of funds. n56.1

The filing of partnership returns will also indicate that a partnership is present. n57

Note:

An LLC with two or more members is treated for tax purposes as a partnership, in the absence of an election to be taxed as a corporation. n58 Therefore, the prohibition of exchanges of partnership interests n59 also applies to exchanges of LLC interests.

[iii] Partnerships with Section 761 Election in Effect

An interest in a partnership that has in effect a valid election under *IRC Section 761* to be excluded from the partnership provisions n60 is treated as an interest in each of the partnership assets and not as an interest in a partnership. n61 Therefore, qualifying exchanges of these partnership interests may qualify for nonrecognition under *IRC Section 1031* if statutory requirements are met. n62

An exchange of an interest in a partnership with a Section 761 election in effect does not qualify for nonrecognition with respect to any asset of the partnership that is otherwise excluded under *IRC Section 1031(a)(2)*, n63 however, or to the extent that the exchange (which is of assets of the partnership) does not otherwise satisfy the statutory requirements for nonrecognition. n64 It should be noted that the Section 761 election is available only for partnerships that are not actively conducting a business. n65

[d] Special Rule For Single-Member LLCs

LLCs that elect to be treated as partnerships for tax purposes are generally treated the same way as partnerships for purposes of the like-kind exchange provisions. Thus, a member of an LLC may not exchange an LLC interest for another LLC interest under *IRC Section 1031*. n66

Similarly, LLCs that elect to be treated as corporations for tax purposes are generally treated the same way as corporations for purposes of the like-kind exchange provisions. Thus, a member of such an LLC may not exchange stock in that LLC for other stock in an LLC without triggering a taxable event. n67

The IRS has ruled, however, that a single-member LLC that does not elect to be treated as an association under the entity classification rules n68 will be disregarded as an entity separate from its owner for tax purposes. n69

Revenue Ruling 99-6 allows a taxpayer to engage in a like-kind exchange by exchanging an interest in real property for an interest in a single member LLC that owns an interest in like-kind property. In essence, the real property owned by the LLC is treated as owned directly by the taxpayer. Therefore the membership interest in the LLC is treated as like-kind to the property exchanged by the taxpayer. This treatment does not apply if the LLC elects to be treated as an association (and taxable as a corporation) for tax purposes. n70

FOOTNOTES:

(n1)Footnote 25. *IRC § 1031(a)(1)*.

(n2)Footnote 26. *IRC § 1031(a)(3)*.

(n3)Footnote 27. *IRC § 1031(a)(2)*.

(n4)Footnote 28. See [b], below, for a discussion.

(n5)Footnote 29. See *Coupe v Commr*, 52 TC 394 (1969) (real property not like-kind to a deed of trust note).

(n6)Footnote 30. See [c], below, for a discussion.

(n7)Footnote 31. *IRC § 1031(a)(2)*.

(n8)Footnote 32. *IRC § 1031(a)(2)(A)*.

(n9)Footnote 33. *IRC §§ 1221(a)(1), 1231(b)(1)(B)*.

(n10)Footnote 34. *IRC § 1031(a)(2)(A)*.

(n11)Footnote 35. See Ch 10 for a discussion of dealer status.

(n12)Footnote 36. *Land Dynamics v Commr*, TC Memo 1978-259 ; *Maddux Construction Co v Commr*, 54 TC 1278 (1970) ; *Margolis v Commr*, 337 F2d 1001 (9th Cir 1964) .

(n13)Footnote 37. *Land Dynamics v Commr*, TC Memo 1978-259 .

(n14)Footnote 38. *Margolis v Commr*, 337 F2d 1001, 1004-1005 (9th Cir 1964) ; *Land Dynamics v Commr*, TC Memo 1978-259 .

(n15)Footnote 39. *Paullus v Commr*, TC Memo 1996-419 .

(n16)Footnote 40. See *IRC § 1221(a)(1)*.

(n17)Footnote 41. *IRC § 1031(a)(2)(A)*; see *Land Dynamics v Commr*, TC Memo 1978-259 ; *Neal Baker Enterprises v Commr*, TC Memo 1998-302 .

(n18)Footnote 42. *Neal Baker Enterprises v Commr*, TC Memo 1998-302 ; see *Malat v Riddell*, 383 US 569, 572

(1966) .

(n19)Footnote 43. *Neal Baker Enterprises v Commr*, TC Memo 1998-302 .

(n20)Footnote 44. See *Eline Realty Co v Commr*, 35 TC 1, 5 (1960) ; *Cottle v Commr*, 89 TC 467, 487 (1987) .

(n21)Footnote 45. See *Eline Realty Co v Commr*, 35 TC 1, 5 (1960) ; *Maddux Construction Co v Commr*, 54 TC 1278, 1284 (1970) .

(n22)Footnote 46. See *Kesicki v Commr*, 34 TC 675, 679 (1960) .

(n23)Footnote 47. See *Olivieri v Commr*, TC Memo 1966-177 ; *Paullus v Commr*, TC Memo 1996-419 .

(n24)Footnote 48. IRC § 1031(a)(2)(D); FSA 200205023 (lease in/lease out transaction not eligible for like-kind treatment because replacement property was partnership interest).

(n25)Footnote 49. IRC § 1031(a)(2)(D).

(n26)Footnote 50. *Treas Reg* § 1.1031(a)-1(a)(1).

(n27)Footnote 51. See Rev Rul 84-52, 1984-1 CB 157 ; Rev Rul 95-37, 1995-1 CB 130 .

(n28)Footnote 52. IRC § 1031(a); see § 8.12 for a discussion of the holding requirement.

(n29)Footnote 53. See Planning tip in § 8.12 regarding these transactions.

(n30)Footnote 54. *Treas Reg* § 1.761-1(a).

(n31)Footnote 55. *Rev Proc* 2002-22, 2002-14 IRB 733 ; see § 8.13[3] for detailed discussion.

(n32)Footnote 56. *Rev Rul* 75-374, 1975-2 CB 261 .

(n33)Footnote 56.1. See PMTA 2010-05 (3/15/10). Note that PMTAs may not be used or cited as precedent.

(n34)Footnote 57. *Ltr Rul* 9741017 .

(n35)Footnote 58. *Treas Reg* § 301.7701-3(b)(1).

(n36)Footnote 59. IRC § 1031(a)(2)(D).

(n37)Footnote 60. See IRC § 761(a).

(n38)Footnote 61. IRC § 1031(a)(2).

(n39)Footnote 62. IRC § 1031(a)(1).

(n40)Footnote 63. See [a], above.

(n41)Footnote 64. *Treas Reg* § 1.1031(a)-1(a)(1).

(n42)Footnote 65. IRC § 761(a).

(n43)Footnote 66. IRC § 1031(a)(2)(D).

(n44)Footnote 67. *Id.*

(n45)Footnote 68. See *Treas Reg* § 301.7701-3(b)(1)(ii), (c).

(n46)Footnote 69. *Rev Rul* 99-6, 1999-1 CB 432 .

(n47)Footnote 70. *Ltr Rul* 200131014 ; see *Ltr Rul* 199911033 ; see also *Ltr Rul* 199945038 (the IRS ruled for *IRC* § 1033 purposes that a taxpayer who received condemnation proceeds could purchase the replacement property through a single-member LLC).



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.11

§ 8.11 Exchange Requirement

[1] In General

IRC Section 1031 provides for nonrecognition treatment only if there is an exchange of property. n71 There are three general requirements for the exchange requirement to be met: n72

- the taxpayer must demonstrate its intent to achieve an exchange (and the properties exchanged must be of like-kind and held for a qualified use); n73
- the steps in the transfers involved in the exchange must be part of an integrated plan to exchange the relinquished property for the replacement property; n74 and
- the party holding the replacement property must not be the taxpayer's agent. n75

[2] Definition of "Exchange"

An exchange is a reciprocal transfer of property, as distinguished from a transfer of property for money consideration. n76 A sale of property with a reinvestment of the proceeds into a second like-kind property ordinarily does not qualify as an exchange, even if the reinvestment is made immediately, n77 and even if other statutory like-kind exchange requirements are met, such as a timely designation and receipt of replacement property. n78 Similarly, in a reverse exchange context, the purchase of one property and the subsequent sale of another property does not generally qualify as an exchange. n79

A transaction may qualify as an exchange for tax purposes even though an actual exchange would be forbidden under state law. In one ruling, the IRS applied a "substance over form" rationale and concluded that a transaction cast as a sale of farmland and subsequent purchase of other farmland was in fact an exchange under *IRC Section 1031*. An exchange would have been illegal under state law because the land was owned by an incompetent whose guardian was acting on his behalf. n80

The distinction between an exchange and a sale/purchase is not always clear, especially when multiple parties and escrows, qualified intermediaries, and/or deferred exchanges are involved. n81 In court challenges involving the exchange requirement, the IRS often asserts that the taxpayer has received or otherwise controls the proceeds from the

property being relinquished, either by virtue of constructive receipt, or because an intermediary or third party holding the proceeds on the taxpayer's behalf is acting as the taxpayer's agent. n82

Nevertheless, applying the step transaction doctrine, courts and the IRS have allowed taxpayers a certain amount of leeway in structuring a series of transactions that eventually accomplish an exchange. The various steps are collapsed and treated as component parts of the ultimate exchange transaction, and the interim steps are ignored for tax purposes. For a series of transactions to comprise an exchange and not be treated as separate sales and purchases, courts generally require that each specific transaction be an interrelated step in a single integrated transaction constituting an exchange. In other words, the step transaction doctrine applies the standard of the "integrated plan" in determining whether a qualified exchange has occurred. n83

Courts have also applied a "contractual interdependence" standard. This usually requires that each step must be contractually interdependent to the others, that is, the sale of the taxpayer's property cannot occur without the purchase of the replacement property. Under this standard, if contractual interdependence is not present, each step is likely to be treated as a separate taxable event. The mere fact that proceeds from the sale of one property are to be used to purchase the other property does not establish the requisite contractual interdependence. n84

Courts have been reluctant to deny nonrecognition treatment due to defects in the form of the transaction so long as an exchange is intended, and all aspects of the transaction reflect an integrated plan whereby the taxpayer would part with property in return for like-kind property. n85

While intent alone is not dispositive of the existence of an exchange, n86 it is relevant in dissecting the various steps. n87 Cases have found an exchange to be present even though one or more of the following circumstances were present:

- the purchaser never held title to the exchange property; n88
- the exchange involved a nonsimultaneous exchange of property; n89
- multiple parties were involved; n90
- a party held transitory ownership of exchange property solely for purposes of effecting the exchange; n91
- sale proceeds were deposited into an escrow account before an exchange property was located; n92
- the intermediary did not acquire legal title to the exchange property; n93
- the initial sale transaction was changed to an exchange transaction even though the property to be received on the exchange was not identified as of the date the original agreement was made; n94
- the taxpayer retained the right to require a cash payment if the other party to the exchange was unable to acquire for exchange an identified property desired by the taxpayer; n95
- the buyer could direct the third party in a three-way exchange to deed property directly to the taxpayer, as long as the cash paid to the third party was transferred directly from the buyer to the third party and not through the taxpayer; n96 and
- the taxpayer oversaw improvements on the replacement property to be acquired and advanced funds toward the purchase of the replacement property to be acquired by exchange. n97

The only defect that is always fatal to the finding of an "exchange" is the taxpayer's actual or constructive receipt of, or discretionary control over, cash proceeds from the relinquished property. Receipt of cash will defeat the existence of an exchange even if the taxpayer takes receipt of the cash simply to avoid otherwise unnecessary duplication of titles and related filing or transaction costs. n98

Other deviations have also resulted in a finding that no exchange is present. These are often the result of poor tax planning. The following circumstances have resulted in a finding that a sale, rather than an exchange, was present:

- a transfer of buildings and land to a contractor in partial consideration for the construction of a new plant on land owned by the taxpayer (the court found a sale because the contractor did not own the land on which the new building was constructed, never owned the new building, and never conveyed the building to the taxpayer); n99
- a disposition of property followed by use of the sales proceeds to pay off the mortgage on the property and to construct a building on other property owned by the taxpayer; n100 and
- the exercise by a buyer of an option to buy property from the taxpayer just before the option was to expire (the taxpayer arranged to exchange the property with another party upon expiration of the option). n101

Planning Tip:

Any contract involving a like-kind exchange should expressly provide that the taxpayer cannot receive cash instead of like-kind property in the exchange, and this restriction should be carefully complied with. Even if a contract clause provides that the transfer of the taxpayer's property is expressly contingent on the receipt of like-kind property, care must be taken that the taxpayer never has even momentary control over cash proceeds.

Generally, the taxpayers in the reported cases have created their own problems. Regardless of whether the courts chose to overlook these problems or whether they denied nonrecognition treatment on the basis of them, most of the problems could have been eliminated by simple planning and careful execution of the transactions. In reviewing the case law for guidance, taxpayers should structure any transactions intended to comprise an exchange in a logical and integrated manner and execute the transactions according to the plan. Since the difference between an exchange and a sale and reinvestment is largely a matter of form, the taxpayer should avoid cutting corners. All escrow instructions and other agreements should follow the exchange format and should be executed accordingly. Although the courts have demonstrated considerable tolerance for error, taxpayers would be foolish to rely on this tolerance when favorable results can be assured through proper attention to detail.

The vast majority of like-kind exchanges involve multiple parties and/or deferred exchanges. The easiest way to assure that the exchange requirement is met with respect to these exchanges is to comply with safe harbors that are provided in regulations, n102 or set up a "qualified exchange accommodation arrangement" in accordance with *Revenue Procedure 2000-37*. n103 Absent this, one may be forced to rely on the above case law standards to establish that an exchange has occurred. n104 This is usually inadvisable, because these standards are more subjective, and their application to a particular set of facts may be unclear at best.

[3] Multi-Party Exchanges

The IRS n105 and courts have long approved of multi-party exchanges, that is, exchanges involving three or more parties. n106 As a practical matter, almost all exchanges *are* multi-party exchanges, since it is rare for two parties to

own properties they want to exchange with each other. There are several typical formats for multi-party exchanges:

- the ultimate purchaser of the taxpayer's property first purchases the property that the taxpayer wants, and then exchanges it with the taxpayer for the taxpayer's property (this is often called an *Alderson* exchange); n107 or
- the taxpayer exchanges property directly with the party owning the desired property, and that party immediately sells the taxpayer's former property to a cash purchaser (this is often called a *Baird Publishing* exchange). n108

Four-party exchanges (the fourth party often being a broker or intermediary) are often used when a party refuses to participate in an exchange directly with other parties. This can occur when a party refuses to take title to an exchange property even momentarily because of environmental or other liability concerns. In that case, the fourth party purchases the property desired by the taxpayer, trades it with the taxpayer, and sells the taxpayer's former property to the party wishing to acquire it. n109

Planning Tip:

Whatever particular form multi-party transactions take, they ultimately involve multiple conveyances of property in an effort to structure an exchange under *IRC Section 1031* instead of a sale and investment. Case law has often focused on the effect of particular circumstances on the ultimate issue of whether an exchange has taken place. As discussed with respect to the "exchange" requirement in [2], above, the line between an exchange on one hand, and a nonqualifying sale and reinvestment on the other, is often subjective and indistinct. n110 The danger of having an exchange not qualify for nonrecognition--especially with respect to matters of constructive receipt of cash and agency concerns--can be avoided by complying with safe harbors enacted for deferred exchanges. n111 The safe harbor for qualified intermediaries is especially useful, since it can be used both for simultaneous or deferred exchanges. n112

The IRS has indicated that it will carefully scrutinize transactions that are not structured to come within the safe harbors, and there is little reason not to comply with them. A multi-party exchange that does not comply with one the safe harbors in the regulations will have to qualify for *IRC Section 1031* nonrecognition under the more nebulous "exchange" standards discussed in [2], above.

[4] Sale-Leaseback Transactions

[a] Overview of Sale-Leaseback Transactions

A sale-leaseback transaction is one in which the owner (the seller-lessee) of the property sells a fee interest in the property to another party but retains possession by simultaneously leasing the property back from the new owner. Thus, in a sense, the owner is exchanging a fee interest in real estate for a leasehold interest in the same property.

A sale-leaseback can be an attractive alternative to mortgaging property. Just as with a mortgage, the seller-lessee in a sale-leaseback receives a lump sum in cash equal to the value of the property, makes periodic payments to the "lender," and retains possession of the property. If the property is subject to a long-term lease, the economic difference between a mortgage and a sale-leaseback is essentially eliminated because the value of the reversionary interest surrendered by the seller-lessee is nominal. If the value of the property at the time of the transaction is lower than the owner's adjusted basis in the property, a bona-fide sale-leaseback permits a taxpayer to realize a taxable loss without losing possession of the property. n113

Sale-leaseback transactions are covered in detail in Chapter 4.

[b] IRS Position in Sale-Leaseback Loss Transactions

In order to prevent taxpayers from recognizing losses in sale-leaseback transactions, the IRS often takes the position that sale-leaseback transactions are in substance a single integrated transaction under which there is an exchange of like-kind property with cash as boot. As such, the IRS insists that *IRC Section 1031(c)* applies, and that no loss on the exchange can be recognized. n114 The IRS position is based on the like-kind equivalence of a fee interest in real estate (which the taxpayer is relinquishing) and a lease of more than 30 years (which the taxpayer is acquiring, along with cash). n115 The IRS collapses the transactions, and argues that what is really occurring is an exchange. As such, the presence of like-kind properties brings the exchange within the ambit of *IRC Section 1031*. As a result, the IRS claims that any realized loss cannot be recognized under Section 1031(c).

The IRS position has validity in cases where the seller-lessee receives less than fair market value on the sale and pays less than market rates of rental. This was the situation in *Century Electric Co v Commr*, in which the court accepted the IRS position. n116 In that case, the taxpayer transferred a foundry to a college in exchange for cash and a 95-year lease. The amount of cash transferred was less than the value of the property. Thus it was clear that the lease had premium value and that a true exchange of valuable real estate (fee interest for a long-term leasehold), plus cash boot, had occurred. Had the taxpayer been permitted to treat the transaction as a cash sale, treating only the cash received as the amount realized, it would have been permitted to realize a fictitious loss. However, in applying Section 1031 to deny recognition of the loss, the court did not stress this factor. Instead, it emphasized that the taxpayer's economic position was unchanged by the transaction, and that under the regulations, the exchange of a fee for a long-term leasehold is an exchange of like-kind property. n117

Courts rightfully reject the IRS position, however, where the seller-lessee receives sale proceeds equal to the full fair market value of the property and subsequently leases the property for fair rental value. In this situation, no exchange should be found to be present because full value is paid in cash for the fee interest, and the lease has no premium value. The leading pro-taxpayer authority is the *Jordan Marsh* case, in which the court refused to find that a sale-leaseback was an exchange when full cash consideration was paid. In the case, n118 the taxpayer sold property to an unrelated party for its full fair market value and leased the property back for a 30-year term, plus renewal options. The court held that the taxpayer could recognize its loss on the sale of the building. The taxpayer received the full value of the property in cash, and thus the lease was not an element of the consideration. The court noted that this factor distinguished the case from *Century Electric*. n119

Although the IRS ruled that it would not follow the decision in *Jordan Marsh*, n120 subsequent court decisions have consistently followed *Jordan Marsh*. In *City Investing Co v Commr*, n121 the taxpayer sold property for fair market value subject to a long-term leaseback at fair market rental. The Tax Court refused to characterize the transaction as an exchange and allowed the taxpayer to recognize a loss on the sale. n122 The IRS refused to follow this decision as well. n123 In *Leslie Co v Commr* n124 the taxpayer was again permitted to recognize a loss on a sale-leaseback transaction because the buyer-lessor paid full fair market value and received the market rate of rent. Thus, the lease obtained by the seller-lessee had no capital value and could not be viewed as part of the consideration paid for the fee. n125 Again the IRS refused to acquiesce. n126

In a 1976 ruling, the IRS reasserted its position. In Revenue Ruling 76-301 n127 the taxpayer held a long term lease on a twenty-story building. The taxpayer needed only the first five floors. The taxpayer transferred its entire leasehold interest to an unrelated corporation. The parties agreed that the taxpayer would sublet the first five floors for the remaining term of the lease, and the corporation would pay the taxpayer a cash sum equal to the value of the leasehold interest and leasehold improvements in the top fifteen floors. This cash amount was less than the taxpayer's basis in the leasehold and improvements for the top fifteen floors. The IRS ruled that the loss could not be recognized. Its rationale was that the transfer of the lease and the receipt of the sublease were "reciprocal." They therefore constituted a like-kind exchange under Section 1031, and loss therefore could not be recognized under *IRC Section 1031(c)*. This was true even though the corporation paid the full value in cash for what it received.

Revenue Ruling 76-301 is more extreme than any position previously taken by the IRS because it denies the taxpayer recognition of loss on the disposition of property that the taxpayer no longer continues to possess or have any economic interest in (the top fifteen floors of the building) merely because the taxpayer continues to possess a portion of the property (the bottom five floors). Interestingly, the ruling makes no mention of the *Jordan Marsh* case, although it does mention *Century Electric* holding.

The Tax Court perhaps attempted to compromise with the IRS by adopting a dual test. In *Crowley, Milner & Co v Commr*, n128 the taxpayers were permitted to recognize loss on the sale-leaseback of a department store. The taxpayers received fair market value on the sale and were to pay fair market rent. Thus, the lease had no value and was not consideration for the fee. In addition, the court was willing to consider whether the transaction, although a true sale, permitted evasion of the policy behind Section 1031. The court was satisfied that the taxpayer had cashed in its investment and that nonrecognition treatment under Section 1031 was therefore inappropriate. n129

Planning Tip:

Given the IRS stubbornness in this area, taxpayers should take precautions to assure that in any sale-leaseback full cash consideration is paid by the purchaser-lessor for the property and that fair market rate rent is paid during the term of the lease. Independent appraisals of both the value of the property and fair market rentals should be obtained by both parties to the transaction.

NOTE:

Nonrecognition treatment under Section 1031 can never apply to the buyer-lessor. The receipt of property in exchange for the execution of a lease is always treated as the advance payment of rent, not as an exchange of like-kind property. n130

FOOTNOTES:

(n1)Footnote 71. *IRC § 1031(a)*.

(n2)Footnote 72. See Ltr Rul 200111025 .

(n3)Footnote 73. *Coastal Terminals, Inc v US*, 320 F2d 333 (4th Cir 1963) ; *Barker v Commr*, 74 TC 555, 564-65 (1980) ; *Biggs v Commr*, 632 F2d 1171, 1176 (5th Cir 1980) ; *Garcia v Commr*, 80 TC 491, 498 (1983) ; *Mars v Commr*, TC Memo 1987-481 , *aff'd in unpublished opinion* (6th Cir 1991) (treatment of alleged exchange as an installment sale on return was reflective of lack if intent to implement exchange); *Fredericks v Commr*, TC Memo 1994-27 (taxpayer's intent to exchange property was evidenced by documentation of the parties' agreement); *Rutland v Commr*, TC Memo 1977-8 ; see § 8.12 for a discussion of the holding requirement and § 8.13 for a discussion of the like-kind requirement.

(n4)Footnote 74. *JH Baird Publishing Co v Commr*, 39 TC 608, 616-17 (1962) , *acq* 1963-2 CB 4 ; *Barker v Commr*, 74 TC 555, 564-65 (1980) ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980), 1178 ; *Garcia v Commr*, 80 TC 491, 502-503 (1983) ; *Redwing Carriers, Inc v Tomlinson*, 399 F2d 652 (5th Cir 1968) .

(n5)Footnote 75. *JH Baird Publishing Co v Commr*, 39 TC 608 (1962) 616-17 , *acq* 1963-2 CB 4 .

(n6)Footnote 76. *Treas Reg § 1.1002-1(d)*.

(n7)Footnote 77. *Coastal Terminals, Inc v US*, 320 F2d 333, 337 (4th Cir 1963) ; *Carlton v US*, 385 F2d 238, 241 (5th Cir 1967) ; *Estate of Bowers v Commr*, 94 TC 582, 589 (1990) ; *Greene v Commr*, TC Memo 1991-403 ; *Allen v Commr*, TC Memo 1982-188 ; *Lincoln v Commr*, TC Memo 1998-421 ; *Hillyer v Commr*, TC Memo 1996-214 .

(n8)Footnote 78. *Hillyer v Commr*, TC Memo 1996-214 .

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(n9)Footnote 79. *Bezdjian v Commr*, 845 F2d 217 (9th Cir 1988) , *aff'g* TC Memo 1987-140 ; *Lee v Commr*, TC Memo 1986-294 ; *Dibsy v Commr*, TC Memo 1995-477 .

(n10)Footnote 80. *Rev Rul* 57-469, 1957-2 CB 521 .

(n11)Footnote 81. See *Garcia v Commr*, 80 TC 491 (1983) ; *Barker v Commr*, 74 TC 555 (1980) .

(n12)Footnote 82. *JH Baird Publishing Co v Commr*, 39 TC 608, 610-12 (1962) , *acq* 1963-2 CB 4 ; *Coupe v Commr*, 52 TC 394 (1969) ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) ; *Garcia v Commr*, 80 TC 491 (1983) .

(n13)Footnote 83. *JH Baird Publishing Co v Commr*, 39 TC 608 (1962) , *acq* 1963-2 CB 4 ; *Barker v Commr*, 74 TC 555 (1980) ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) ; *Garcia v Commr*, 80 TC 491 (1983) ; *Redwing Carriers, Inc v Tomlinson*, 399 F2d 652 (5th Cir 1968) ; *Fredericks v Commr*, TC Memo 1994-27 ; see *Ltr Rul* 200111025 .

(n14)Footnote 84. *Barker v Commr*, 74 TC 555 (1980) ; *Allen v Commr*, TC Memo 1982-188 .

(n15)Footnote 85. *Coastal Terminals, Inc v US*, 320 F2d 333 (4th Cir 1963) .

(n16)Footnote 86. *Carlton v US*, 385 F2d 238(5th Cir 1967) ; *Biggs v Commr*, 632 F2d 1171(5th Cir 1980) .

(n17)Footnote 87. See *Barker v Commr*, 74 TC 555 (1980) ; *Biggs v Commr*, 632 F2d 1171(5th Cir 1980) ; *Garcia v Commr*, 80 TC 491 (1983) ; *Mars v Commr*, TC Memo 1987-481 , *aff'd* in unpublished opinion (6th Cir 1991) (treatment of alleged exchange as an installment sale on return was reflective of lack if intent to implement exchange).

(n18)Footnote 88. *WD Haden Co v Commr*, 165 F2d 588 (5th Cir 1948) ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) ; *Rev Rul* 90-34, 1990-1 CB 154 .

(n19)Footnote 89. *Starker v US*, 602 F2d 1341 (9th Cir 1979) ; see § 8.14 for a detailed discussion of nonsimultaneous or deferred exchanges.

(n20)Footnote 90. *Barker v Commr*, 74 TC 555 (1980) ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) ; *Alderson v Commr*, 317 F2d 790 (9th Cir 1963) ; *JH Baird Publishing Co v Commr*, 39 TC 608 (1962) , *acq* 1963-2 CB 4 ; *Rev Rul* 77-297, 1977-2 CB 304 .

(n21)Footnote 91. *Barker v Commr*, 74 TC 555 (1980) .

(n22)Footnote 92. *JH Baird Publishing Co v Commr*, 39 TC 608, 610-12 (1962) , *acq* 1963-2 CB 4 .

(n23)Footnote 93. *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) .

(n24)Footnote 94. *Alderson v Commr*, 317 F2d 790 (9th Cir 1963) .

(n25)Footnote 95. *Mercantile Trust Co of Baltimore v Commr*, 32 BTA 82 (1935) .

(n26)Footnote 96. *WH Haden Co v Commr*, 165 F2d 588 (5th Cir 1948) .

(n27)Footnote 97. See *JH Baird Publishing Co v Commr*, 39 TC 608, 610-12 (1962) , *acq* 1963-2 CB 4 ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) .

(n28)Footnote 98. *Carlton v US*, 385 F2d 238 (5th Cir 1967) ; *Barker v Commr*, 74 TC 555 (1980) ; *Greene v Commr*, TC Memo 1991-403 (taxpayer constructively received proceeds, which were placed in trusts for several years before replacement property was found and purchased); *Klein v Commr*, TC Memo 1993-491 (no exchange because taxpayer's ability to alter disposition of escrow funds by amending escrow instructions was equivalent to constructive

receipt of sale proceeds); *Swaim v US*, 651 F2d 1066 (5th Cir 1981) .

(n29)Footnote 99. *Bloomington Coca-Cola Bottling Co v Commr*, 189 F2d 14 (7th Cir 1951) .

(n30)Footnote 100. *Ltr Rul 8701015* .

(n31)Footnote 101. *Rogers v Commr*, 44 TC 126 (1965) , *aff'd per curiam* 377 F2d 534 (9th Cir 1967) .

(n32)Footnote 102. *Treas Reg* §§ 1.1031(b)-2, 1.1031(k)-1(g)(2)-(5); see § 8.14 for a discussion.

(n33)Footnote 103. *Rev Proc 2000-37*, 2000-40 IRB 308 ; see § 8.14[8] for a discussion.

(n34)Footnote 104. See *Ltr Rul 200111025* .

(n35)Footnote 105. *Rev Rul 77-297*, 1977-2 CB 304 ; *Rev Rul 90-34*, 1990-1 CB 154 ; *Rev Rul 57-244*, 1957-1 CB 247 .

(n36)Footnote 106. *Barker v Commr*, 74 TC 555 (1980) ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) ; *Alderson v Commr*, 317 F2d 790 (9th Cir 1963) ; *JH Baird Publishing Co v Commr*, 39 TC 608 (1962) , *acq* 1963-2 CB 4 .

(n37)Footnote 107. See *Alderson v Commr*, 317 F2d 790 (9th Cir 1963) ; *Rev Rul 77-297*, 1977-2 CB 304 .

(n38)Footnote 108. See *JH Baird Publishing Co v Commr*, 39 TC 608, 610-612 (1962) , *acq* 1963-2 CB 4 .

(n39)Footnote 109. See *WD Haden Co v Commr*, 165 F2d 588 (5th Cir 1948) ; *Biggs v Commr*, 632 F2d 1171 (5th Cir 1980) ; *Coupe v Commr*, 52 TC 394 (1969) (taxpayer's attorneys acted as fourth parties in the exchange).

(n40)Footnote 110. See *Barker v Commr*, 74 TC 555 (1980) ; *Starker v US*, 602 F2d 1341 (9th Cir 1979) ; *Hillyer v Commr*, *TC Memo 1996-214* .

(n41)Footnote 111. See *Treas Reg* § 1.1031(k)-1(g); see *TAM 200039005* (because safe harbors were not available a party to the exchange held property as the taxpayer's agent, rather than as a qualified intermediary); see § 8.14[7] for a discussion.

(n42)Footnote 112. *Treas Reg* § 1.1031(k)-1(g)(4); see § 8.14[7][[d]].

(n43)Footnote 113. See *IRC* § 1001(c).

(n44)Footnote 114. *Rev Rul 60-43*, 1960-1 CB 687 ; *Century Electric Co v Commr*, 192 F2d 155 (8th Cir 1951) , *cert denied* 342 U.S. 954 (1952) ; *Jordan Marsh Company v Commr*, 269 F2d 453 (2d Cir 1959) .

(n45)Footnote 115. See *Treas Reg* § 1.1031(a)-1(c).

(n46)Footnote 116. *Century Electric Co v Commr*, 192 F2d 155 (8th Cir 1951) , *cert denied* 342 US 954 (1952) .

(n47)Footnote 117. *Id.* at 159 .

(n48)Footnote 118. *Jordan Marsh Company v Commr*, 269 F2d 453 (2d Cir 1959) .

(n49)Footnote 119. *Id.* at 456-57 .

(n50)Footnote 120. *Rev Rul 60-43*, 1960-1 CB 687 .

(n51)Footnote 121. *City Investing Co v Commr*, 38 TC 1 (1962) .

(n52)Footnote 122. *Id. at 9* .

(n53)Footnote 123. *City Investing Co v Commr, nonacq 1963-2 CB 6* .

(n54)Footnote 124. *Leslie Co v Commr, 539 F2d 943 (3d Cir 1976) , aff'g 64 TC 247 (1975)* .

(n55)Footnote 125. *Id. at 949*.

(n56)Footnote 126. *Leslie Co v Commr, nonacq 1978-2 CB 3* .

(n57)Footnote 127. *Rev Rul 76-301, 1976-2 CB 241* .

(n58)Footnote 128. *Crowley, Milner & Co v Commr, 76 TC 1030 (1981) , aff'd 689 F2d 635 (6th Cir 1982)* .

(n59)Footnote 129. *Id. at 1038* .

(n60)Footnote 130. *Rev Rul 66-209, 1966-2 CB 299 ; Rev Rul 72-601, 1972-2 CB 467* .



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Federal Taxes Affecting Real Estate

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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

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§ 8.12 Holding Requirement

[1] In General

Nonrecognition under *IRC Section 1031* is available only if the properties exchanged are both held for productive use in a trade or business or for investment. n131 This is referred to as the "holding" requirement. It should be noted that property held for productive use in a trade or business may be exchanged for property to be held for investment, and property held for investment may be exchanged for property to be held for productive use in a trade or business. n132

A taxpayer's intent to hold property for investment or in a trade or business is determined as of the time of the exchange. n133 Thus, property held for a qualifying purpose at the time of an exchange meets the holding requirement even if it was not originally acquired with the intent to hold it in a trade or business or for investment. n134 A taxpayer ordinarily has the burden of proving the requisite holding intent. n135

Investment intent must be the taxpayer's primary motivation for holding the exchanged property in order for the holding requirement to be met. n135.1 The exclusive use of property as a residence by the taxpayer prevents the property from being held for investment for purposes of the holding requirement, even if the property is held with an expectation that it will appreciate in value. n135.2 Similarly, one case held that an exchange of vacation homes did not meet the holding requirement because the properties were held primarily for use by the taxpayers for recreational purposes. n135.3

In the Ninth Circuit, a taxpayer may satisfy the holding requirement merely by lacking an intent either to liquidate the property or use to it for personal pursuits. n136 Under this standard, an intent to exchange property for like-kind property satisfies the holding requirement, because it is not an intent to improperly dispose of it or use it for personal pursuits. n137

The IRS sets a higher standard, and seems to forbid acquiring property merely for the purpose of exchanging it. The IRS even seems to recognize that there may exist situations where a transaction will qualify under *IRC Section 1031* with respect to one party but not the other. n138

An Illinois case also held that the holding requirement was not met when the taxpayers, who were farmers, acquired a restaurant (which the exchange party wanted) and immediately exchanged it for farmland. The court found that because the restaurant was not held for productive use in a trade or business or for investment, the requirements of *IRC Section*

1031 were not met. This was the result the taxpayers wanted, however; they hoped to claim the investment tax credit on farm improvements they received in the exchange and could not do so if the exchange qualified under *IRC Section 1031*. n139

Another case found the holding requirement not met when the taxpayers held the replacement property for rent for only two months before moving into it as their personal residence. Sales efforts were minimal and the taxpayers had not inquired before purchasing the property whether homeowners association rules permitted the property to be rented out. The Tax Court also rejected the argument that an investment intent was shown by the fact that the value of the replacement property was not extravagant when compared to the costs of properties given up. The court held that the relative values of the exchanged properties are irrelevant in determining investment intent or whether there is productive use in a trade or business. n139.1

With respect to replacement property received in an exchange, numerous cases have held that the taxpayer's intent at the time of the exchange to liquidate or dispose of an interest in property acquired in the exchange disqualifies the exchange for nonrecognition under *IRC Section 1031*. n140 For example, nonrecognition treatment has been denied when the taxpayer had a binding contract to sell the property received in the exchange. The court held that the binding contract prevented the possibility of meeting any holding requirement at the time of the exchange. n141 Nonrecognition was also denied when the sole individual owner of a corporation, in a pre-arranged plan, liquidated the corporation and transferred its sole asset--a shopping center--to a third party in exchange for like-kind property. The IRS ruled that the corporation was liquidated to facilitate the further exchange between the individual and third party of their respective properties. Consequently, the individual did not hold the shopping center for use in a trade or business or for investment because the corporation's previous trade or business use could not be attributed to its sole shareholder. Therefore the exchange did not qualify for nonrecognition under *IRC Section 1031*. n141.1

The holding requirement will also not be met if the taxpayer at the time of the exchange intends to sell the property, n142 give it to relatives as a gift, n143 or donate it to charity. n144

That property is eventually disposed of or used in a nonconforming manner does not always require a finding that the requisite intent to hold the property was not present at the time of the exchange. n145 In one ruling, an exchange by a testamentary trust was held to qualify as a like-kind exchange even though the trust would terminate shortly thereafter, with the acquired property being distributed to beneficiaries. The IRS ruled that the termination date of the trust had been fixed by the decedent, and that the trust was therefore not engaging in the exchange in order to dispose of the acquired property pursuant to a pre-arranged plan. Because the exchange was wholly independent of the distribution of the properties under the plan of termination of the trust, and other statutory requirements were met, the IRS ruled that the exchange would qualify for nonrecognition under *IRC Section 1031*. The length of time between the exchange and the termination of the trust was not specified in the ruling, and in any event appeared to be irrelevant. n145.1 However, because actual subsequent behavior is evidence of intent at the time of the exchange, taxpayers have been denied nonrecognition treatment when they dispose of or improperly use property shortly after the exchange. n146 Both the length of the holding period after the exchange n147 and other circumstances come into play in determining whether a taxpayer has the requisite holding intent at the time of the exchange. n148

NOTE:

A taxpayer need not actually dispose of the property after the exchange to be denied nonrecognition treatment. The taxpayer need only lack the requisite intent to hold for investment at the time of the exchange. n149

[2] Length of Time Property Must Be Held

There is no clear answer to the question of the length of time a taxpayer must hold property in order to satisfy the holding requirement. The IRS has not established a "safe harbor" period of time that will suffice. The IRS position is

often simply that at some point before the taxpayer decides to exchange the property (for property that is relinquished) he or she must have intended to keep the property as an investment or for use in a trade or business. n150 Similarly, for property acquired in an exchange, the IRS position is that the holding requirement is not met if a taxpayer has a contractual obligation to dispose of the property before receiving it, n151 or if the taxpayer puts the property to a nonconforming use or disposes of it shortly after it is received in the exchange. n152

Nowhere, however, has the IRS stated exactly how long a taxpayer has to hold the property in order to satisfy the holding requirement. In one ruling, the IRS ruled that the holding requirement would be met by a trust that acquired like-kind replacement property in an exchange, even though the trust would involuntarily terminate "shortly after the exchange" when the youngest beneficiary of the trust reached age 25. The IRS ruled that the mere fact of the involuntary termination would not alone prevent the holding requirement from being met. n153

Cases do not give clear guidance for establishing time-limit parameters either. The focus is on determining the taxpayer's holding intent at the time of the exchange, and the length of time the taxpayer holds the property after the exchange is merely one factor--and perhaps not the most important one--taken into account. Nonrecognition treatment has been denied when the taxpayer donated the exchange property to charity eight days after the exchange, the court understandably feeling that the taxpayer's donative intent had been formed before the exchange. n154

Similarly, another court held that a corporate taxpayer's vote to liquidate and sell property received in an exchange two weeks after an exchange reflected a lack of intent to hold the property for investment at the time of the exchange. n155 Another case held that gifts of two residences made seven months after they were received in an exchange were part of a prearranged plan, which showed that the taxpayer did not intend to hold the houses for investment at the time of the exchange. n156 In another case, a taxpayer exchanged land for a house. She then had the house painted, put it up for sale, and sold it eight months later. The court held that the taxpayer never held the house for investment, but its decision rested less on the period of the time the taxpayer held the house after the exchange than on her testimony that she at all times was holding it for sale. n157

A gift of a ranch nine months after it was received in an exchange, however, was found not to negate the necessary holding intent at the time of the exchange. Facts other than the length of time the property was held after the exchange were more important to the court in determining the taxpayer's intent at the time of the exchange. Nonrecognition treatment was allowed because the taxpayer had no concrete plans at the time of the exchange to make the gift. He did not discuss the gift with his accountants until after the exchange, and he used the exchange property in his ranching business after the exchange before making the gift. The court held that a general desire to make a gift before the exchange is not inconsistent with an intent to hold property for productive use in business or for investment. n158

Probably the most pro-taxpayer decision in this regard is a Ninth Circuit case, *Bolker v Commr.*, n159 In *Bolker*, a taxpayer received property in a liquidating distribution from his wholly-owned corporation. Three months later, he exchanged the property in a like-kind exchange pursuant to an executory contract that was entered into the same day of the liquidating distribution. The IRS claimed that the taxpayer could not have the requisite holding intent because of the almost immediate contractual obligation he had entered into to exchange it. The Ninth Circuit rejected the IRS position as improperly reading into *IRC Section 1031* an additional requirement that the taxpayer have, previous to forming the intent to exchange property for like-kind property, an intent to keep the first property indefinitely. The Ninth Circuit held that the holding requirement was met if a taxpayer owned property that he or she did not intend to liquidate or use for personal pursuits. Under this rationale, the intent to exchange property for like-kind property satisfied the holding requirement because it was not an intent to use it for personal pursuits. Although the court did not expressly address the length of time the property had to be held with this intent, the taxpayer's 3-month holding period was sufficient, and the implication is that the requisite intent, even if held only momentarily at the time of the exchange, was sufficient. n160

Following *Bolker*, the Tax Court has also held that the holding requirement was met when a corporation engaged in a like-kind exchange and several days later liquidated under former *IRC Section 333* and distributed the property received

in the exchange to its controlling shareholders, who continued to use the property for investment purposes. The court rejected the IRS argument that the intent to liquidate the asset at the time of the exchange by distributing it to shareholders caused the exchange to fail the holding requirement. The court found the necessary continuity of investment, and it attributed the corporate holding purposes to the taxpayer-shareholders. n161 Although former *IRC Section 333* has been repealed, the rationale of *Bolker* and *Maloney* may arguably be extended to other situations when a taxpayer receives a tax-free distribution of property and shortly thereafter exchanges it for like-kind property.

Note:

The analysis of the period for holding property differs when the taxpayer transfers property received in an exchange to a controlled entity shortly after an exchange. n162

[3] Post-Exchange Transfer to Corporation or Partnership

The IRS takes the position that a post-exchange transfer of property received in an exchange to a corporation, n163 partnership, n164 or other entity controlled by the taxpayer violates the holding requirement and prevents the exchange from eligibility for nonrecognition under *IRC Section 1031*. The reasoning of the IRS is that the entity's holding of the property for productive use in a trade or business or for investment cannot be attributed to the taxpayer. n165

Courts, however, may be more lenient. In *Magneson v Commr*, n166 the taxpayers exchanged an apartment building for a 10 percent undivided fee interest in another property. On the same day, they transferred their interest in the new property to a California limited partnership. The Ninth Circuit held that the taxpayers met the holding requirement with respect to property received in the exchange. Its rationale was that contributing the property to a partnership in return for a partnership interest was "holding" the property for investment within the meaning of *IRC Section 1031*. Moreover, the court found that the conversion from a tenant-in-common interest to that of a general partner did not involve a substantial change in the form of the taxpayer's investment. n167

The Ninth Circuit's holding in *Magneson* is broad. It expressly declined to read into Section 1031(a) a requirement that taxpayers continue to hold property in an exchange in the same exact form of ownership in which it was acquired. All that is necessary, according to the Ninth Circuit, is that the taxpayers continue to own the property and to hold it for investment. A change in the mechanism of ownership that does not significantly alter the amount of control or the nature of the underlying investment does not preclude nonrecognition under Section 1031(a).

Although the court pointed out that it was not bound by *Revenue Ruling 75-292*, it did not reject the position in that ruling, at least as applied to post-exchange transfers to corporations. The court distinguished a transfer to a general partnership from a transfer to a corporation, noting that taxpayers retain management control over property transferred to a general partnership, but relinquish ownership and control of property transferred to a corporation. n168

Note:

Since the time of the transaction in *Magneson*, Section 1031 has been amended to exclude from its provisions any exchange of partnership interests. n169 It is unclear how this statutory restriction might affect a court's analysis of the holding requirement in a case with the same scenario as was present in *Magneson* today. It is possible that taxpayers would be permitted to receive property in a distribution from a partnership, exchange it for other property, and contribute the new property to another partnership, all without the recognition of gain, under a rationale that the transfer of the property to the partnership is merely a continuation of the old investment in a different form, and that the transfer of the property to the partnership is a distinct step for tax purposes. However, a court might also apply the step transaction doctrine, n170 collapse the various transactions, and find that the substance of what occurred was an exchange of partnership interests. In that case, the exchange would not be eligible for

nonrecognition under *IRC Section 1031*. n171

[4] Effect of Intervening Entity Restructurings

The IRS takes a fairly liberal view of corporate and other entity restructurings during and after like-kind exchanges and has allowed liquidations, mergers, and transfers of properties to substituted parties to occur without jeopardizing the existence of a like-kind exchange. In doing so, it seems to be recognizing the pragmatic non-tax exigencies that require the formation of wholly owned, but separate, entities to receive properties, as well as occasional lender requirements for single asset entities.

Sometimes, the rulings involve a simple disregarding of an entity that is not treated as separate from its owner for tax purposes. In one ruling, the IRS allowed the taxpayer, a limited partnership, to form separate entities to receive individual replacement properties in a proposed exchange. Each entity was a "business entity" that was a "domestic eligible entity" and was not a corporation under the regulations. n172 Because the taxpayer was the sole owner of the ownership interests in each replacement entity, and each entity was disregarded as an entity separate from its owner for tax purposes, the IRS ruled that the replacement property would be treated as being received directly by the taxpayer for purposes of nonrecognition under *IRC Section 1031*. n173

In the entity restructuring rulings, the common theme is the underlying rationale behind granting tax-free treatment to like-kind exchanges in the first place--that there should not be a taxable event if the taxpayer has not cashed in the investment in the relinquished property. (The IRS has also mentioned concern with administrative problems that may arise with respect to valuing property that is exchanged for like-kind property.) In the rulings, the IRS has noted that under *IRC Section 1031*, there is a carryover of tax attributes following a Section 332 liquidation, a tax-free merger, n174 a C reorganization, n175 or D reorganization spinoff. n176

A review of facts in specific rulings can be instructive. In one, the IRS ruled that a taxpayer's intervening corporate liquidation and merger n177 into another entity does not necessarily affect whether the holding requirement is met with respect to property the taxpayer received in an exchange. In the ruling, the taxpayer was a corporation, whose stock was held by a holding company, H. After the taxpayer relinquished real property to a qualified intermediary as part of a like-kind exchange, but before it received replacement property, the taxpayer formed a separate LLC (which did not elect to be taxed as an association) and directed the qualified intermediary to transfer the property to that LLC. After the property was transferred to the LLC, the taxpayer planned to liquidate into H in a tax-free liquidation under *IRC Section 332*. H would then merge with another corporation, S, in a Type A tax-free reorganization. As a result of the merger of H with S, S would be the sole owner of the LLC. S would then transfer its interest in the LLC to another LLC and both LLCs would continue in existence. The IRS ruled that the liquidation and merger would not prevent the taxpayer from meeting the holding requirement and that the transfer by S of its interest in the LLC would not affect the qualification of the exchange under *IRC Section 1031*. n178

In another ruling, two subsidiaries in a consolidated group relinquished hotel properties and, before they acquired replacement properties, planned to liquidate into their parent corporation, the taxpayer. A sister corporation of the taxpayer would then merge into the taxpayer. n179 Then, the taxpayer would form separate LLCs to receive each separate replacement property. The taxpayer would own the entire LLC ownership interest of each LLC and neither LLC would elect to be classified as an association. The IRS ruled that the taxpayer would be treated as the transferor of the relinquished properties and the transferee of the replacement properties, and that the acquisition of the replacement property by each wholly owned LLC would be deemed an acquisition by the taxpayer. The IRS ruled that the holding requirement would not be violated merely because the replacement property was received by the wholly-owned LLCs. n180

In another ruling, the IRS permitted a publicly traded REIT that acquired a taxpayer solely for voting stock (a C reorganization) n181 to be treated as the transferor of the relinquished property that was transferred in a deferred

exchange before the reorganization. That a different taxpayer received replacement property than transferred the relinquished property did not prevent there being an exchange or violate the holding requirement. n182

FOOTNOTES:

(n1)Footnote 131. *IRC § 1031(a)(1)*.

(n2)Footnote 132. *Treas Reg § 1.1031(a)-1(a)*.

(n3)Footnote 133. *Click v Commr*, 78 TC 225 (1982) ; *Goolsby v Commr*, TC Memo 2010-64 (2010) .

(n4)Footnote 134. *Rev Rul 57-244*, 1957-1 CB 247 .

(n5)Footnote 135. *Click v Commr*, 78 TC 225 (1982) ; *Regals Realty Co v Commr*, 127 F2d 931 (2d Cir 1942) , *affg* 43 BTA 194 (1940) .

(n6)Footnote 135.1. *Montgomery v Commr*, TC Memo 1997-279 , *affd in part and revd in part on another issue without published opinion* 300 F3d 866 (10th Cir 1999) ; *Moore v Commr*, TC Memo 2007-134 ; *Goolsby v Commr*, TC Memo 2010-64 (2010) .

(n7)Footnote 135.2. *Starker v US*, 602 F2d 1341 (9th Cir 1979) .

(n8)Footnote 135.3. *Moore v Commr*, TC Memo 2007-134 .

(n9)Footnote 136. *Bolker v Commr*, 760 F2d 1039 (9th Cir 1985), 1045 ; see *Wagensen v Commr*, 74 TC 653, 659 (1980) .

(n10)Footnote 137. *Bolker v Commr*, 760 F2d 1039, 1045 (9th Cir 1985) .

(n11)Footnote 138. *Rev Rul 77-297*, 1977-2 CB 304 ; but see § 8.14 for a discussion of safe harbors for deferred exchanges.

(n12)Footnote 139. *Barker v US*, 668 FSupp 1199 (CD Ill 1987) .

(n13)Footnote 139.1. *Goolsby v Commr*, TC Memo 2010-64 (2010) .

(n14)Footnote 140. *Click v Commr*, 78 TC 225 (1982) ; *Regals Realty Co v Commr*, 127 F2d 931 (2d Cir 1942) , *affg* 43 BTA 194 (1940) ; *Land Dynamics v Commr*, TC Memo 1978-259 .

(n15)Footnote 141. *Griffin v Commr*, 49 TC 253, 260 (1967) .

(n16)Footnote 141.1. *Rev Rul 77-337*, 1977-2 CB 305 .

(n17)Footnote 142. *Regals Realty Co v Commr*, 127 F2d 931 (2d Cir 1942) , *affg* 43 BTA 194 (1940) .

(n18)Footnote 143. *Click v Commr*, 78 TC 225 (1982) .

(n19)Footnote 144. *Lindsley, Jr. v Commr*, TC Memo 1983-729 .

(n20)Footnote 145. *Wagensen v Commr*, 74 TC 653 (1980) (intent at time of exchange to hold for productive use was not negated by a desire to eventually give the property to children).

(n21)Footnote 145.1. *Ltr Rul 200521002* .

(n22)Footnote 146. *Regals Realty Co v Commr*, 127 F2d 931, 934 (2d Cir 1942) , *affg* 43 BTA 194 (1940) .

- (n23)Footnote 147. See [2], below, for a discussion.
- (n24)Footnote 148. See *Click v Commr*, 78 TC 225 (1982) ; *Wagensen v Commr*, 74 TC 653 (1980) .
- (n25)Footnote 149. See *Bolker v Commr*, 760 F2d 1039 (9th Cir 1985) .
- (n26)Footnote 150. *Id.*
- (n27)Footnote 151. *Griffin v Commr*, 49 TC 253 (1967) .
- (n28)Footnote 152. See *Magneson v Commr*, 753 F2d 1490, 1492 (9th Cir 1985) ; *Click v Commr*, 78 TC 225 (1982) ; *Regals Realty Co v Commr*, 127 F2d 931 (2d Cir 1942) , *affg* 43 BTA 194 (1940)
- (n29)Footnote 153. *Ltr Rul* 8126070 .
- (n30)Footnote 154. *Lindsley, Jr. v Commr*, TC Memo 1983-729 .
- (n31)Footnote 155. *Regals Realty Co v Commr*, 127 F2d 931, 934 (2d Cir 1942) , *affg* 43 BTA 194 (1940) .
- (n32)Footnote 156. *Click v Commr*, 78 TC 225 (1982) .
- (n33)Footnote 157. *Black v Commr*, 35 TC 90 (1960) .
- (n34)Footnote 158. *Wagensen v Commr*, 74 TC 653 (1980) .
- (n35)Footnote 159. *Bolker v Commr*, 760 F2d 1039 (9th Cir 1985) .
- (n36)Footnote 160. *Id.*
- (n37)Footnote 161. *Maloney v Commr*, 93 TC 89 (1989) .
- (n38)Footnote 162. See [3], below, for a discussion.
- (n39)Footnote 163. *Rev Rul* 75-292, 1975-2 CB 333 ; see *Rev Rul* 77-337, 1977-2 CB 305 .
- (n40)Footnote 164. See *Magneson v Commr*, 753 F2d 1490 (9th Cir 1985) .
- (n41)Footnote 165. *Rev Rul* 75-292, 1975-2 CB 333 .
- (n42)Footnote 166. *Magneson v Commr*, 753 F2d 1490 (9th Cir 1985) .
- (n43)Footnote 167. *Id.*
- (n44)Footnote 168. *Id.*
- (n45)Footnote 169. *IRC* § 1031(a)(2)(D).
- (n46)Footnote 170. See *Commr, v Court Holding Co*, 324 US 331 (1945) .
- (n47)Footnote 171. *IRC* § 1031(a)(2)(D).
- (n48)Footnote 172. *Treas Reg* §§ 301.7701-2, 301.7701-3.
- (n49)Footnote 173. *Ltr Rul* 9807013 .

(n50)Footnote 174. *Ltr Rul 200151017* ; see *Ltr Rul 9850001* .

(n51)Footnote 175. *Ltr Rul 9152010* ; see *IRC § 368(a)(1)(C)*.

(n52)Footnote 176. *TAM 9252001* ; see *IRC § 368(a)(1)(D)*.

(n53)Footnote 177. See *IRC §§ 332, 368(a)(1)(A)*.

(n54)Footnote 178. *Ltr Rul 9850001* .

(n55)Footnote 179. See *Treas Reg § 1.1031(a), 368(a)(1)(A)*.

(n56)Footnote 180. *Ltr Rul 9751012* .

(n57)Footnote 181. See *IRC § 368(a)(1)(C)*.

(n58)Footnote 182. *Ltr Rul 9152010* .



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Federal Taxes Affecting Real Estate

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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.13

§ 8.13 "Like-Kind" Requirement

[1] Overview

[a] In General

The properties exchanged in a Section 1031 nonrecognition transaction must be of "like-kind." n183 With respect to different kinds of real estate, the "like-kind" is a fairly expansive concept. It has reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, however, for that fact relates only to the grade or quality of the property and not to its kind or class. n184

The regulations give the following examples of exchanges of real estate that satisfy the like-kind requirement: n185

- urban real estate for rural real estate;
- a 30-year leasehold for a fee simple interest in real estate; n185.1 and
- improved real estate for unimproved real estate.

The following properties have also been held to be of like-kind:

- rental real property (land and improvements) and farm real property (land and improvements); n186
- ranchland and a multi-unit apartment building; n187
- a commercial building and a commercial condominium (conditioned on there being a common interest in the underlying land being part of the condominium articles); n188
- a tenant-stockholder's interest in a cooperative building and a condominium; n189
- a tenant-stockholder's shares in a New York cooperative apartment and improved or unimproved real property; n189.1

- a possessory fee interest in real estate and a nonpossessory remainder interest, but an important factor was that the remainder interest was indefeasible and was certain to become certain to become a fee interest; n190
- farmland and personal residences in a city; n191
- a fee interest in real property and a contract right to purchase real property; n192 and
- perpetual water rights for a fee interest in real estate, provided the water rights are treated as real estate under state law. n193

Although the like-kind requirement is liberally construed, the mere fact that the properties exchanged both constitute real property does not entirely determine whether they are of like-kind. There must be a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. n194 One court making this comparison determined that water rights of 50 years duration that were limited in quantity and priority were not like-kind to a fee interest in real estate, even though they were treated as a real property interest under state law. n194.1

[b] Effect of State Law Characterization of Property Interest

State law usually controls for purposes of determining whether various interests in property--often interests in natural resources or easements--are like-kind to other interests in real property. Interests in property that are treated as real property under state law are usually treated as like-kind to real estate for purposes of *IRC Section 1031*. Thus, in one case, oil, gas, and mineral rights that were treated as real property under state (Louisiana) law were held to be like-kind to an interest in a city lot with which they were exchanged. n195 Similarly, residential land use and development rights that were interests in real estate under state law have been ruled to be like-kind to a fee interest in real estate, to a leasehold interest in real estate with 30 years or more remaining at the time of the exchange, and to land use rights for hotel units. n195.1 See § 8.13[4][c], below, for a detailed discussion of water rights and the duration requirement. Similarly, an interest treated as personalty under state law will usually not be treated as like-kind to real estate. n195.2

Perpetual water rights, n196 agricultural conservation easements n197 and scenic conservation easements n198 that are treated as real estate under state law have also been treated as like-kind to a fee interest in land. Water rights of 50 years duration that were limited in quantity and priority, however, have been held to be *not* like-kind to a fee interest in real estate, even though they were treated as a real property interest under state law. n198.1 The IRS has also ruled that unharvested crops on land are classified as interests in real estate and are like-kind with other land with unharvested crops. n199

In a ruling not involving easements or natural resources, the IRS held that shopping center improvements (separate from the land) were like-kind to a fee simple interest in real estate, because the improvements affixed to land were real property under state law. n200

A tenant-stockholder's interest in a cooperative building and a condominium interest have also been ruled to be like-kind, because the tenant-stockholder's interest included a lease with a term in excess of 30 years and because state law characterized the interest as a real property interest. n201

In a ruling involving an involuntary conversion, the IRS ruled that life beneficiaries' interests in a trust owning real estate were like-kind to real property because under state law the beneficiaries' interests were considered interests in

land. n202 The IRS later clarified that the ruling presumed the beneficiaries' life expectancies at the time of the purchase were at least 30 years n202.1.

State law characterization of an interest as real property, however, is not conclusive of like-kind status with other real estate. Although the IRS generally looks to state law in determining what property rights constitute real property interests, state law classifications are not necessarily determinative of what real property interests are of like kind to other real property interests under federal income tax law. That determination is a matter of federal law, rather than state law. n202.2 The nature and the character of the physical properties must still be examined, as well as the nature and character of the title conveyed or the rights of the parties therein. If the rights are not of the same general character and substantial equality, the properties will not be like-kind for purposes of *IRC Section 1031*. In one case, the U.S. Supreme Court held that a carved out oil payment right was not like-kind to a fee interest in real estate, even though applicable state law characterized the oil payment right as an interest in real property. n203

[2] Land and Improvements

[a] In General

Improved real estate and unimproved real estate are like-kind properties. n204 Thus, land with buildings and other improvements can be exchanged for unimproved land. n204.1 Assets on land that are in the nature of real estate can also be exchanged for real estate. For example, unharvested crops on land are classified as interests in real estate and can be transferred for other land with unharvested crops. n205

The IRS takes the position that improvements that are owned separately from land are *not* like-kind property with unimproved land. Thus, in a ruling involving an involuntary conversion, it has ruled that land is not like-kind to a building, because land is not of the same character or nature as a building. The IRS noted that although the term "real estate" often is used to describe both land and improvements on the land, the two are not alike merely because one term is used to describe both. n206 This ruling seems surprising and implausible, since land is like-kind to land that is improved with a building. n207

If state law characterizes the improvements as real property, the IRS may not feel bound by its position in *Rev Rul 67-255*. In one private ruling, the IRS held that shopping center improvements (separate from the land) were like-kind to a fee simple interest in real estate, because improvements affixed to land were real property under state law. n208

[b] Improvements to Be Constructed

The IRS takes the position that real estate is not like-kind to improvements that are to be constructed on land owned by the taxpayer. Thus, in interpreting the involuntary conversion provisions, it has ruled that the proceeds from the condemnation of a mobile home park (land) cannot be used to construct a motel (an improvement) on land owned by the taxpayer. n209 Similarly, it has ruled that the proceeds from the condemnation of farmland (land) cannot be used to construct an office building (an improvement) on land owned by the taxpayer. n210 In a private ruling, the IRS has similarly ruled that land is not like-kind to a shopping mall to be constructed on land owned by the taxpayer because land and improvements are not of like-kind. n211

Although the above rulings deal with the "like-kind" requirement in the context of replacing property that has been involuntarily converted, n212 they also have relevance for like-kind exchanges because the meaning of "like-kind" is the same under both *IRC Section 1031* and *IRC Section 1033(g)*. n213 Therefore, taxpayers who exchange real estate for improvements to be built on their own land can expect a challenge from the IRS if they claim nonrecognition treatment under Section 1031.

Planning Tip:

To circumvent the Service's position regarding separately owned or constructed improvements and land under *IRC Section 1031*, a taxpayer could first sell the land it owns to an exchange partner. The exchange partner could then develop the land, and trade the improved property back to the taxpayer for the land that the taxpayer wishes to relinquish. n214 The exchange of two parcels of improved land would qualify as a like-kind exchange. n215

If property upon which improvements are to be constructed is not owned by the taxpayer, like-kind exchange treatment may be available if a qualified intermediary or exchange partner acquires the desired property and completes improvements on the property before transferring the property to the taxpayer as part of the exchange. n216 In that case, however, the transaction may file to qualify for nonrecognition under *IRC Section 1031* for the exchange partner because of the "holding" requirement. n217

In one ruling the IRS allowed the taxpayer a certain amount of latitude in structuring a like-kind exchange involving improvements to be constructed on leased property owned by a third party. It approved a like-kind exchange in which the exchange partner leased land desired by the taxpayer from a third party and built an office building on it pursuant to plans and specifications approved by the taxpayer and with construction financing provided by the taxpayer. The taxpayer then exchanged land and a building for the leasehold interest (which had a remaining term of more than 30 years) along with the improvements. The ruling contained detailed contractual provisions the parties had devised that set forth the relationship of the parties as grantor and grantee. The parties took special pains taken to avoid having themselves be treated as partners or joint venturers and carefully avoided creating an agency, representative, nominee or similar relationship. The exchange party also had significant risks of ownership prior to the exchange. n218

In another ruling, the IRS allowed a taxpayer to exchange a fee interest in an apartment building with property upon which a qualified intermediary constructed a golf course using funds from the taxpayer that were deposited in a qualified escrow account. n219 Courts have also allowed taxpayers to oversee improvements on land to be acquired in an exchange. n220

In any situation involving improvements made on land to be acquired by the taxpayer, however, the IRS may challenge like-kind exchange treatment by claiming the party building the improvements is acting as the taxpayer's agent or that the parties are involved in a joint venture or partnership. It may also challenge like-kind exchange treatment for the other party in the exchange because of lack of compliance with the holding requirement. n221

[c] Development Rights

Development rights in land have been ruled to be like-kind to real estate. In one ruling, the taxpayer transferred one set of development rights pertaining to density of permitted residential development for other development rights pertaining to hotel development. The IRS ruled that the two types of development rights were like-kind to each other. In addition, the taxpayer transferred other development rights for a separate fee interest in land, and another long-term leasehold interest in additional real property. The IRS ruled that these interests were also like-kind to the development rights. Although not necessarily determinative of the issue, it was relevant that the development rights were treated as real property interests under applicable state law. n221.1

[3] Fractional Interests

A fractional interest in real estate may be like-kind to another fractional interest or to an undivided fee in real property. The IRS takes a fairly liberal view of conversions of commonly held property into individually held property, as when jointly held property is partitioned. Exchanges of undivided interest in multiple parcels of real estate for 100 percent ownership of one or more parcels of the same real estate routinely qualify as valid like-kind exchanges. n221.2 For example, tenants in common may exchange their fractional interests in a property for undivided, individually held ownership interests in single parcels under *IRC Section 1031*. n222 The fractional interest need not involve a fee in

order to be like-kind to real estate. For example, an undivided fractional interest in minerals has been treated as like-kind to an undivided interest in a hotel. n223

The acquisition of an additional interest in property already owned by the exchanging taxpayer will constitute a valid replacement with like-kind property so long as the taxpayer acquires it in an arm's length transaction. n223.1

If a fractional interest in property is an interest in a business entity n223.2 it will not qualify as an undivided fractional interest, so as to be eligible replacement property under *IRC Section 1031(a)*. n223.3 The IRS has issued a revenue procedure in which it specifies the conditions under which it will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property) is not an interest in a business entity for tax purposes. n224 The procedure details the guidelines for submitting ruling requests, the information to be submitted, and conditions for obtaining rulings. The conditions relate to tenancy in common ownership of the property, number of co-owners, no treatment of the co-ownership as an entity, co-ownership agreements, voting by co-owners, restrictions on alienation, sharing of proceeds and liabilities upon sale of the property, proportionate sharing of profits and losses, proportionate sharing of debt, options, no business activities by the co-owners, management and brokerage agreements, leasing agreements, loan agreements, and payments to sponsors. In addition, the revenue procedure sets forth a list of documents, supplementary materials, and general information required for a ruling. n224.1 The procedure applies to co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common. It should be noted that the guidelines provided are only issued for the purpose of assisting taxpayers in preparing ruling requests; they are not intended to be substantive rules, and are not to be used for audit purposes. n224.2

[4] Natural Resource Interests, Water Rights, Mineral Payment Rights, and Royalty Interests

[a] In General

Whether an interest in natural resources is treated like-kind property to a fee interest in real estate depends on the duration of the particular interest, that is, whether the interest continues until the natural resource is exhausted, or whether interest is a lesser, carved out, right that terminates when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received. n225 An overriding royalty interest in minerals--one that continues until the mineral deposit is exhausted--is treated as like-kind to a fee interest in real property. An undivided fractional interest in minerals, for example, has been held to be like-kind to an undivided interest in a hotel. n226 An exchange of an oil producing lease (which is not limited to a fixed amount of proceeds or minerals, and which extends until exhaustion of the oil) for a fee interest in a ranch also qualifies as a like-kind exchange. n227 The IRS has also approved as like-kind an exchange of an interest in coal leases, surface rights in the land above it (subject to options), and lease bonus payments for a fee interest in other real estate. n228

In contrast, a carved out oil payment right (or other limited extraction interest) is not like-kind to a fee interest in real estate, even if applicable state law characterizes the oil payment right as an interest in real property. Therefore, an assignment of a fixed amount of income from producing oil wells in exchange for a fee interest in real estate has been held not to be an exchange of like-kind properties. n229 Similarly, an exchange of an oil payment for an overriding oil and gas royalty reserved from the same lease is not an exchange of like-kind property, because the oil payment is a limited interest in the property, whereas the overriding royalty continues so long as oil or gas is produced. n230

A right to remove a specified amount of gravel has also been held not to be like-kind to a residual fee interest in real property because of the difference in the duration of the rights received by each party. n231-232

Occasionally courts grapple with a similar, but distinct, issue of whether assets connected with the land should be treated as part of the underlying real estate eligible for nonrecognition under *Internal Revenue Code Section 1031* or as a separate asset, such as non-qualifying inventory. n233 In one case, the Tax Court held that unmined sand located on real estate that was exchanged was a part of the underlying land eligible for nonrecognition, and not an asset separate

from it. n234 In another, the Tax Court held that operating gold mines, including realty, were like-kind to operating coal mines that were subject to coal supply contracts that obligated the mine owner to provide electric utilities with coal. The gold mines were not subject to supply contracts. Although the IRS argued that the coal supply contracts were not real property and/or like-kind property and therefore constituted taxable "boot", the Tax Court held that the contracts were real property under State (New Mexico) law because they were covenants running with and appurtenant to the underlying land. They were therefore like-kind property to the gold mines. n234.1

Similar holdings have been made with respect to unharvested crops exchanged as a part of land, n235 and coal in an abandoned coal mine. n236 In each case, the court has focused on the primary purpose for which the taxpayer held the particular asset, i.e. whether it was held primarily for sale, or whether it was treated by the taxpayer as a part of the underlying property. n237

[b] Timber and Timberlands

Consistent with the expansive concept of "like-kind" set forth in the regulations, n238 the IRS has ruled that different timberlands may be exchanged for each other as like-kind property under Section 1031 regardless of the differences in quantity, quality, age, and species of timber growing on the land. These differences do not influence the kind or class of the property (land) that is exchanged. n239

The IRS has also ruled that an exchange of timberland for bare land is a like-kind exchange, n240 as is an exchange of timberland for a tree farm. n241

A mere timber-cutting right, however, has been held not to be like-kind to a fee interest in real property because the right to cut timber is transient (and personal property under state law), whereas the fee interest is ownership of the land itself. n242 Similarly, the IRS has ruled that an exchange of a fee interest in real property for a 2-year right to remove all cut and standing timber from property is not an exchange of like-kind properties because the right of removal is temporary and does not include the right to remove an unlimited quantity of trees. The timber-cutting right is therefore more similar to a limited "carved-out" interest in minerals than to an unlimited overriding royalty interest. n243

The IRS has also ruled that planned cutting of timber within two years of an exchange would not be a disposition that requires recognition of gain under *IRC Section 1031(f)*. n243.1

[c] Water Rights

Perpetual water rights are treated as like-kind to a fee interest in land. Water rights of a lesser duration, however, have been found to be not of like-kind to a fee interest in real estate. For example, water rights limited to a specific total amount of water or a specific amount of water for a limited period have been ruled to be not like-kind to a fee interest in real estate. n243.2

The exact parameters of the required duration or amount of water in order to qualify for like-kind status to land are not completely clear, and the categorization of water rights as a real property interest (as opposed to a perpetual interest) under state law is not conclusive. In one case, water rights of 50 years duration that were limited in quantity and priority were held not to be like-kind to a fee interest, even though they were treated as a real property interest under state law. n243.3 In a private ruling, however, the IRS found that restricted water rights were like-kind to a fee interest in farm land. The rights in question gave the owner a right to pump ground water from an aquifer for irrigation purposes and specified tracts of land. The water rights were limited to a per-minute and per-year maximum diversion rate. The water rights were not limited in duration, but the state retained the authority to make reasonable reductions in the diversion rate and the quantity pumped as might be deemed to be in the public interest. Also of importance was the classification of the water rights as a perpetual interest under state law. Unlike the water rights in *Wiechens*, the water rights in the ruling were limited in quantity to a specified amount per year rather than to a specific percentage of the overall supply

of agricultural water. This distinction, the lack of a limited duration to the rights, and the priority of the taxpayer's rights enabled the IRS to conclude that the water rights were like-kind to the replacement interest in farm land. n243.4

[5] Leasehold Interests

[a] In General

A leasehold is an interest of limited duration and therefore, in principle, is not like-kind to a fee interest. Nevertheless, a leasehold of a fee with 30 years or more to run is treated as like-kind to a fee interest in real estate. n244 Therefore, the exchange of a fee interest in real property for a 30-year or longer leasehold in real property qualifies for nonrecognition treatment under *IRC Section 1031*. n245 Similarly, an exchange of a 30-year leasehold for another 30-year leasehold is an exchange of like-kind property. n246

The exchange of a leasehold with less than 30 years to run for a leasehold with 30 or more years to run is not an exchange of like-kind property. n247 A leasehold for less than 30 years can, however, be exchanged tax-free for another leasehold of a term less than 30 years. n248 Renewal options are included in determining the length of a leasehold. n249

When property is encumbered by a 30-year lease, both the lessee and the lessor may transfer their interests in exchange for a fee or a long-term leasehold in other real estate, because the lessor holds the fee and the lessee is also deemed to hold the equivalent of a fee. n250

The like-kind equivalence of a long-term leasehold and real property is not affected by options that may be exercised by third parties with respect to the leasehold. The IRS has ruled that a taxpayer's exchange of a fee interest in real estate for a 51-year leasehold interest in land and an office building qualified as a like-kind exchange under Section 1031, even though the leasehold interest received by the taxpayer in the exchange was taken subject to an option by the property's owner (who was not a party to the exchange) to buy back the leasehold and building if specified events occurred. The characterization of the leasehold as like-kind to a fee was not affected by the option because the taxpayer continued to have a right to possess, occupy, and use the property for 51 years. n251

[b] Initial Execution of Lease as Part of Exchange

The initial execution of a leasehold as part of an exchange, as opposed to the exchange of an existing leasehold interest, does not qualify for nonrecognition to the lessor under *IRC Section 1031*. This is true even if the leasehold is for longer than 30 years, and even though the leasehold is executed in exchange for an interest in property (such as a fee) that is like-kind to the leasehold interest. The reason is that the transaction is viewed as an in-kind advance payment of rent rather than an exchange. In *Pembroke v Helvering*, n252 the taxpayer executed a 99-year lease on property he owned in consideration of annual rents and a fee interest in other property. The taxpayer was required to include the value of the fee interest in income as an advance rental payment. Consistent with the *Pembroke* decision, the IRS has ruled that although the transfer of a fee interest in real property in consideration of the execution of a leasehold interest in the same or other property may be a Section 1031 nonrecognition exchange to the transferor-lessee, it is not a like-kind exchange for the transferee-lessor, because the fee interest received by the lessor is an advance rental payment under the lease, includable in gross income. n253

The execution of an option to buy under a 99-year lease is also considered a purchase rather than an exchange. In one case, taxpayers were deemed to have purchased rather than exchanged property when they exercised a \$200,000 option to buy property on which they had a 99-year lease. The court held that the taxpayers did not exchange the balance of the leasehold for the title to the land because the two merged with the acquisition of the legal title. n254

[c] Exchange of Property Subject to a Lease

The exchange of property that is subject to a lease, as opposed to the execution of an initial lease as part of an exchange,

n255 is eligible for like-kind exchange treatment. In one case, the taxpayer exchanged a fee interest in certain parcels of real estate, not encumbered by a leasehold interest, for other parcels that were subject to 99-year condominium leases. The IRS argued that the taxpayers had transferred a fee interest in real property for a 99-year income stream, plus a reversionary interest that could be disregarded because it had only nominal value at the time of the exchange. The Tax Court disagreed, however, and held that the exchange of fee interests constituted a like-kind exchange regardless of the lease. The court held that the taxpayer's right to receive rent was inherent in the ownership of the fee, not a separate property right; furthermore, if the rent was not paid the taxpayer would obtain possession of the property before the lease expired. The taxpayer's interest in the land was of unlimited duration, even though the taxpayer was obligated to accept a certain income stream for a long period of time. Thus, the taxpayer's interest was not limited to a fixed amount of income as with an oil payment. n256

[6] Easements

A perpetual agricultural conservation easement n257 or perpetual scenic conservation easement n258 that is treated as real property under state law is treated as like-kind to a fee interest in land. Thus, an exchange of the easement for a fee interest in other real estate may qualify as a like-kind exchange under *IRC Section 1031* if other statutory requirements are also met. n258.1 Like-kind treatment does not apply, however, if the easement is not perpetual. n259

The IRS has also ruled that a permanent power line easement and right of way is like-kind to a fee interest in real property. Although the ruling involved the investment of proceeds from an easement and right of way that were granted under threat of condemnation under *IRC Section 1033(g)*, the ruling also applies under *IRC Section 1031*. The rationale for like-kind treatment is that the easement/right of way and the replacement property are continuing interests in real estate and therefore of the same nature and character. n260

[7] Life Estates, Remainder Interests, and Reversionary Interests

The 30-year benchmark that applies for leaseholds to be treated as equivalent to a fee interest in property n261 also comes into play for life estates and other interests of limited duration. Thus, a life estate with at least 30 years to run is treated as the equivalent of a fee interest. The duration of a life estate is determined by reference to standard mortality tables. n262

In Revenue Ruling 72-601 , n263 a father aged 70 owned a farm in fee, and so did his son. The son conveyed a life estate in his farm to the father, measured by the father's life, and retained the reversion. In exchange, the father conveyed the remainder interest in his farm to the son, reserving a life estate in himself. The ruling equates a remainder interest with a fee and equates a life estate with a leasehold. The father had transferred a remainder interest (treated as a fee interest) in exchange for a possessory interest (the life estate). Since the father's life expectancy did not exceed 30 years, the life estate was not like-kind to the remainder interest transferred. The son was denied nonrecognition treatment because the receipt of a fee interest (or equivalent) in exchange for the execution of a possessory interest (i.e. a life estate) in property was treated as an advance payment of rent rather than an exchange of property. The granting of the life estate was treated in the same manner as the initial execution of a leasehold. n264

An exchange of remainder interests qualifies as an exchange of like-kind properties. In one ruling, the taxpayer and her husband owned two tracts of land as community property. The husband died, leaving the taxpayer a life estate in his community half-interest in the parcels and leaving the remainder interest to his children. Thus the taxpayer owned one half of each parcel in fee (her retained community half-interest) and held a life estate in the other half of each parcel. The taxpayer divided her fee interest in one of the parcels into a life estate and remainder, and exchanged the remainder for the children's remainder interest in half of the other parcel. The taxpayer now owned one parcel entirely in fee and had a life estate in the other parcel. The IRS ruled that the exchange of remainder interests qualified as a like-kind exchange. n265

The IRS has also ruled that an indefeasible vested remainder interest in real property is like-kind to a fee interest in real property. The IRS noted that the remainder interest was indefeasible and certain to become a fee interest. n265.1 Similarly, a reversionary interest following a 47-year ground lease has been ruled to be like-kind to a fee interest in real estate. n265.2

In a ruling involving an involuntary conversion, the IRS ruled that life beneficiaries' interests in a trust owning real estate were like-kind to real property because under state law the beneficiaries' interests were considered interests in land. n266

[8] Land Trust Interests

An Illinois land trust is a trust created under Illinois law solely for the purpose of having the trustee hold title to real property and execute documents related to the title. The purpose of the trust is to hide the true owner's identity. The beneficiary, who creates the trust, continues to exercise all other rights and powers of an owner with respect to the property. The trustee has no power to act with respect to the title except pursuant to instructions from the beneficiary. The IRS has ruled that a beneficiary's interest in an Illinois land trust is like-kind to a fee interest in other real property of the same kind as the property subject to the trust. n267

The ruling also applies to interests or similar arrangements under the laws of any state where the following requirements are met: n268

- the trustee has title to real property;
- the beneficiary (or a designee of the beneficiary) has the exclusive right to direct or control the trustee in dealing with the title to the property; and
- the beneficiary has the exclusive control of the management of the property, the exclusive right to the earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property.

In a ruling involving an involuntary conversion, the IRS ruled that life beneficiaries' interests in a trust owning real estate were like-kind to real property because under state law the beneficiaries' interests were considered interests in land. n269

In a ruling involving a Delaware statutory trust, n269.1 the IRS ruled that a taxpayer could exchange real property for an interest in the Delaware statutory trust without recognition of gain or loss under *IRC Section 1031*, if the other requirements of *IRC Section 1031* were satisfied. The ruling concluded that real property and the trust interest were like-kind properties. n269.2

[9] Foreign Real Property

Foreign real property and real property located in the United States are not like-kind property, and cannot be exchanged tax-free under *IRC Section 1031*. n270 Two or more properties each of which is located outside the United States, however, are like-kind properties with respect to each other. n271 In determining whether property is located outside the United States for this purpose, Puerto Rico and the U.S. Virgin Islands are treated as part of the United States. n272

[10] Real Estate and Personal Property

An exchange of real estate for personal property does not satisfy the like-kind requirement. n273 Thus, an exchange of land for the right to cut timber on other land (personal property) is not an exchange of like-kind property and is not

eligible for nonrecognition treatment under *IRC Section 1031*. n274 Similarly, real property is not like-kind to a deed of trust note. n275

[11] Special Rule For Single-Member LLCs

LLCs that elect to be treated as partnerships for tax purposes are generally treated the same way as partnerships for purposes of the like-kind exchange provisions. Thus, a member of an LLC may not exchange an interest in an LLC for another LLC interest under *IRC Section 1031*. n276

Similarly, LLCs that elect to be treated as corporations for tax purposes are generally treated the same way as corporations for purposes of the like-kind exchange provisions. Thus, a member of such an LLC may not exchange stock in that LLC for other LLC stock without triggering a taxable event. n277 The IRS has ruled, however, that a single-member LLC that does not elect to be treated as an association (and therefore taxable as a corporation) under the entity classification rules n278 will be disregarded as an entity separate from its owner for tax purposes. n279

Revenue Ruling 99-6 allows a taxpayer to engage in a like-kind exchange by exchanging an interest in real property for a membership interest in a single member LLC that owns an interest in like-kind property. In essence, the real property owned by the LLC is treated as owned directly by the taxpayer. The membership interest in the LLC is therefore like-kind to the property exchanged by the taxpayer. This like-kind treatment does not apply if the LLC elects to be treated as an association (and taxable as a corporation) for tax purposes. n280

[12] Personal Property for Personal Property

[a] Tangible Personal Property

An exchange of business or investment personal property for other like-kind personal property comes within the scope of *IRC Section 1031*. The nonrecognition rules of *IRC Section 1031* do not apply to an exchange of one kind or class of tangible personal property for another kind or class of tangible personal property. n281 Personal property used predominantly within the United States and personal property used predominantly outside the United States can never be like-kind property. n282

Depreciable tangible personal properties of a like-class are considered to be of a like-kind under *IRC Section 1031*. An exchange of these properties of a like-kind may qualify as a like-kind exchange regardless of whether the properties are also of a like-class. In determining whether exchanged properties are of a like-kind, no inference is to be drawn from the fact that they are not of a like-class. n283 Depreciable tangible personal properties are of a like class (and consequently of a like-kind) if they are either within the same "General Asset Class" or within the same "Product Class." n284

There are 13 General Business Asset Classes, which consist of depreciable tangible personal property described in asset classes 00.11 through 00.28 and 00.4 of *Revenue Procedure 87-56*. n285 *Revenue Procedure 87-56*, as modified from time to time, provides a classification system for property for the purpose of determining depreciation deductions under *IRC Section 168*. Certain of these general asset classes are adopted to determine what property is of like-kind for purposes of the like-kind exchange rules, and the types of personal property included in each general class listed are identified. n285.1 The North American Industry Classification System (NAICS), Sectors 31 through 33 (pertaining to manufacturing), are used to define the product classes for purposes of like-kind exchanges of depreciable tangible personal property. n285.2 Within NAICS, product classes are designated using 6-digit codes. The Commissioner may revise general asset classes and product classes as set forth in the NAICS manual. n285.3

An exchange of nondepreciable personal property qualifies for nonrecognition under *IRC Section 1031* only if the exchanged properties are of a like-kind. No like-classes are provided for nondepreciable personal property. n286

The IRS has issued a revenue procedure that provides various safe harbors for meeting *IRC Section 1031* requirements with respect to like-kind exchange programs involving ongoing exchanges of tangible personal property using a single intermediary. n286.1

[b] Intangible Property

An exchange of intangible personal property qualifies for nonrecognition under *IRC Section 1031* only if the exchanged properties are of a like-kind. No like-classes are provided for intangible property. Whether intangible personal property is of a like-kind to other intangible personal property generally depends not only on the nature or character of the rights involved (for example, a patent or a copyright) but also on the nature or character of the underlying property to which the intangible personal property relates. n287 Goodwill or going concern value of one business is not of a like-kind to the goodwill or going concern value of another business. n288

The IRS has reversed its prior position, and ruled that intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill can qualify as like-kind property under *IRC Section 1031*. Trademarks and trade names will only rarely be treated as inseparable from goodwill. n288.1

In one ruling, the IRS ruled that an old facility used in a trade or business of transporting processed minerals to customers was like kind to a new facility that the taxpayer would use in the same business. Both the old and new facilities consisted of unspecified tangible and intangible property. The ruling noted that although of like kind, there might nevertheless be gain that could not be deferred under *IRC § 1031* because multiple properties were involved. n288.2

[13] Exchanges of Multiple Properties

The regulations set forth the rules for determining gain recognition and basis in a Section 1031 exchange involving multiple properties. They provide an exception to the general rule that the application of *IRC Section 1031* requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. n289

An exchange is considered an exchange of multiple properties if the properties transferred are separable into more than one "exchange group." An exchange group consists of all properties transferred and received within an exchange that are of a like-kind or like-class. For example, all properties within the same General Asset Class or within the same Product Class are within the same exchange group. n290 Thus, in an exchange of cars and computers for cars and computers, there would be two exchange groups--one of cars and one of computers. Each exchange group must consist of at least one property transferred and at least one property received in the exchange. n291

[14] Air Rights

Although no ruling or case has directly addressed the issue, a perpetual easement of air rights over land is probably like-kind to fee simple real estate for purposes of *IRC Section 1031*. In other contexts, air rights have been treated as an interest in real property. In a case allowing a charitable deduction for a grant of a right to build on top of a building, the Tax Court stated that the right to use the air space superjacent to the ground is one of the rights in land. Furthermore, it observed that air rights can be one of the most valuable rights connected with land since the value of commercial property consists almost exclusively of the right of the owner to erect business and industrial structures. n291.1 Air rights have also been found to constitute an interest in real property for purposes of the REIT provisions. n291.2 Finally, the grant of an air rights easement has been treated as a sale of a portion of land for purposes of the involuntary conversion provisions. n291.3

[15] Shares of Stock in Mutual Ditch, Reservoir, or Irrigation Company

In general *IRC Section 1031* does not apply to exchanges of stocks, bonds, or notes. n291.4 Tax-free treatment is permitted under *IRC Section 1031*, however, for shares in a mutual ditch, reservoir, or irrigation company, if at the time of the exchange the following requirements are met: n291.5

- The company is an organization described in *IRC Section 501(c)(12)(A)* (determined without regard to the percentage of its income that is collected from its members for the purpose of meeting losses and expenses); and

- The shares in the company have been recognized by the highest court of the State in which that company was organized or by applicable State statute as constituting or representing real property or an interest in real property.

FOOTNOTES:

(n1)Footnote 183. *IRC § 1031(a)(1)*.

(n2)Footnote 184. *Treas Reg § 1.1031(a)-1(b)*.

(n3)Footnote 185. *Treas Reg § 1.1031(a)-1(c)*.

(n4)Footnote 185.1. See *Peabody Natural Resources Company et al v Commr*, 126 TC No 14 (2006) (coal supply contract payment rights did not fall within the 30-year leasehold safe harbor because the rights did not constitute a leasehold interest in fee property).

(n5)Footnote 186. *Rev Rul 72-151*, 1972-1 CB 225 .

(n6)Footnote 187. *Ltr Rul 9413024* .

(n7)Footnote 188. *Ltr Rul 8938045* .

(n8)Footnote 189. *Ltr Rul 8443054* ; *Ltr Rul 8810034* ; see *TAM 200039005* (because safe harbors were not available a party to the exchange held property as the taxpayer's agent, rather than as a qualified intermediary).

(n9)Footnote 189.1. *Ltr Rul 200631012* (the ruling relied on characterization of the interest in the cooperative as real property under New York law).

(n10)Footnote 190. *Ltr Rul 8950034* .

(n11)Footnote 191. See *Click v Commr*, 78 TC 225 (1982) .

(n12)Footnote 192. *Starker v US*, 602 F2d 1341 (9th Cir 1979) .

(n13)Footnote 193. *Rev Rul 55-749*, 1955-2 CB 295 ; but see *Wiechens et al v US*, 2002-2 USTC P 50,708 (DC Ariz 2002) (water rights of 50 years duration that were limited in quantity and priority were held not to be like-kind to a fee interest, even though they were treated as a real property interest under state law).

(n14)Footnote 194. *Koch v Commr*, 71 TC 54, 65 (1978) , acq 1979-1 CB 1 .

(n15)Footnote 194.1. *Wiechens et al v US*, 2000-2 USTC P 50,708 (DC Ariz 2002).

(n16)Footnote 195. *Commr v Crichton*, 122 F2d 181 (5th Cir 1941) .

(n17)Footnote 195.1. *Ltr Rul 200901020* . Note that private letter rulings cannot be used or cited as precedent [*IRC*

§ 6110(k)(3)]. See § 8.13[2][c], below, for a discussion of development rights as like-kind property.

(n18)Footnote 195.2. *Oregon Lumber v Commr*, 20 TC 192 (1953) (fee simple in real property not like kind to rights to cut and remove standing timber, which were personal property under state law); *TAM 200424001* (components of railroad track that were assembled and attached to the land and considered real property under state law were not like kind to unassembled and unattached railroad track components, which were personal property under state law).

(n19)Footnote 196. *Rev Rul 55-749*, 1955-2 CB 295 .

(n20)Footnote 197. *Ltr Rul 9215049* ; *Ltr Rul 9232030* ; *Ltr Rul 9851039* .

(n21)Footnote 198. *Ltr Rul 9621012* .

(n22)Footnote 198.1. *Wiechens et al v US*, 2000-2 USTC P 50,708 (DC Ariz 2002).

(n23)Footnote 199. *Rev Rul 59-229*, 1959-2 CB 180 .

(n24)Footnote 200. *Ltr Rul 8008113* .

(n25)Footnote 201. *Ltr Rul 8443054* (applying California law); *Ltr Rul 8810034* ; see *Ltr Rul 200137032* (New York housing cooperative interest determined to be like-kind to condominium); *Ltr Rul 200631012* (interest in New York cooperative apartment held like kind to improved or unimproved realty).

(n26)Footnote 202. *Rev Rul 70-511*, 1970-2 CB 166 .

(n27)Footnote 202.1. *Rev Rul 72-601*, 1972-2 CB 467 .

(n28)Footnote 202.2. See *Ltr Rul 200901020* .

(n29)Footnote 203. *Fleming v Commr*, 24 TC 818, 823-24 (1955) , *aff'd sub nom Commr v PG Lake, Inc*, 356 US 260, 268, 81 SCt 557, 5 L Ed 2d 546 (1958) .

(n30)Footnote 204. *Treas Reg § 1.1031(a)-1(c)*.

(n31)Footnote 204.1. See *Ltr Rul 9431025* (vacant land ruled to be like-kind to townhouse).

(n32)Footnote 205. *Rev Rul 59-229*, 1959-2 CB 180 .

(n33)Footnote 206. *Rev Rul 67-255*, 1967-2 CB 270 .

(n34)Footnote 207. See *Treas Reg § 1.1031(a)-1(b)*.

(n35)Footnote 208. *Ltr Rul 8008113* .

(n36)Footnote 209. *Rev Rul 76-390*, 1976-2 CB 243 .

(n37)Footnote 210. *Rev Rul 76-391*, 1976-2 CB 243 .

(n38)Footnote 211. *Ltr Rul 8307007* .

(n39)Footnote 212. See *IRC Section 1033(g)*.

(n40)Footnote 213. *Treas Reg § 1.1033(g)-1(a)*.

(n41)Footnote 214. See *Ltr Rul 9149018* ; *Coastal Terminals, Inc v US*, 320 F2d 333, 339 (4th Cir 1963) ; see also

JH Baird Publishing Co v Commr, 39 TC 608, 610-12 (1962) , acq 1963-2 CB 4 .

(n42)Footnote 215. *Treas Reg* § 1.1031(a)-1(b), (c).

(n43)Footnote 216. *Rev Rul* 75-291, 1975-2 CB 333 ; *Ltr Rul* 9428007 ; *Ltr Rul* 8110028 .

(n44)Footnote 217. *Rev Rul* 75-291, 1975-2 CB 333 ; see § 8.12 for a discussion of the holding requirement.

(n45)Footnote 218. *Ltr Rul* 9149018 .

(n46)Footnote 219. *Ltr Rul* 9428007 .

(n47)Footnote 220. *JH Baird Publishing Co v Commr*, 39 TC 608 (1962) , acq 1963-2 CB 4 .

(n48)Footnote 221. *Rev Rul* 75-291, 1975-2 CB 333 ; see § 8.12 for a discussion of the holding requirement.

(n49)Footnote 221.1. *Ltr Rul* 200901020 . Note that private letter rulings cannot be used or cited as precedent [*IRC* § 6110(k)(3)].

(n50)Footnote 221.2. *Rev Rul* 73-476, 1973-2 CB 300 .

(n51)Footnote 222. *Rev Rul* 73-476, 1973-2 CB 300 ; *Rev Rul* 79-44, 1979-1 CB 265 ; *Ltr Rul* 8809019 ; *Ltr Rul* 199926045 ; *Ltr Rul* 199945046 ; *Ltr Rul* 200706001 (IRS noted that the related party rules of *IRC* § 1031(f) were not violated by the partition because there was no shifting of basis between properties); *Ltr Rul* 200708054 (portions of two properties held by 5 family trusts and a partnership were exchanged among the trusts, and then partitioned so that adjacent properties had common ownership).

(n52)Footnote 223. *Commr, v Crichton*, 122 F2d 181, 181-82 (5th Cir 1941) .

(n53)Footnote 223.1. *Rev Rul* 68-394, 1968-2 CB 338 (taxpayer acquired a 45-year lease burdening the fee interest already held).

(n54)Footnote 223.2. See *Treas Reg* § 301.7701-2(a).

(n55)Footnote 223.3. *Ltr Rul* 200625009 ; *Ltr Rul* 200625010 .

(n56)Footnote 224. *Rev Proc* 2002-22, 2002 1 CB 733 .

(n57)Footnote 224.1. *Rev Proc* 2002-22 , §§ 4, 5, 6, 2002-1 CB 733 .

(n58)Footnote 224.2. *Rev Proc* 2002-22 , § 3, 2002-1 CB 733 .

(n59)Footnote 225. *Koch v Commr*, 71 TC 54, 65 (1978) .

(n60)Footnote 226. *Commr, v Crichton*, 122 F2d 181, 181-82 (5th Cir 1941) ; *Rev Rul* 72-117, 1972-1 CB 226 (interest in overriding oil and gas royalties acquired with proceeds from sale of unimproved real estate under threat of condemnation was treated as like-kind property under *IRC* § 1033).

(n61)Footnote 227. *Rev Rul* 68-331, 1968-1 CB 352 ; see *Rev Rul* 68-226, 1968-1 CB 362 (interest of a lessee in oil and gas is an interest in real property); *Ltr Rul* 7935126 .

(n62)Footnote 228. *Ltr Rul* 7931038 .

(n63)Footnote 229. *Fleming v Commr*, 24 TC 818, 823-24 (1955) , *aff'd sub nom Commr v PG Lake, Inc*, 356 US

260, 268 , 81 SCt 557, 5 L Ed 2d 546 (1958) .

(n64)Footnote 230. *Midfield Oil Co v Commr*, 39 BTA 1154 (1939) , acq 1939-2 CB 25 .

(n65)Footnote 231-232. *Clemente, Inc v Commr*, TC Memo 1985-367 .

(n66)Footnote 233. See IRC § 1031(a)(2).

(n67)Footnote 234. *Beeler v Commr*, TC Memo 1997-73 .

(n68)Footnote 234.1. *Peabody Natural Resources Company et al v Commr*, 126 TC No 14 (2006) .

(n69)Footnote 235. *Asies v Commr*, 74 TC 1005 (1980) .

(n70)Footnote 236. *Butler Consol. Coal Co v Commr*, 6 TC 183 (1946) .

(n71)Footnote 237. *Beeler v Commr*, TC Memo 1997-73 ; *Asies v Commr*, 74 TC 1005 (1980) ; *Butler Consol. Coal Co v Commr*, 6 TC 183 (1946) .

(n72)Footnote 238. See *Treas Reg* § 1.1031(a)-1(b).

(n73)Footnote 239. *Rev Rul* 72-515, 1972-2 CB 466 ; *Ltr Rul* 8404099, *Ltr Rul* 200541037 (exchange of old-growth timberlands for reproduction timberlands).

(n74)Footnote 240. *Rev Rul* 78-163, 1978-1 CB 257 .

(n75)Footnote 241. *Ltr Rul* 8818034 .

(n76)Footnote 242. *Oregon Lumber Co v Commr*, 20 TC 192, 197 (1953) , acq 1953-2 CB 5 .

(n77)Footnote 243. TAM 9525002 ; see [a], above, for a discussion of mineral interests.

(n78)Footnote 243.1. *Ltr Rul* 200541037 .

(n79)Footnote 243.2. *Rev Rul* 55-749, 1955-2 CB 295 .

(n80)Footnote 243.3. *Wiechens et al v US*, 228 F Supp 2d 1080 (DC Ariz 2000) .

(n81)Footnote 243.4. *Ltr Rul* 200404044 .

(n82)Footnote 244. *Treas Reg* § 1.1031(a)-1(c).

(n83)Footnote 245. *Treas Reg* § 1.1031(a)-1(c); *Ltr Rul* 8453034 (exchange of motel for leasehold interest in other motel was like-kind exchange).

(n84)Footnote 246. See *Rev Rul* 76-301, 1976-2 CB 241 .

(n85)Footnote 247. *Treas Reg* § 1.1031(a)-1(c).

(n86)Footnote 248. *Rev Rul* 76-301, 1976-2 CB 241 . See also *Ltr Rul* 9126007 (10-year renewable leasehold interests in grazing lands are like-kind to other such leasehold interests); *Ltr Rul* 200842019 (exchange of leases, leasehold improvements and office furniture).

(n87)Footnote 249. *Rev Rul* 78-72, 1978-1 CB 258 .

(n88)Footnote 250. *Koch v Commr*, 71 TC 54, 69 (1978) .

(n89)Footnote 251. *Ltr Rul 9110007* .

(n90)Footnote 252. *Pembroke v Helvering*, 70 F2d 850, 851 (DC Cir 1934) .

(n91)Footnote 253. *Rev Rul 66-209*, 1966-2 CB 299 ; see also *Rev Rul 72-601*, 1972-2 CB 467 .

(n92)Footnote 254. *Molbreak v Commr*, 61 TC 382 (1973) , *aff'd per curiam* 509 F2d 616 (7th Cir 1975) .

(n93)Footnote 255. See [b], above, for a discussion.

(n94)Footnote 256. *Koch v Commr*, 71 TC 54 (1978) .

(n95)Footnote 257. *Ltr Rul 9215049* ; *Ltr Rul 9232030* ; *Ltr Rul 9851039* .

(n96)Footnote 258. *Ltr Rul 9621012* .

(n97)Footnote 258.1. *Ltr Rul 200201007* ; *Ltr Rul 200203033* ; *Ltr Rul 200203042* (all rulings holding that an exchange of perpetual conservation easement (PCE) for a fee interest in real estate that would also be burdened with a PCE on receipt qualified as a like-kind exchange).

(n98)Footnote 259. See *Treas Reg § 1.1031(a)-1(c)*.

(n99)Footnote 260. *Rev Rul 72-549*, 1972-2 CB 472 ; see *Rev Rul 59-121*, 1951-1 CB 212 (consideration received for an easement with respect to land is proceeds from the sale of an interest in real property).

(n100)Footnote 261. *Treas Reg § 1.1031(a)-1(c)*; see [5][a], above, for a discussion.

(n101)Footnote 262. *Rev Rul 72-601*, 1972-2 CB 467 .

(n102)Footnote 263. *Rev Rul 72-601*, 1972-2 CB 467 .

(n103)Footnote 264. *Rev Rul 72-601*, 1972-2 CB 467 ; see *Rev Rul 66-209*, 1966-2 CB 299 ; *Pembroke v Helvering*, 70 F2d 850 (DC Cir 1934) ; see [5][b], above, for discussion of the initial execution of a lease as part of an exchange.

(n104)Footnote 265. *Rev Rul 78-4*, 1978-1 CB 256 .

(n105)Footnote 265.1. *Ltr Rul 9143053* ; see *Ltr Rul 8950034* .

(n106)Footnote 265.2. *Ltr Rul 9224008* .

(n107)Footnote 266. *Rev Rul 70-511*, 1970-2 CB 166 .

(n108)Footnote 267. *Rev Rul 92-105*, 1992-2 CB 204 .

(n109)Footnote 268. *Id.*

(n110)Footnote 269. *Rev Rul 70-511*, 1970-2 CB 166 .

(n111)Footnote 269.1. See *Del Code Ann tit 12, §§ 3801-3824*.

(n112)Footnote 269.2. *Rev Rul 2004-86*, 2004-2 CB 191 .

(n113)Footnote 270. *IRC § 1031(h)(1)*.

(n114)Footnote 271. See *id*.

(n115)Footnote 272. *Ltr Rul 9038030* .

(n116)Footnote 273. *Treas Reg § 1.1031(a)-1(b)*.

(n117)Footnote 274. *Oregon Lumber Co v Commr*, 20 TC 192, 197 (1953) , acq 1953-2 CB 5 .

(n118)Footnote 275. *Coupe v Commr*, 52 TC 394 (1969) .

(n119)Footnote 276. *IRC § 1031(a)(2)(D)*.

(n120)Footnote 277. *IRC § 1031(a)(2)(D)*.

(n121)Footnote 278. See *Treas Reg § 301.7701-3(b)(1)(ii)*, (c).

(n122)Footnote 279. *Rev Rul 99-6*, 1999-1 CB 432 .

(n123)Footnote 280. *Ltr Rul 200131014* ; see *Ltr Rul 945038* (the IRS ruled for purposes of *IRC § 1033*, that a taxpayer who received condemnation proceeds could purchase the replacement property through a single-member LLC); also see *Ltr Rul 9807013* and *Ltr Rul 9751012* (purchase of *IRC § 1031* replacement assets through single-member LLCs).

(n124)Footnote 281. *Treas Reg § 1.1031(a)-1(b)*.

(n125)Footnote 282. *IRC § 1031(h)(2)*.

(n126)Footnote 283. *Treas Reg § 1.1031(a)-2(a)*.

(n127)Footnote 284. *Treas Reg § 1.1031(a)-2(a)*, (b).

(n128)Footnote 285. *Rev Proc 87-56*, 1987-2 CB 674 .

(n129)Footnote 285.1. *Treas Reg § 1.1031(a)-2(b)(2)*.

(n130)Footnote 285.2. Temp *Treas Reg § 1.1031(a)-2T(b)(3)*, effective for transfers of property made on or after Aug 12, 2004, although taxpayers may elect to use the NAICS system for certain transfers of property made after 1996 [Temp *Treas Reg § 1.1031(a)-2T(d)*]. For prior transfers, the Standard Industrial Classification (SIC) system was used to determine what properties are of a like class for purposes of *IRC § 1031*.

(n131)Footnote 285.3. Temp *Treas Reg § 1.1031(a)-2T(b)(5)*.

(n132)Footnote 286. *Treas Reg § 1.1031(a)-2(c)(1)*.

(n133)Footnote 286.1. *Rev Proc 2003-39*, 2003-1 CB 971 .

(n134)Footnote 287. *Id*.

(n135)Footnote 288. *Treas Reg § 1.1031(a)-2(c)(2)*.

(n136)Footnote 288.1. OCS Memo 200911006, reversing the prior IRS position in *TAM 200602034* ; the IRS' prior position was that the registered trademarks and trade names of a business entity could not be of like kind to the

trademarks and trade names of another business entity because they were closely related to (if not a part of) the goodwill or going concern value of a business [see *Treas Reg* § 1.1031(a)-2(c)(2)]. Note that private letter rulings cannot be used or cited as precedent [*IRC* § 6110(k)(3)].

(n137)Footnote 288.2. *Ltr Rul* 200901004 . Note that private letter rulings cannot be used or cited as precedent [*IRC* § 6110(k)(3)].

(n138)Footnote 289. *Treas Reg* § 1.1031(j)-1.

(n139)Footnote 290. *Treas Reg* § 1.1031(k).

(n140)Footnote 291. *Treas Reg* § 1.1031(k); see *Treas Reg* § 1.1031(k) regarding the calculation of gain and basis with exchanges of multiple properties.

(n141)Footnote 291.1. See *Fair v Commr*, 27 TC 866 (1957) , acq 1957-2 CB 4 .

(n142)Footnote 291.2. *Rev Rul* 71-286, 1971-2 CB 263 .

(n143)Footnote 291.3. *Rev Rul* 54-575, 1954-2 CB 145 , modified by *Rev Rul* 72-433, 1972-2 CB 470 ; see Chief Counsel Memorandum 200246015 (the ruling gives a detailed discussion of general tax principles regarding cash payments made by an airport authority to settle a class action suit brought by landholders near the airport).

(n144)Footnote 291.4. *IRC* § 1031(a)(2)(B).

(n145)Footnote 291.5. *IRC* § 1031(i), effective for exchanges completed after May 22, 2008 [Pub Law 110-234, § 15342(b)].



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Federal Taxes Affecting Real Estate

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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.14

§ 8.14 Nonsimultaneous (Deferred) Exchanges

[1] In General

A deferred exchange is one in which, pursuant to agreement, a taxpayer transfers the property to be relinquished in an exchange and subsequently receives the replacement property. n292 Typically, the timing delay preventing simultaneous closings for the relinquished and replacement properties occurs because the buyer of the taxpayer's property has not acquired the replacement property the taxpayer wants, or because the taxpayer has not yet identified the desired replacement property. Deferred exchanges are often referred to as "*Starker* exchanges" in homage to the case that first sanctioned their use and held that deferred exchanges could qualify for nonrecognition under *IRC Section 1031*. n293

[2] Statutory Framework

In response to the *Starker* decision, Congress enacted a statutory scheme setting forth time limits for identifying and receiving replacement property in deferred exchanges. The time limits must be met in order for a deferred exchange to be entitled to nonrecognition under *IRC Section 1031*. If the time limits are not met, the replacement property will not be considered like-kind property to the property relinquished by the taxpayer in the exchange. n294

The statutory requirements are as follows: n295

- the replacement property must be identified as property to be received in the exchange within 45 days after the date on which the taxpayer transfers the property relinquished in the exchange; n296 and
- the replacement property must be received within the earlier of the following:
 - ☐ 180 days after the date on which the taxpayer transfers the property relinquished in the exchange; or
 - ☐ the due date (determined with regard to extensions) of the taxpayer's return for the taxable year in which the transfer of the relinquished property occurs. n297

The extensions with respect to a tax return refer to actual extensions granted, not to available or possible extensions. Therefore, if no extension for filing a return is in fact given, the initial due date of the taxpayer's return is the critical date. n298

Note:

The above timing requirements are strictly construed. However diligent a taxpayer's attempts are to satisfy the above timing requirements, failure to do so results in a denial of nonrecognition treatment even if failure to comply is due to circumstances outside of the taxpayer's control. Equitable relief cannot be given. n299 In one ruling, a receivership proceeding against the qualified intermediary froze proceeds of a sale of real property that the taxpayer had deposited with the intermediary. The IRS ruled that this circumstance did not excuse non-compliance with the 180-day statutory replacement period for a like-kind exchange, or allow that replacement period to be suspended during the period of the receivership. n299.1 Bankruptcy of the qualified intermediary also does not permit the statutory replacement period to be extended. n299.2 Notwithstanding the strict construction, the IRS has authorized relief to taxpayers affected by disasters or terrorist or military actions. In these situations, the IRS may grant relief up to 180 days after the last day of a period to perform an act that is part of a deferred like-kind exchange or a safe-harbor parking arrangement. n299.3

Extensive regulations have been issued that govern the treatment of deferred exchanges. n300

[3] Requirements for Identification of Replacement Property

[a] In General

The regulations provide detailed rules for the identification of replacement property. n301 Replacement property must be identified before the end of the identification period. The identification period begins on the date the taxpayer transfers the relinquished property and ends on midnight on the 45th day after the date the taxpayer transfers the relinquished property. n302 If, as part of the same deferred exchange, a taxpayer transfers more than one relinquished property and they are transferred on different dates, the identification period is determined by reference to the earliest date on which any of the properties are transferred. n303

Replacement property is treated as identified only if it is designated as replacement property in either (1) a written agreement covering the exchange that is signed by all parties before the end of the identification period, or (2) a written document signed by the taxpayer and hand delivered or mailed, telecopied, or otherwise sent before the end of the identification period to a person involved in the exchange (such as an intermediary, escrow agent, or title company) other than the taxpayer or a related party. n304 The replacement property is treated as identified only if it is unambiguously described in the written document or agreement. For real property, a legal description or street address, or distinguishable name (e.g., the Mayfair Apartment Building) is acceptable. n305

Notwithstanding the above identification requirements, however, any replacement property that is received by the taxpayer before the end of the identification period will be treated as timely identified. n306

An identification of property as replacement property may be revoked at any time before the end of the identification period. If the identification was made in a written agreement, the revocation must be made in a written amendment to the agreement or in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to all parties to the agreement. Otherwise, the revocation must be made in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to the person to whom the initial identification was sent. n307

[b] Identification of Alternative and Multiple Replacement Properties

A taxpayer may identify more than one property as replacement property. However, the maximum number of replacement properties that the taxpayer may identify are: n308

- three properties of any fair market value (the "3-property rule"); or
- any number of properties, as long as their aggregate fair market value at the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred (the "200-percent rule").

The above rules apply regardless of the number of relinquished properties transferred as part of the same deferred exchange. n309

If a taxpayer identifies more properties than is permitted, the situation is generally treated as if no replacement property had been identified, but this "non-identification" penalty does not apply to the following property: n310

- any replacement property that is received by the taxpayer before the end of the identification period; or
- any replacement property identified before the end of the identification period and received by the taxpayer before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the "95-percent rule") [for this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period].

Fair market value is measured on the earlier of the date the taxpayer receives the property or the last day of the exchange period. n311 Fair market value under the rules refers to the fair market value without regard to any liabilities secured by the property. n312 For purposes of applying the 3-property rule, 200-percent rule, and 95-percent rule, all unrevoked identifications of property are taken into account. n313

Special rules also apply to multiple replacement property transactions in which incidental property is transferred with a larger item of replacement property, as where a taxpayer exchanges furniture and fixtures along with a condominium. This incidental property is ignored for purposes of the multiple property identification rules if it is standard commercial practice to transfer that property, and the fair market value of the incidental property does not exceed 15 percent of the fair market value of the larger item of property. n314 Accordingly, the incidental property is not counted as a separate property for purposes of the three-property limitation, and does not have to be separately identified and described for purposes of the deferred exchange replacement property identification requirements. n315

[4] Requirements for Receipt of Replacement Property

[a] Replacement Period

The regulations provide detailed rules regarding the timely receipt of replacement property. n316 Property is timely received if it is received before the end of the exchange period and is substantially the same property as was identified. n317 The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of (1) 180 days after the date on which the taxpayer transfers the relinquished property, or (2) the due date (including extensions) for the taxpayer's return for the year in which the transfer occurs. n318

The extensions with respect to a tax return refer to actual extensions granted, not to available or possible extensions.

Therefore, if no extension for filing a return is, in fact, given, the initial due date of the taxpayer's return is the critical date. n319

If, as part of the same deferred exchange, a taxpayer transfers more than one relinquished property and they are transferred on different dates, the exchange period is determined by reference to the earliest date on which any of the properties are transferred. n320

Ordinarily, it is the taxpayer who receives the replacement property, so the identity of the taxpayer does not raise an issue with respect to a qualifying receipt of the property. One private letter ruling involved an exchange by a wholly-owned third-tier LLC. That LLC assigned its rights in a contract of sale to its parent, the second-tier LLC, who then assigned the rights to its parent LLC, the taxpayer. It was also arranged that the replacement property would be acquired by a newly created LLC, which would also be wholly owned by the taxpayer. All the lower-tier LLCs were disregarded as an entity separate from the taxpayer under the entity classification regulations. n320.1 Given this fact, the IRS ruled that the actions of the lower tier LLCs were attributable to the taxpayer, and that the acquisition of the replacement property by the newly created LLC would also be treated as an acquisition of property by the taxpayer. Provided the exchange complied with the various timing requirements, it would qualify under *IRC Section 1031*. n320.2

[b] Substantially the Same Property Requirement

Any replacement property that is received in an exchange must be substantially the same property that was identified. n321 The regulations provide several examples involving real property that illustrate this requirement. Replacement property is substantially the same property as the real property identified in the following situations: n322

- the taxpayer initially identifies three real properties as potential replacement properties, and later timely selects one and receives it within the replacement period;
- a fence is erected on the property after its identification; or
- the taxpayer initially identifies a 2-acre unimproved lot as replacement property, but eventually ends up receiving only 1.5 acres of the 2-acre parcel in the exchange, which has a value of 75 percent of the 2-acre lot.

The regulations also provide an example of the requirement not being met. In the example, a 2-acre parcel with a barn is identified as replacement property, with a fair market value of \$250,000 (\$187,500 for the barn and underlying land, and \$87,500 for the remaining land). The taxpayer eventually receives in exchange only the barn and the property underlying it. The example states that the barn and underlying land differ in basic nature or character from the 2-acre parcel as a whole, and therefore are not substantially the same property as identified. n323

[5] Replacement Property to be Constructed

Special rules apply for identification and receipt of replacement property that is not in existence or is to be produced at the time it is identified as replacement property. n324 A transfer of relinquished property in a deferred exchange can qualify for nonrecognition even though replacement property is not in existence or is being produced at the time the property is identified as replacement property. This rule allows replacement property to be built to the taxpayer's specifications. n324.1 Although these rules apply primarily to personal property, they can also come into play for real property upon which improvements are to be constructed. Regarding identification, when replacement property includes real property upon which improvements are to be constructed, the identifying description should include a legal description of the underlying land and as much detail regarding construction of improvements as is practicable at the time the identification is made. n325

In determining whether the replacement property received by the taxpayer is substantially the same property as identified when the identified replacement property is to be constructed, variations due to usual or typical construction changes are not taken into account. However, if substantial changes are made in the property to be constructed, the replacement property received will not be considered to be substantially the same property as identified. n326

In addition, if the identified property is real property upon which improvements are to be constructed and the construction is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had the construction been completed by the date the taxpayer receives the property, the replacement property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law. n327

Further, any additional production occurring with respect to the replacement property after the property is received by the taxpayer is not treated as the receipt of property of a like-kind, but is instead considered to be transferred in exchange for services. n328 Thus, if construction to take place on the replacement real property is only 20 percent completed when the taxpayer receives it, then the property is considered to be substantially the same property as identified only to the extent of the underlying land and the 20 percent of construction that is completed. Any additional construction performed after the taxpayer receives it is not treated as receipt of like-kind property. n329

For purposes of the 200-percent rule and incidental property, the fair market value of replacement property that is to be constructed is its estimated fair market value as of the date it is expected to be received by the taxpayer. n330

[6] Receipt of Money or Other Property

Actual or constructive receipt of money or other property in a deferred exchange can be a pitfall that prevents a tax-free exchange under *IRC Section 1031* from taking place. In a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before actually receiving the like-kind replacement property. In addition, if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before receiving like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer eventually receives like-kind replacement property. n331

A taxpayer is in constructive receipt of money or property when it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or upon giving notice of intent to withdraw it. Substantial limitations or restrictions on the taxpayer's right to receive or control the money or property will prevent constructive receipt until the limitations or restrictions lapse, expire, or are waived. Actual or constructive receipt of money or property by the taxpayer's agent is treated as actual or constructive receipt by the taxpayer. n332

Constructive receipt can occur unexpectedly. Merely reserving a right to require that another party to an exchange transaction pay cash instead of acquiring and transferring replacement property may result in constructive receipt if that right may be exercised before the end of the exchange period. n333

Planning Tip:

The safest way to avoid the possibility of constructive receipt of cash or other property that will destroy a like-kind exchange is to comply with one of the safe harbors provided in the regulations, as discussed in [7], below. Given the relative ease of doing so, it is imprudent not to structure deferred exchanges to take advantage of the safe harbors. n334

[7] Safe Harbors to Avoid Premature Actual or Constructive Receipt

[a] In General

The use of various guarantee or security arrangements is common in deferred exchanges due to the unwillingness of taxpayers to rely on a transferee's unsecured promise to transfer the like-kind replacement property. Intermediary arrangements are often used because the transferee is unwilling or unable to acquire the replacement property. The use of these arrangements, however, raises issues concerning actual or constructive receipt. Therefore, the regulations provide four safe harbors that prevent taxpayers from being treated as in actual or constructive receipt of money or other property. n335

CAUTION

The IRS has indicated that it will carefully scrutinize transactions that are not structured to come within the safe harbors.

[b] First Safe Harbor: Non-Cash Security or Guaranty Arrangements

The first safe harbor deals with security or guarantee arrangements. Under this rule, the transferee's obligation to transfer the replacement property to the taxpayer may be secured or guaranteed by one or more of the following: n336

- a mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent);
- a standby letter of credit n337 that does not allow the taxpayer to draw on it except upon a default of the transferee's obligation to transfer like-kind property to the taxpayer; or
- a guarantee of a third party.

This safe harbor ceases to apply if at any time the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement. n338

[c] Second Safe Harbor: Qualified Escrow Accounts and Qualified Trusts

Under the second safe harbor, the obligation of the transferee to transfer the replacement property to the taxpayer may be secured by cash or a cash equivalent that is held in a qualified escrow account or a qualified trust. n339 An escrow account or trust is qualified if the escrow holder or trustee is not the taxpayer or a "disqualified person," n340 and if the terms of the escrow or trust agreement expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account or by the trustee as provided in the regulations. n341

This safe harbor ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account or by the trustee. The taxpayer may, however, exercise rights under state law to terminate or dismiss the escrow holder or trustee without losing benefit of the safe harbor. n342

[d] Third Safe Harbor: Use of Qualified Intermediary**[i] In General**

Under the third safe harbor, a taxpayer may use a qualified intermediary in a deferred exchange without being considered in constructive receipt of the proceeds. The taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in

actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary were not the agent of the taxpayer. This safe harbor is available only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or property held by the qualified intermediary, as provided in regulations. n343

In one ruling, a partnership violated this requirement because one partner had the right to, and did, receive cash proceeds from the intermediary. Although each partner separately satisfied the qualified escrow account safe harbor, the partnership was treated as constructively receiving the money received by the partner. The IRS found that this occurred only as to the exchange account attributable to the particular partner, however, and not to proceeds held in the other exchange accounts. The IRS ruled that the partnership had to recognize gain to the extent of the amount of cash received by the one partner. n344

A qualified intermediary is a person other than the taxpayer or a "disqualified person" who enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer. n345

A "disqualified person" is anyone who is the taxpayer's agent or who is related to the taxpayer or the agent in a manner described in the regulations. n346

Any person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties is treated as the taxpayer's agent at the time of the transaction. Thus, these parties generally cannot act as the intermediary in the deferred exchange without the taxpayer being considered in constructive receipt of the proceeds of the relinquished property, resulting in a taxable sale rather than a tax-deferred exchange. Certain services provided for the taxpayer are not taken into account in determining if the provider is the taxpayer's agent, including services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition under *IRC Section 1031* and routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company. n347 In one ruling, a taxpayer offered loans to customers to facilitate like-kind exchanges. The IRS ruled that the taxpayer qualified as a financial institution and that the loan services were routine. Therefore, those services were ignored in determining if the taxpayer was an agent or a disqualified person under the like-kind exchange rules. In addition to offering loans, the taxpayer offered properties as replacement properties in like-kind exchanges to customers of a qualified intermediary that was related to the taxpayer. The IRS also ruled that the sale or offering for sale of these properties would not by itself cause the taxpayer or the qualified intermediary to be considered an agent of the customers, so as to be a disqualified person with respect to the transactions. The IRS noted that the taxpayer would be a disqualified person, however, if it acted as a real estate broker or agent. n347.1

Also treated as "disqualified persons" are persons related to the above agents of the taxpayer. n348

Parties related to the taxpayer who are "disqualified persons" for this purpose include those in any of the following relationships with the taxpayer: n349

- family members (brothers, sisters, spouses, ancestors, and lineal descendants);
- a corporation and a more than 10 percent shareholder;
- corporations in the same controlled group;
- grantors and trust fiduciaries;

- fiduciaries of different trusts with the same grantor;
- fiduciaries and beneficiaries of the same trust or of different trusts with the same grantor;
- trust fiduciaries and corporations more than 10 percent in value of the outstanding stock of which is owned by or for the trust or the grantor of the trust;
- persons and certain tax exempt organizations controlled by that person and family members;
- a corporation and a partnership if the same persons own more than 10 percent interests;
- two S corporations or an S corporation and a C corporation with more than 10 percent overlapping interests;
- executors or an estate and a beneficiary of the estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest;
- partnerships and partners with more than 10 percent of the capital or profits interest; or
- partnerships in which the same persons own more than 10 percent of the capital or profits interest.

Complex entity composition and prior interactions among parties involved in an exchange may make it quite unclear whether a particular party is disqualified with respect to a particular exchange. These conditions may mandate that a taxpayer request a letter ruling. n349.1

Example:

An LLC electing to be treated as a C corporation is an intermediary (O) that facilitates like-kind exchanges. The taxpayers wish to use O as the qualified intermediary to facilitate a like-kind exchange. O has a single shareholder, IS. A separate entity, Manager LLC, serves as the O's sole manager. A legal firm is the sole member of Manager LLC and the firm has provided legal services and advice to the taxpayers and to IS within the past two years. Accordingly, the law firm is considered an agent of the taxpayers and is a disqualified person. n349.2 In addition, the taxpayers' son is a manager of Manager LLC and a member of the law firm. He is related to the taxpayers and is also a disqualified person. n349.3

Even though the law firm and the son are disqualified persons with respect to the taxpayers, neither owns an interest, directly or indirectly, in O. Moreover, Manager LLC does not own an interest, directly or indirectly in O. Therefore, even though the law firm has provided legal services to the taxpayers within the two years prior to the exchange, and the firm owns Manager LLC, which is the manager of the O, the law firm's ownership of Manager LLC does not make the O a disqualified person. Therefore, O is not a disqualified person with respect to the taxpayers for purposes of qualifying as a qualified intermediary. n349.4

NOTE:

Before 2000, banks could not be affiliated with entities engaged principally in the issue, flotation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes or other securities. Legislation enacted in 1999 n349.5 repealed these restrictions, and also authorized qualifying financial institutions to engage in certain financial activities, such as (1) providing financial, investment, or economic advice (including advising investment companies), (2) issuing and selling instruments

representing interests in pools of assets permissible for a bank to hold directly, and (3) underwriting, dealing in, and making a market in securities.

As a result of the above legislation and other policy changes by the Federal Reserve System in recent years, many banks and bank holding companies are becoming members of controlled groups that include investment banking and brokerage firms. To account for these changes, the definition of "disqualified person" in the regulations has been modified. A member of a controlled group that includes an investment banking or brokerage firm as a member will not be a disqualified person merely because the investment banking or brokerage firm has provided services to an exchange customer within a two-year period ending on the date of the transfer of the relinquished property by the customer. n350

The qualified intermediary safe harbor provides considerable flexibility in structuring deferred exchanges. An intermediary is considered to have acquired and transferred property if it transfers legal title to that property. As long as the requisite acquisitions and transfers to implement an exchange occur pursuant to the intermediary's contract, the intermediary need not take legal title to the properties. This allows the intermediary to facilitate the direct conveyance of deeds between the principal parties, thereby insulating itself from potential liabilities, such as environmental liabilities, that can arise from being included in the chain of title. n351

Moreover, an intermediary is considered to have entered into an agreement if the rights of a party to an agreement are assigned to it and if all parties to the agreement are notified in writing of the agreement on or before the date of transfer. This provides maximum flexibility to the parties in negotiating and contracting for the overall exchange transaction, while delaying the intermediary's involvement until the parties are ready to proceed with the transactions necessary to complete the exchange. n352

The use of an otherwise qualified intermediary or escrow account to hold funds from the sale of taxpayer's property until a replacement property is identified will not prevent a finding of constructive receipt if the taxpayer has unrestricted control over the escrow account and the ability to change the escrow instructions. In that situation the taxpayer is in constructive receipt of the funds deposited in escrow and a taxable sale and reinvestment, rather than a tax-deferred exchange, occurs. n353

CAUTION

Although it is studying the area, the IRS currently takes the position that the qualified intermediary safe harbor is **not** available for reverse-*Starker* exchange transactions, i.e. those in which the taxpayer closes on the purchase of replacement property before selling the relinquished property. Therefore, if the transactions in an exchange occur in this order, a taxpayer will have to rely on ordinary rules of agency and constructive receipt in order to have the exchange respected as a tax-free like-kind exchange of properties. n354 For reverse-*Starker* exchanges, however, a separate safe harbor under *Revenue Procedure 2000-37* may be available. n355

A taxpayer who uses a qualified intermediary in a Section 1031 exchange is considered to have engaged in the exchange with the qualified intermediary. Consequently, the qualified intermediary considered the transferee of the relinquished property and the qualified intermediary considered the transferor of the replacement property must be the same person or entity. n355.1 The IRS has issued a ruling addressing the change in legal status of a qualified intermediary during the pendency of an exchange. In the ruling, ownership of three qualified Subchapter S subsidiaries--all of which were qualified intermediaries--was transferred to an LLC. As Subchapter S subsidiaries, they were disregarded entities for tax purposes. After the transfer, they were C corporations. After the transfer, each corporation would conduct is same qualified intermediary business in the same manner. The IRS ruled that, notwithstanding the transfer, the legal identities of the three corporations would not change because each would continue to be, for state law purposes, an entity engaged

in the business of providing qualified intermediary services that is no different from the entity that existed prior to the transfer. Therefore, the IRS ruled that with respect to pending like-kind exchanges (exchanges in which a taxpayer has transferred relinquished property to a qualified intermediary but not yet received replacement property from it), a change from a disregarded entity to an entity no longer disregarded should not cause the subsidiaries to be treated as qualified intermediaries that are different from the entities considered to be the transferees of the relinquished property. Accordingly, the IRS ruled that, after the ownership transfer, each subsidiary would retain its status as the transferee of the relinquished property. n355.2

[iii] Safe Harbor for Transactions when Qualified Intermediary Defaults

Numerous taxpayers who have initiated like-kind exchanges with qualified intermediaries have failed to complete them because the qualified intermediary (QI) defaults on its obligation to acquire and transfer replacement property to the taxpayer. In many of these cases, the QI enters bankruptcy or receivership, thus preventing the taxpayer from obtaining immediate access to the proceeds of the sale of the relinquished property. Numerous taxpayers have sought relief from the IRS in this situation--such as seeking to extend the 180-day statutory replacement period, n355.3 but the IRS has been hamstrung in providing equitable relief by the mandatory statutory provisions.

The IRS has generally taken the view, however, that a taxpayer who in good faith sought to complete the exchange using the QI, but who failed to do so because the QI defaulted on the exchange agreement and became subject to a bankruptcy or receivership proceeding, should not be required to recognize gain from the failed exchange until the taxable year in which the taxpayer receives a payment attributable to the relinquished property. As a result, the IRS has issued a revenue procedure that provides a safe harbor method of reporting gain or loss when there is a failed like-kind exchange due to a QI default. n355.4

The revenue procedure is effective for taxpayers whose like-kind exchanges fail due to a QI default occurring on or after January 1, 2009. A taxpayer who is within the scope of this revenue procedure may, subject to statutory limitations on credit or refund, n355.5 file an original or amended return to report a deferred like-kind exchange that failed due to a QI default in a taxable year ending before January 1, 2009. n355.6

The safe harbor is available only to taxpayers who did all of the following: n355.7

- Transferred relinquished property to a QI in accordance with regulations; n355.8
- Properly identified replacement property within the identification period (unless the QI default occurs during that period);
- Did not complete the like-kind exchange solely because of a QI default involving a QI that becomes subject to a bankruptcy proceeding under the United States Code or a receivership proceeding under federal or state law; and
- Did not, without regard to any actual or constructive receipt by the QI, have actual or constructive receipt of the proceeds from the disposition of the relinquished property or any property of the QI prior to the time the QI entered bankruptcy or receivership. (For this purpose, relief of a liability pursuant to the exchange agreement prior to the QI default, either through the assumption or satisfaction of the liability in connection with the transfer of the relinquished property or through the transfer of the relinquished property subject to the liability, is disregarded. n355.9

If the safe harbor applies, the following rules are used to determine gain or loss for taxpayers who qualify to use it: n355.9.1

No gain is recognized until payment is received. If a QI defaults on its obligation to acquire and transfer replacement property to the taxpayer and becomes subject to a bankruptcy or receivership proceeding, the taxpayer generally may not seek to enforce its rights under the exchange agreement with the QI or otherwise access the sale proceeds from the relinquished property outside of the bankruptcy or receivership proceeding while the proceeding is pending. Consequently, the IRS will treat the taxpayer as not having actual or constructive receipt of the proceeds during that period if the taxpayer reports gain in accordance with this revenue procedure. Accordingly, the taxpayer need recognize gain on the disposition of the relinquished property only as required under the safe harbor gross profit ratio method described below. n355.10

Gain is recognized upon receipt of payment. The taxpayer may report gain realized on the disposition of the relinquished property as the taxpayer receives payments attributable to the relinquished property using the safe harbor gross profit ratio method described below. n355.11

A safe harbor gross profit ratio method is used to report gain. Under the safe harbor gross profit ratio method, the portion of any payment attributable to the relinquished property that is recognized as gain is determined by multiplying the payment by a fraction. The numerator of the fraction is the taxpayer's gross profit and the denominator of which is the taxpayer's contract price. n355.12 The terms used in the gross profit ratio method are given specific definitions:

- A payment attributable to the relinquished property is a payment of proceeds, damages, or other amounts attributable to the disposition of the relinquished property (other than selling expenses), whether paid by the QI, the bankruptcy or receivership estate of the QI, the QI's insurer or bonding company, or any other person. Satisfied indebtedness is generally not a payment attributable to the relinquished property, but the amount of satisfied indebtedness in excess of the adjusted basis of the relinquished property is treated as a payment attributable to the relinquished property in the year in which the indebtedness is satisfied. n355.13

- *Gross profit* is the selling price of the relinquished property, minus the taxpayer's adjusted basis in the relinquished property (increased by any selling expenses not paid by the QI using proceeds from the sale of the relinquished property). n355.14

- *Selling price* of the relinquished property is generally the amount realized on the sale of the relinquished property, without reduction for selling expenses. However, if a court order, confirmed bankruptcy plan, or written notice from the trustee or receiver specifies, by the end of the first taxable year in which the taxpayer receives a payment attributable to the relinquished property, an amount to be received by the taxpayer in full satisfaction of the taxpayer's claim, the selling price of the relinquished property is the sum of the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis) received or to be received and the amount of any satisfied indebtedness not in excess of the adjusted basis of the relinquished property. n355.15

- *Contract price* is the selling price of the relinquished property minus the amount of any satisfied indebtedness not in excess of the adjusted basis of the relinquished property. n355.16

- *Satisfied indebtedness* is any mortgage or encumbrance on the relinquished property that was assumed or taken subject to by the buyer or satisfied in connection with the transfer of the relinquished property. n355.17

Recapture income is taken into account. Any required depreciation recapture must be taken into account in accordance with *IRC Sections 1245 and 1250*, except that the recapture income is included in income in the taxable year in which gain is recognized under the above safe harbor, and only to the extent of the gain recognized in that taxable year. n355.18

A maximum amount of gain to be recognized applies. The maximum total gain (including recapture income) recognized under the safe harbor should not exceed the sum of (1) the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis) and (2) the satisfied indebtedness not in excess of basis, minus the adjusted basis of the relinquished property. Adjustments to the gain determined using the safe harbor gross profit ratio method should be made in the last taxable year in which the taxpayer receives a payment attributable to the relinquished property. n355.19

Loss deduction is available. Taxpayers eligible to use the safe harbor may claim a loss deduction under *IRC Section 165* for the amount, if any, by which the adjusted basis of the relinquished property exceeds the sum of (1) the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis), plus (2) the amount of any satisfied indebtedness not in excess of basis. They may also claim a loss deduction under *IRC Section 165* for the amount of any gain recognized in accordance with the safe harbor in a prior taxable year. n355.20

Imputed interest rules apply. In applying the safe harbor, the selling price, the contract price, and any payment attributable to the relinquished property must be reduced by the amount of any imputed interest allocable to the payment, as determined under *IRC Section 483* or *IRC Section 1274* and the regulations. For purposes of applying either provision to a transaction within the scope of the safe harbor, the taxpayer is treated as selling the relinquished property on the date of the confirmation of the bankruptcy plan or other court order that resolves the taxpayer's claim against the QI (the "safe harbor sale date"). As a result, if the only payment in full satisfaction of the taxpayer's claim is received by the taxpayer on or before the date that is six months after the safe harbor sale date, then no interest is imputed on this payment under either provision. In addition, the selling price (determined without regard to this imputed interest rule) is used to determine whether *IRC Section 483* (in general, sales for \$250,000 or less) or *IRC Section 1274* (in general, sales for more than \$250,000) applies to the transaction. n355.21

Special imputed interest rule applies for exchange facilitator loans. A special imputed interest rule applies if in the transaction subject to the safe harbor, exchange funds held by the QI were treated as an exchange facilitator loan n355.22 and the loan otherwise met the requirements of *Treas Reg § 1.1031(k)*. (Under that regulation, an exchange facilitator loan is exempt from *Treas Reg § 1.1031(k)* if the amount of the exchange funds treated as loaned does not exceed \$2 million and the duration of the loan is six months or less.) If these conditions are met, the IRS will continue to treat the loan as being exempt from *IRC Section 7872* by virtue of the regulatory exception until the safe harbor sale date, even if the duration of the loan exceeds six months solely due to the QI default. In addition, if an exchange facilitator loan fails to qualify for the exception because it exceeds \$2 million, the IRS will not impute additional interest on the loan after the date of the QI default under *Treas Reg § 1.1031-1(g)(8)*. However, interest may be imputed under *IRC Section 483* or *IRC Section 1274*, as noted above. n355.23

Examples:

The revenue procedure provides the following examples to illustrate how the safe harbor works: n355.24

Example 1. A, an individual calendar year taxpayer, owns investment property (Property 1) with a fair market value of \$150x and an adjusted basis of \$50x. A enters into an agreement with QI, a qualified intermediary, to facilitate a deferred like-kind exchange. On May 6, Year 1, A transfers Property 1 to QI and QI transfers Property 1 to a third party in exchange for \$150x. A intends that the \$150x held by QI be used by QI to acquire A's replacement property. On June 1, Year 1, A identifies Property 2 as replacement property. On June 15, Year 1, QI notifies A that it has filed for bankruptcy protection and cannot acquire replacement property. Consequently, A fails to acquire Property 2 or any other replacement property within the exchange period. As of December 31, Year 1, QI's bankruptcy proceedings are ongoing and A has received none of the \$150x proceeds from QI or any other source.

On July 1, Year 2, QI exits from bankruptcy and the bankruptcy court approves the trustee's final report,

which shows that A will be paid \$130x in full satisfaction of QI's obligation under the exchange agreement. A receives the \$130x payment on August 4, Year 2 and does not receive any other payment attributable to the relinquished property. A is within the scope of *Revenue Procedure 2010-14* and thus may report the failed like-kind exchange due to the QI default in accordance with its safe harbor.

Accordingly, A is not required to recognize gain in Year 1 because A did not receive any payments attributable to the relinquished property in Year 1. A recognizes gain in Year 2. A's selling price is \$130x (the payments attributable to the relinquished property (the amount specified by the trustee before the end of the first taxable year in which A receives a payment attributable to the relinquished property)). A's contract price also is \$130x because there is no satisfied or assumed indebtedness. A's gross profit is \$80x (the selling price (\$130x) minus the adjusted basis (\$50x)). A's gross profit ratio is 80/130 (the gross profit over the contract price). A must recognize gain in Year 2 of \$80x (the payment attributable to the relinquished property (\$130x) multiplied by A's gross profit ratio (80/130)). Furthermore, even though the payment attributable to the relinquished property (\$130x) is less than the \$150x proceeds received by the QI, A is not entitled to a *IRC Section 165* loss deduction because the payment attributable to the relinquished property exceeds A's adjusted basis in the relinquished property (\$50x).

Example 2. B, an individual calendar year taxpayer, owns investment property (Property 1) with a fair market value of \$160x and an adjusted basis of \$90x. Property 1 is encumbered by a mortgage of \$60x. B enters into an agreement with QI, a qualified intermediary, to facilitate a deferred like-kind exchange. On May 6, Year 1, B transfers Property 1 to QI and QI transfers Property 1 to a third party in exchange for \$160x. At closing, QI uses \$60x of the proceeds to satisfy the mortgage on Property 1 and retains the remaining \$100x. B intends that the \$100x held by QI be used by QI to acquire B's replacement property. On June 1, Year 1, B identifies Property 2 as replacement property. On June 15, Year 1, QI notifies B that it has filed for bankruptcy protection and cannot acquire replacement property. Consequently, B fails to acquire Property 2 or any other replacement property during the exchange period. As of December 31, Year 1, QI's bankruptcy proceedings are ongoing and B has received none of the \$100x proceeds from QI or any other source.

On September 1, Year 2, QI exits from bankruptcy and the bankruptcy plan of reorganization specifies that B will receive \$70x in full satisfaction of QI's obligation under the exchange agreement. The terms of the bankruptcy plan of reorganization provide that QI will pay B \$35x in October of Year 2 and \$35x in February of Year 3. B receives the payments according to the plan and does not receive any other payment attributable to the relinquished property. B is within the scope of *Revenue Procedure 2010-14* and thus may report the failed like-kind exchange due to the QI default in accordance with its safe harbor.

Accordingly, B is not required to recognize gain in Year 1 because B did not receive any payments attributable to the relinquished property in Year 1 (the amount of the mortgage satisfied by QI did not exceed B's adjusted basis in Property 1). B recognizes gain in Year 2 and Year 3. B's selling price is \$130x (the payments attributable to the relinquished property (the amount specified by the bankruptcy plan before the end of the first taxable year in which B receives a payment attributable to the relinquished property (\$70x)) plus the mortgage satisfied by QI (60x)). B's contract price is \$70x (the selling price (\$130x) minus the satisfied indebtedness not in excess of basis (\$60x)). B's gross profit is \$40x (the selling price (\$130x) minus the adjusted basis (\$90x)). B's gross profit ratio is 40/70 (the gross profit over the contract price). In Year 2 and Year 3, B must recognize gain of \$20x each year (the payment attributable to the relinquished property (\$35x) multiplied by B's gross profit ratio (40/70)). B is not entitled to a *IRC Section 165* loss deduction because the sum of all payments attributable to the relinquished property (\$70x) and the amount of B's satisfied indebtedness not in excess of basis (\$60x) exceeds B's adjusted basis in the relinquished property (\$90x).

Example 3. The facts are the same as in Example 2 except *B*'s adjusted basis in Property 1 is \$40x. *B* is within the scope of *Revenue Procedure 2010-14* and thus may report the failed like-kind exchange due to the QI default in accordance with its safe harbor. *B* is considered to have received a payment of \$20x in Year 1 because the amount of the mortgage satisfied by QI (\$60x) exceeds *B*'s adjusted basis in the relinquished property (\$40x). *B* recognizes gain in Year 1. *B*'s selling price is \$160x (the amount realized by the QI on the sale of the relinquished property because neither a court order, the bankruptcy plan, nor the trustee specified by the end of Year 1, the first year in which *B* receives a payment attributable to the relinquished property, the amount *B* will receive in full satisfaction of *B*'s claim). *B*'s contract price is \$120x (the selling price (\$160x) minus the satisfied indebtedness not in excess of basis (\$40x)). *B*'s gross profit is \$120x (the selling price (\$160x) minus the adjusted basis (\$40x)). *B*'s gross profit ratio is 120/120 (the gross profit over the contract price). Thus, *B* must recognize gain in Year 1 of \$20x (the deemed payment of \$20x multiplied by 120/120) and \$35x in Year 2 and Year 3 (the payments attributable to the relinquished property received by *B* in those years multiplied by 120/120). *B* is not entitled to a *IRC Section 165* loss deduction because the sum of the payments attributable to the relinquished property (\$90x) and the amount of *B*'s satisfied indebtedness not in excess of basis (\$40x) exceeds *B*'s adjusted basis in the relinquished property (\$40x).

Example 4. *C*, an individual calendar year taxpayer, owns investment property (Property 1) with a fair market value of \$100x and an adjusted basis of \$40x. *C* enters into an agreement with QI, a qualified intermediary, to facilitate a deferred like-kind exchange. On May 6, Year 1, *C* transfers Property 1 to QI and QI transfers Property 1 to a third party in exchange for \$100x. *C* intends that the \$100x held by QI be used by QI to acquire *C*'s replacement property. On June 1, Year 1, *C* identifies Property 2 as replacement property. On June 15, Year 1, QI notifies *C* that it has filed for bankruptcy protection and cannot acquire replacement property. Consequently, *C* fails to acquire Property 2 or any other replacement property within the exchange period. As of December 31, Year 1, QI's bankruptcy proceedings are ongoing and *C* has received none of the \$100x proceeds from QI or any other source. On September 1, Year 2, QI exits from bankruptcy and the bankruptcy plan of reorganization provides that *C* will receive \$35x in October of Year 2 in partial satisfaction of QI's obligation under the exchange agreement. The bankruptcy plan also provides that, depending on various facts and circumstances described in the reorganization plan, *C* may receive a payment in February of Year 3. On October 2, Year 2, QI pays *C* \$35x. On February 3, Year 3, *C* is notified that there will be no Year 3 payment and that the \$35x received by *C* in Year 2 represents full satisfaction of QI's obligation under the exchange agreement. *C* receives no other payments attributable to the relinquished property. *C* is within the scope of this *Revenue Procedure 2010-14* and thus may report the failed like-kind exchange due to the QI default in accordance with its safe harbor.

Accordingly, *C* is not required to recognize gain in Year 1. *C* recognizes gain in Year 2. *C*'s selling price is \$100x (the amount realized by the QI on the sale of the relinquished property because, by stating that *C* may receive a payment in Year 3, the bankruptcy plan did not specify by the end of Year 2, the first year in which *C* receives a payment attributable to the relinquished property, the amount *C* will receive in full satisfaction of *C*'s claim). Because there is no satisfied or assumed indebtedness, *C*'s contract price also is \$100x. *C*'s gross profit is \$60x (the selling price (\$100x) minus the adjusted basis (\$40x)). *C*'s gross profit ratio is 60/100 (the gross profit over the contract price). Thus, *C* must recognize gain in Year 2 of \$21x (the payment attributable to the relinquished property (\$35x) multiplied by 60/100). In Year 3, *C* is entitled to a Section 165 loss deduction of \$5x, the excess of *C*'s adjusted basis (\$40x) over the payments attributable to the relinquished property (\$35x). *C* is also entitled to a *IRC Section 165* loss deduction of \$21x in Year 3, the amount of gain that *C* recognized in Year 2.

Example 5. *D*, an individual who uses the cash receipts and disbursements method of accounting and

files federal income tax returns on a calendar year basis, owns investment property (Property 1) with a fair market value of \$150x and an adjusted basis of \$50x. *D* enters into an agreement with *QI*, a qualified intermediary, to facilitate a deferred like-kind exchange. On May 6, Year 1, *D* transfers Property 1 to *QI* and *QI* transfers Property 1 to a third party in exchange for \$150x. *D* intends that the \$150x held by *QI* be used by *QI* to acquire *D*'s replacement property. On June 1, Year 1, *D* identifies Property 2 as replacement property. On June 15, Year 1, *QI* notifies *D* that it has filed for bankruptcy protection and cannot acquire replacement property. Consequently, *D* fails to acquire Property 2 or any other replacement property within the exchange period. As of December 31, Year 1, *QI*'s bankruptcy proceedings are ongoing and *D* has received none of the \$150x proceeds from *QI* or any other source. On July 1, Year 2, *QI* exits from bankruptcy and the bankruptcy court approves the trustee's final report, which shows that *D* will be paid, in August of Year 3, \$130x in full satisfaction of *QI*'s obligation under the exchange agreement. *D* receives the \$130x payment on August 1, Year 3 and does not receive any other payment attributable to the relinquished property. Assume that the selling price of Property 1 is less than \$250,000 and that, based on *IRC Section 483*, \$5x of the \$130x payment is unstated interest.

D is within the scope of *Revenue Procedure 2010-14* and thus may report the failed like-kind exchange due to the *QI* default in accordance with its safe harbor.

D is not required to recognize gain in Year 1 or Year 2 because *D* did not receive any payments attributable to the relinquished property in those years. Further, *IRC Section 483* applies to *D*'s Year 3 payment because the payment was due more than 6 months after the safe harbor sale date and *D* received the payment more than 1 year after that date [See *IRC § 483(c)*]. *D*'s selling price is \$125x (\$130x minus the \$5x of unstated interest). *D*'s contract price also is \$125x because there is no assumed or satisfied indebtedness. *D*'s gross profit is \$75x (the selling price (\$125x) minus the adjusted basis (\$50x)). *D*'s gross profit ratio is 75/125 (the gross profit over the contract price). *D* must recognize gain in Year 3 of \$75x (the payment attributable to the relinquished property (\$125x) multiplied by *D*'s gross profit ratio (75/125)). In addition, *D* must include \$5x of the \$130x payment in income in Year 3 as interest income [see *Treas Reg § 1.446-2*]. Even though the payment attributable to the relinquished property (\$125x) is less than the \$150x proceeds received by the *QI*, *D* is not entitled to a *IRC Section 165* loss deduction because the payment attributable to the relinquished property exceeds *D*'s adjusted basis in the relinquished property (\$50x).

[e] Fourth Safe Harbor: Entitlement to Growth Factor on Exchange Property

Under the fourth safe harbor a taxpayer is permitted to receive interest or a growth factor with respect to a deferred exchange without being considered in constructive receipt of the proceeds. This safe harbor applies, however, only if the agreement allowing the taxpayer to receive the interest or growth factor expressly limits the taxpayer's rights to do as provided in the regulations. n356 A taxpayer is treated as being entitled to receive interest or a growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time elapsed between transfer of the relinquished property and receipt of the replacement property. n357 The taxpayer must include the interest or growth factor in gross income. n358

[f] Additional Restrictions on Safe Harbors

Additional restrictions must be met for the second, third, and fourth safe harbors. n359 For these safe harbors, the agreement between the escrow or the qualified intermediary, or the agreement under which the taxpayer is or may be entitled to interest or growth factor with respect to the deferred exchange, generally must provide that the taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period. n360

The agreements may provide, however, that if a taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period. This rule permits the taxpayer to have access to cash if the transaction fails to qualify for exchange treatment due to lack of identification. n361 Furthermore, the agreements may provide that if a taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property on or after: n362

- receipt by the taxpayer of all the replacement property to which the taxpayer is entitled under the exchange agreement (this allows the taxpayer to have access to cash if the exchange is completed); or
- the occurrence after the end of the identification period of a material and substantial contingency that (a) relates to the deferred exchange, (b) is provided for in writing, and (c) is beyond the control of the taxpayer and of any disqualified person, other than the person obligated to transfer the replacement property to the taxpayer.

The substantial contingency provision does not give a taxpayer a right to proceeds simply because, after bargaining in good faith, a taxpayer cannot acquire one or more of the identified replacement properties. The IRS takes the position that the types of contingencies considered to be beyond an owner's control are those of a party not involved in the exchange (such as a government agency's seizure, requisition, or condemnation of the replacement property, or refusal to rezone or approve the transfer of the property), or an act beyond anyone's control (such as destruction of the property by natural forces). It is the view of the IRS that deciding whether or not to meet a seller's demands is within the control of the taxpayer. n363

In determining whether the second, third, and fourth safe harbors n364 cease to apply and whether the taxpayer's right to funds is properly limited, n365 the taxpayer may receive or be entitled to receive the following amounts without violating the safe harbor: n366

- items that a seller may receive as a consequence of the disposition of property which are not included in the amount realized from the disposition, such as prorated rents; and
- transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property, and which appear under local standards in the typical closing statement as the responsibility of the buyer or seller, including such items as commissions, prorated taxes, recording or transfer taxes, and title company fees.

[8] Reverse *Starker* Transactions

[a] In General

A "reverse *Starker*" transaction occurs when replacement property is received before the date on which the relinquished property is transferred. n367 A reverse *Starker* transaction may occur when a taxpayer needs possession of the replacement property but the exchangor insists on finding a potential buyer for the taxpayer's relinquished property before acquiring it. It may also occur when an accommodation party insists on closing on the replacement property transaction before the relinquished property transaction can close. n368

The deferred exchange rules of Section 1031(a)(3) and the final regulations (including the safe harbors) under that section n369 do not apply to reverse *Starker* transactions. n370

To circumvent that prohibition, taxpayers have engaged in a wide variety of so-called "parking" transactions to facilitate

reverse like-kind exchanges. Parking transactions typically are designed to park the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee. In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.

[b] Revenue Procedure 2000-37 Safe Harbor for Like-Kind Exchange Parking Arrangements

The IRS has recognized the existence of reverse *Starker* parking arrangements, and has issued a revenue procedure that provides a safe harbor for any reverse-*Starker* exchange that is structured as a "qualified exchange accommodation arrangement" ("QEAA"). Under the safe harbor, taxpayers may treat the exchange accommodation titleholder party as the beneficial owner of property for federal income tax purposes, thereby enabling taxpayers to accomplish a qualifying like-kind exchange. n371

Practice Tip:

The safe harbor offered by *Revenue Procedure 2000-37* is significant because it outlines a simple approach for reversing the order of the steps of a non-simultaneous exchange of like-kind properties. Allowing these reverse exchanges significantly aids taxpayers whose transfer of a relinquished property is delayed, or whose acquisition of a replacement property is accelerated by events beyond the taxpayer's control. Owners of real property often face the prospect of losing the opportunity to acquire a desirable replacement property because the current owner of that property is unwilling to wait while the taxpayer completes the disposition of a relinquished property. *Revenue Procedure 2000-37* gives taxpayers a useful tool to sidestep these timing problems and complete legitimate business and investment exchanges on a tax-deferred basis.

Under the safe harbor, if property is held in a QEAA, the IRS will treat an exchange accommodation titleholder as the beneficial owner of property for tax purposes if the property is held in a QEAA. Property held in a QEAA may therefore qualify as either replacement property or relinquished property in a like-kind exchange. For this treatment to apply, the exchange must otherwise meet the requirements for a like-kind exchange. The safe harbor does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder. n371.1

Note:

As initially adopted, *Revenue Procedure 2000-37* provided that if property was held in a QEAA, the IRS would not challenge (1) the treatment of property as replacement property or relinquished property, or (2) the treatment of an exchange accommodation titleholder as the beneficial owner of property. Some taxpayers then took the position that the language in *Revenue Procedure 2000-37* allowed them to treat as a like-kind exchange a transaction in which the taxpayer transferred property to an exchange accommodation titleholder and received that same property as replacement property in a purported exchange for other property of the taxpayer. The safe harbor language of *Revenue Procedure 2000-37* was modified, as noted above, to make clear that this was not the case. n371.2

Property is held in a QEAA only if all of the following requirements are met: n372

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person. In addition, that person must be subject to federal income tax or, if that person is treated as a member of a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock must be owned by partners or shareholders who are subject to federal income tax. Qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as required under paragraph (5) below. "Qualified indicia of ownership" means legal title to property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g. a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g. a single-member LLC) and that holds either legal title to the property or such other indicia of ownership.

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under *IRC Section 1031*.

(3) No later than 5 business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under *IRC Section 1031* and *Revenue Procedure 2000-37*, and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in *Revenue Procedure 2000-37*. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement.

Note:

The IRS has issued a letter ruling that should ease concerns about duplicate property transfer taxes in qualified exchange accommodation arrangements. The ruling allows taxpayers to avoid duplicate State and local transfer taxes by providing a clause in the written agreement that the exchange accommodation titleholder is to be treated as the taxpayer's agent for all purposes other than federal income tax purposes. The inclusion of such a clause will not affect the qualification of the agreement between the parties or the QEAA, nor will it violate the requirements of *Revenue Procedure 2000-37*. The Service's approval of the clause recognizes the state law property transfer tax advantages of an agency relationship, while disavowing the state law characterization of that relationship for federal tax purposes. The ruling prevents adverse federal tax consequences (such as constructive receipt) resulting from the state law characterization of the relationship. n373

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder the relinquished property is properly identified. Identification must be made in a manner consistent with the principles of *Regulation Section 1.1031(k)-1(c)*. For purposes of the QEAA requirements, the taxpayer may properly identify alternative and multiple properties, as described in *Regulation Section 1.1031(k)-1(c)(4)*.

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred [either directly or indirectly through a qualified intermediary (as defined in *Treas Reg § 1.1031(k)-1(g)(4)*)] to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property.

(6) The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether they contain terms that typically would result from arm's length bargaining between unrelated parties with respect to those arrangements: n374

- an exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in *Regulation Section 1.1031(k)-1(g)(4)* may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under *IRC Section 1031*;
- the taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;
- the taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder;
- the property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person;
- the taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property;
- the taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder; or
- the taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder.

Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the exchange accommodation titleholder is different from the treatment required by paragraph (3) above. n375

If the requirements of *Revenue Procedure 2000-37* are not satisfied (for example, the property subject to a QEAA is not transferred within the time period provided), then *Revenue Procedure 2000-37* does not apply. Accordingly, the determination of whether the taxpayer or the exchange accommodation titleholder is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of *Revenue Procedure 2000-37*.

Revenue Procedure 2000-37 is limited in scope. The safe harbor of *Revenue Procedure 2000-37* has no application to any federal income tax determinations other than determinations that involve arrangements qualifying for the safe harbor. No inference is intended with respect to the federal income tax treatment of arrangements similar to those

described in the revenue procedure that were entered into prior to its effective date (September 15, 2000). The IRS recognizes that "parking" transactions can be accomplished outside of the safe harbor. Accordingly, no inference is intended with respect to the federal income tax treatment of parking transactions that do not satisfy the terms of the safe harbor provided in *Revenue Procedure 2000-37*, whether entered into prior to or after the effective date of *Revenue Procedure 2000-37*.

Services for the taxpayer in connection with a person's role as the exchange accommodation titleholder in a QEAA are not taken into account in determining whether that person or a related person is a disqualified person [as defined in *Treas Reg § 1.1031(k)-1(k)*]. Even though property will not fail to be treated as being held in a QEAA as a result of one or more arrangements that qualify as QEAA's, the IRS still may recast an amount paid pursuant to such an arrangement as a fee paid to the exchange accommodation titleholder for acting as an exchange accommodation titleholder to the extent necessary to reflect the true economic substance of the arrangement. Other federal income tax issues implicated, but not addressed, in *Revenue Procedure 2000-37* include the following:

- the tax treatment of payments made by the taxpayer to the exchange accommodation titleholder or by the exchange accommodation titleholder to the taxpayer resulting from a variation in the value of relinquished property after it is received by the exchange accommodation titleholder; and
- whether an exchange accommodation titleholder may be precluded from claiming depreciation deductions (e.g., as a dealer) with respect to the relinquished property or the replacement property.

Revenue Procedure 2000-37 may be used to by a taxpayer to acquire an entire partnership interest under *IRC Section 1031*, at least where the taxpayer already owns the remaining partnership interest at the time of the exchange. In a private ruling, the IRS allowed an exchange accommodation titleholder to acquire from a person unrelated to the taxpayer a 50-percent interest in a partnership whose only asset was real estate. The other 50 percent interest in the partnership was already owned by the taxpayer. The IRS ruled that under those circumstances, the acquisition of the partnership interest by the exchange accommodation titleholder was not inconsistent with that entity's status as an exchange accommodation titleholder. n375.1

[c] Use of Same Property for Both Reverse Like-Kind Exchange and Deferred Like-Kind Exchange

The IRS Chief Counsel has ruled that a taxpayer may engage in a reverse like-kind exchange under *Revenue Procedure 2000-37* n375.2 and a deferred like-kind exchange (a "forward" exchange) n375.3 using the same relinquished property in both exchanges. n375.4 In the ruling, the taxpayer structured two separate exchanges, one a reverse exchange in which replacement property was acquired and "parked" with an exchange accommodation titleholder before the taxpayer transferred its relinquished property, followed by a standard deferred exchange in which the relinquished property was transferred prior to the acquisition of the replacement property. For the reverse exchange, RP was acquired and parked with an exchange accommodation titleholder within the guidelines of *Revenue Procedure 2000-37*, and the taxpayer identified RQ in a timely manner. RQ, however, had a value far in excess of RP. Thus, the taxpayer intended to engage in a second like-kind exchange to defer the gain that remained after the exchange of RQ for RP. Although the taxpayer acted in good faith, the second exchange was never completed.

The ruling notes that *IRC Section 1031*, the regulations under it, and *Revenue Procedure 2000-37* do not expressly allow the same relinquished property to be used in both a reverse exchange under *Revenue Procedure 2000-37* and a deferred exchange. Yet, the ruling concludes that nothing in the statute, regulations or revenue procedure prohibits this coupling in the use of the same relinquished property. Also, taxpayers using the revenue procedure are not constrained to exclusively acquire as replacement property only the property parked with the exchange accommodation titleholder. n375.5

FOOTNOTES:

(n1)Footnote 292. See *Treas Reg § 1.1031(k)-1(a)*.

(n2)Footnote 293. See *Starker v US*, 602 F2d 1341 (9th Cir 1979) .

(n3)Footnote 294. *IRC § 1031(a)(3)*.

(n4)Footnote 295. *IRC § 1031(a)(3)*.

(n5)Footnote 296. *Treas Reg § 1.1031(k)-1(b)*; *Smith v Commr, TC Memo 1997-109* ; *Florida Industries Investment Corporation and Subsidiaries v Commr, TC Memo 1999-236* ; *Dobrich v Commr, TC Memo 1997-477* , *aff'd* 99-2 USTC P 50,826 (9th Cir 1999).

(n6)Footnote 297. *Knight v Commr, TC Memo 1998-107* .

(n7)Footnote 298. *Christensen v Commr, TC Memo 1996-254* , *aff'd* 98-1 USTC P 50,352 (9th Cir 1998).

(n8)Footnote 299. *Knight v Commr, TC Memo 1998-107* ; *Christensen v Commr, TC Memo 1996-254* , *aff'd* 98-1 USTC P 50,352 (9th Cir 1998). See INFO 2007-0041 (national and local real estate, credit, and financial crises did not allow extension of replacement period).

(n9)Footnote 299.1. *Ltr Rul 200211016* .

(n10)Footnote 299.2. See INFO 2009-0049 (Jan 21, 2009); INFO 2009-0017 (Feb 4, 2009); INFO 2009-0018 (Mar 27, 2009); INFO 2009-0063 (Jun 26, 2009), INFO 2009-0066 (Mar 26, 2009), INFO 2009-0106 (May 14, 2009).

(n11)Footnote 299.3. IRS Delegation Order No 25-11 (Rev 2), effective Dec 1, 2008.

(n12)Footnote 300. *Treas Reg § 1.1031(k)-1*, effective generally for transfers made on or after June 10, 1991.

(n13)Footnote 301. *Treas Reg § 1.1031(k)-1(b), (c)*.

(n14)Footnote 302. *Treas Reg § 1.1031(k)-1(b)(1)(i), (2)(i), (c)*; *Smith v Commr, TC Memo 1997-109* .

(n15)Footnote 303. *Treas Reg § 1.1031(k)-1(b)(2)(ii)*.

(n16)Footnote 304. *Treas Reg § 1.1031(k)-1(c)(2)*.

(n17)Footnote 305. *Treas Reg § 1.1031(k)-1(c)(3)*.

(n18)Footnote 306. *Id.*

(n19)Footnote 307. *Treas Reg § 1.1031(k)-1(c)(6)*.

(n20)Footnote 308. *Treas Reg § 1.1031(k)-1(c)(4)(i)*.

(n21)Footnote 309. *Id.*

(n22)Footnote 310. *Treas Reg § 1.1031(k)-1(c)(4)(ii)*.

(n23)Footnote 311. *Id.*

(n24)Footnote 312. *Treas Reg § 1.1031(k)-1(m)*.

(n25)Footnote 313. *Treas Reg § 1.1031(k)-1(c)(4)(iii)*.

- (n26)Footnote 314. *Treas Reg § 1.1031(k)-1(c)(5)*.
- (n27)Footnote 315. See *Treas Reg § 1.1031(k)-1(b), (c)*.
- (n28)Footnote 316. *Treas Reg § 1.1031(k)-1(b), (d)*.
- (n29)Footnote 317. *Treas Reg § 1.1031(k)-1(b)(1), (d)*.
- (n30)Footnote 318. *Treas Reg § 1.1031(k)-1(b)(1)(ii), (2)(ii)*; *Christensen v Commr, TC Memo 1996-254, aff'd 98-1 USTC P 50,352 (9th Cir 1998)* (exchange properties not received until after due date of taxpayer's return).
- (n31)Footnote 319. *Christensen v Commr, TC Memo 1996-254, aff'd 98-1 USTC P 50,352 (9th Cir 1998)*.
- (n32)Footnote 320. *Treas Reg § 1.1031(k)-1(b)(2)(ii)*.
- (n33)Footnote 320.1. See *Treas Reg § 301.7701-3(b)(ii)*.
- (n34)Footnote 320.2. *Ltr Rul 200732012*.
- (n35)Footnote 321. *Treas Reg § 1.1031(k)-1(d)(1)(ii)*.
- (n36)Footnote 322. *Treas Reg § 1.1031(k)-1(d)(2)*.
- (n37)Footnote 323. *Treas Reg § 1.1031(k)-1(d)(2), Ex 4*.
- (n38)Footnote 324. *Treas Reg § 1.1031(k)-1(e)*.
- (n39)Footnote 324.1. *Treas Reg § 1.1031(k)-1(e)(1)*; see *J.H. Baird v Commr, 39 TC 608 (1962)*; see *Ltr Rul 200842019*.
- (n40)Footnote 325. *Treas Reg § 1.1031(k)-1(e)(2)(i)*.
- (n41)Footnote 326. *Treas Reg § 1.1031(k)-1(e)(3)(i)*.
- (n42)Footnote 327. *Treas Reg § 1.1031(k)-1(e)(3)(iii)*.
- (n43)Footnote 328. *Treas Reg § 1.1031(k)-1(e)(4)*.
- (n44)Footnote 329. *Treas Reg § 1.1031(k)-1(e)(5)*.
- (n45)Footnote 330. *Treas Reg § 1.1031(k)-1(e)(2)(ii)*.
- (n46)Footnote 331. *Treas Reg § 1.1031(k)-1(f)(1)*.
- (n47)Footnote 332. *Treas Reg § 1.1031(k)-1(f)(2)*; *Garcia v Commr, 80 TC 491 (1983)*.
- (n48)Footnote 333. *Treas Reg § 1.1031(k)-1(f)(3)*.
- (n49)Footnote 334. See *Treas Reg § 1.1031(k)-1(g)*; see *TAM 200039005* (because safe harbors were not available a party to the exchange held property as the taxpayer's agent, rather than as a qualified intermediary).
- (n50)Footnote 335. *Treas Reg § 1.1031(k)-1(g)(1)-(5)*.
- (n51)Footnote 336. *Treas Reg § 1.1031(k)-1(g)(2)*.

(n52)Footnote 337. See *Treas Reg* § 15A.453-1(b)(3)(iii).

(n53)Footnote 338. *Treas Reg* § 1.1031(k)-1(g)(2).

(n54)Footnote 339. *Treas Reg* § 1.1031(k)-1(g)(3)(i).

(n55)Footnote 340. See [d], below.

(n56)Footnote 341. *Treas Reg* § 1.1031(k)-1(g)(3)(ii), (iii); see *Treas Reg* § 1.1031(k)-1(g)(6); see [f], below, for a discussion of restrictions that the agreement must meet.

(n57)Footnote 342. *Treas Reg* § 1.1031(k)-1(g)(3)(iv).

(n58)Footnote 343. *Treas Reg* § 1.1031(k)-1(g)(4)(ii); see *Treas Reg* § 1.1031(k)-1(g)(6); see [f], below, for a discussion of restrictions that the agreement must meet.

(n59)Footnote 344. *TAM* 199907029 .

(n60)Footnote 345. *Treas Reg* § 1.1031(k)-1(g)(4)(iii).

(n61)Footnote 346. *Treas Reg* § 1.1031(k)-1(k).

(n62)Footnote 347. See *Treas Reg* § 1.1031(k)-1(k)(2).

(n63)Footnote 347.1. *Ltr Rul* 200630005 .

(n64)Footnote 348. *Treas Reg* § 1.1031(k)-1(k)(4).

(n65)Footnote 349. *Treas Reg* § 1.1031(k)-1(k)(3); *IRC* §§ 267(b), 707(b).

(n66)Footnote 349.1. See *Treas Reg* § 1.1031(k)-1(k)(5), Example 3; see *Ltr Rul* 200338001 .

(n67)Footnote 349.2. See *Treas Reg* § 1.1031(k)-l(k)(2).

(n68)Footnote 349.3. See *Treas Reg* § 1.1031(k)-l(k)(3).

(n69)Footnote 349.4. See *Ltr Rul* 200338001 ; *Treas Reg* § 1.1031(k)-l(k)(5), Example 3.

(n70)Footnote 349.5. Pub Law No 106-102.

(n71)Footnote 350. *Treas Reg* § 1.1031(k)-1(k)(4)(ii).

(n72)Footnote 351. *Treas Reg* §§ 1.1031(k)-1(g)(4)(iv), 1.1031(k)-1(g)(8), Exs 4, 5.

(n73)Footnote 352. *Treas Reg* §§ 1.1031(k)-1(g)(4)(v), 1.1031(k)-1(g)(8), Ex 4; *TAM* 200130001 (notice requirement not met).

(n74)Footnote 353. *Klein v Commr*, *TC Memo* 1993-491 (no exchange because taxpayer's ability to alter disposition of escrow funds by amending escrow instructions was equivalent to constructive receipt of sale proceeds).

(n75)Footnote 354. See *TAM* 200039005 .

(n76)Footnote 355. See Rev Proc 2000-37, 2000-2 CB 308 ; see § 8.14[8][b], below, for a discussion.

(n77)Footnote 355.1. See *Treas Reg* § 1.1031(k)-1(g).

(n78)Footnote 355.2. *Ltr Rul 200908005* ; see *Treas Reg § 1.1031(k)-1(g)(4)(iii)(B)*. Note that private letter rulings cannot be used or cited as precedent [*IRC § 6110(k)(3)*].

(n79)Footnote 355.3. See *IRC § 1031(a)(3)*.

(n80)Footnote 355.4. *Rev Proc 2010-14, 2010-12 IRB 456* .

(n81)Footnote 355.5. See *IRC § 6511*.

(n82)Footnote 355.6. *Rev Proc 2010-14, 2010-12 IRB 456* , § 5.

(n83)Footnote 355.7. *Rev Proc 2010-14, 2010-12 IRB 456* , § 3.

(n84)Footnote 355.8. See *Treas Reg § 1.1031(k)-1(g)(4)*.

(n85)Footnote 355.9. *Rev Proc 2010-14, 2010-12 IRB 456* , § 3.04.

(n86)Footnote 355.9.1. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.

(n87)Footnote 355.10. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.01.

(n88)Footnote 355.11. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.02.

(n89)Footnote 355.12. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.03.

(n90)Footnote 355.13. *Rev Proc 2010-14, 2010-12 IRB 456* , §§ 4.04(1), 4.05.

(n91)Footnote 355.14. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.04(2).

(n92)Footnote 355.15. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.04(3).

(n93)Footnote 355.16. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.04(4).

(n94)Footnote 355.17. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.04(5).

(n95)Footnote 355.18. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.06.

(n96)Footnote 355.19. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.07.

(n97)Footnote 355.20. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.08. The timing and character of the loss is determined under the usual rules.

(n98)Footnote 355.21. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.09(1).

(n99)Footnote 355.22. See *Treas Reg § 1.468B-6(c)(1)*.

(n100)Footnote 355.23. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.09(2).

(n101)Footnote 355.24. *Rev Proc 2010-14, 2010-12 IRB 456* , § 4.10.

(n102)Footnote 356. *Treas Reg § 1.1031(k)-1(g)(5), (6)*; see [f], below, for a discussion of restrictions that the agreement must meet.

(n103)Footnote 357. *Treas Reg § 1.1031(k)-1(h)(1)*.

(n104)Footnote 358. *Treas Reg § 1.1031(k)-1(h)(2)*.

(n105)Footnote 359. *Treas Reg § 1.1031(k)-1(g)(3), (4), (5), (6)*; see [c], [d], and [e], above, for a discussion of those safe harbors.

(n106)Footnote 360. *Treas Reg § 1.1031(k)-(g)(6)(i)*; *TAM 200130001* (requirement not met).

(n107)Footnote 361. *Treas Reg § 1.1031(k)-(g)(6)(ii)*; see *FSA 200048021* (like-kind exchange agreement did not comply with 45-day statutory identification requirement; proceeds could be distributed if the seller had not accepted the sales contracts presented by 45 days after the transfer date).

(n108)Footnote 362. *Treas Reg § 1.1031(k)-1(g)(6)(iii)*.

(n109)Footnote 363. *Ltr Rul 200027028* ; see *Treas Reg § 1.1031-1(g)(8)*, Ex 2.

(n110)Footnote 364. See *Treas Reg § 1.1031(k)-1(g)(3), (4), (5)*; see [c], [d], and [e], above, for a discussion of those safe harbors.

(n111)Footnote 365. See *Treas Reg § 1.1031(k)-1(g)(6)*.

(n112)Footnote 366. *Treas Reg § 1.1031(k)-1(g)(7)(ii)*.

(n113)Footnote 367. See *Treas Reg § 1.1031(k)-1(a)*; see *TAM 200039005* .

(n114)Footnote 368. See *TAM 200039005* .

(n115)Footnote 369. See *Treas Reg § 1.1031(k)-1*.

(n116)Footnote 370. Preamble to *Treas Reg § 1.1031(k)-1*; *TAM 200039005* .

(n117)Footnote 371. *Rev Proc 2000-37, 2000-2 CB 308* , effective for QEAA's entered into with respect to an exchange accommodation titleholder that acquires qualified indicia of ownership of property on or after September 15, 2000. The IRS has given approval to extraordinarily complex parking transactions under *Rev Proc 2000-37* (see *Ltr Ruls 20071203, 200329021, 200251008*).

(n118)Footnote 371.1. *Rev Proc 2004-51* , § 4.03, *2004-2 CB 294* , adding new § 4.05 to *Rev Proc 2000-37* . This safe harbor is effective for transfers occurring on or after July 20, 2004. For prior transfers, if property was held in a QEAA, the IRS would not challenge the qualification of property as either "replacement property" or "relinquished property" for purposes of the like-kind exchange requirements, nor would the IRS challenge the treatment of the exchange accommodation titleholder as beneficial owner of that property.

(n119)Footnote 371.2. *Rev Proc 2004-51* , §§ 4.01, 4.02, *2004-2 CB 294* , modifying *Rev Proc 2000-37* , §§ 1, 4.01, *2000-2 CB 308* .

(n120)Footnote 372. *Id.*

(n121)Footnote 373. *Ltr Rul 200148042* .

(n122)Footnote 374. *Rev Proc 2000-37, 2000-2 CB 308* .

(n123)Footnote 375. *Id.* at § 4.04.

(n124)Footnote 375.1. *Ltr Rul 200909008* . Note that private letter rulings cannot be used or cited as precedent [*IRC § 6110(k)(3)*].

(n125)Footnote 375.2. See § 8.14[8][b], above.

(n126)Footnote 375.3. See *Treas Reg* § 1.1031(k)-1.

(n127)Footnote 375.4. CCA 200836024 .

(n128)Footnote 375.5. CCA 200836024 .



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate §§ 8.15 through 8.19

[Reserved]

§§ 8.15[Reserved]



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Federal Taxes Affecting Real Estate

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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.20

§ 8.20 Computation of Gain or Loss

[1] In General

No realized gain or loss is recognized if a taxpayer receives only qualifying like-kind property in exchange for qualifying property. n376 Any gain or loss that is not recognized because of Section 1031 is simply deferred. That gain or loss is preserved in the taxpayer's basis in the replacement property received in the exchange. n377

[2] Exchanges Not Solely in Kind; Boot

[a] Gain

Since it is unusual for two properties being exchanged to be exactly equal in value, an exchange of real property is likely to also involve a transfer of cash or other nonqualifying (that is, non-like-kind) property to equalize the transaction. This nonqualifying property, whether cash or other property, is referred to as "boot." If a taxpayer receives boot in an exchange in addition to qualifying like-kind property, any realized gain is recognized, but only to the extent of the amount of money and the fair market value of any non-cash boot received. This rule allows taxpayers to enjoy at least a partial deferral of gain under *IRC Section 1031*. n378 The partial gain attributable to the boot that is recognized in the exchange is added to the taxpayer's basis in the replacement property. n379

Taxpayers may be in constructive receipt of boot that they do not receive directly. In one case, the taxpayers had excess cash deposited directly from the escrow account to reduce the mortgage they had assumed on the replacement property. The Tax Court found that the taxpayers' control of the proceeds was equivalent to ownership and receipt and held that the proceeds were taxable as boot. n380

[b] Loss

In contrast to the relatively lenient rule that allows at least some nonrecognition of gain when boot is received, n381 an extreme "all-or-nothing" rule applies to losses from exchanges that are not solely of like-kind properties. If a taxpayer transfers qualifying loss property and receives *any* like-kind replacement property as consideration, no loss can be recognized on the exchange of the qualifying loss property to any extent. Thus, a taxpayer wishing to dispose of real estate worth less than its adjusted basis must be sure that no qualifying like-kind property is received as consideration. Otherwise, the transaction may be treated as an exchange not solely in kind, and no loss may be recognized, even if the

like-kind replacement property constitutes only a small portion of the total consideration received for the relinquished property. n382 Although the unrecognized loss is preserved through the taxpayer's substituted basis in the replacement property, n383 this may be of little solace to a taxpayer who was hoping to deduct a large loss in the year of the exchange.

Example:

T owns real property with a basis of \$200,000 and a fair market value of \$50,000. If T sells the property for \$50,000 in cash, the \$150,000 loss is both realized and recognized. However, if T instead receives as consideration both \$45,000 in cash and qualifying like-kind property worth \$5,000, none of the \$150,000 realized loss may be recognized. n384

[c] Transfer of Qualifying Property and Boot by Taxpayer

Giving boot or nonqualifying property along with qualifying property in an exchange will not take the transaction out of Section 1031. n385 A taxpayer who transfers qualifying property and non-cash boot in an exchange and receives only qualifying replacement property has received no boot, and therefore does not recognize any gain or loss on the exchange of the qualifying property. n386

The taxpayer must, however, recognize any realized gain or loss on the transfer of the non-cash boot, because as nonqualifying property, it is not entitled to nonrecognition under Section 1031. n387 The taxpayer is deemed to have received an amount equal to the nonqualifying property's fair market value on the date of the exchange, n388 and the taxpayer's gain or loss is the difference between the nonqualifying property's fair market value and its adjusted basis. n389

[d] Transfer and Receipt of Both Qualifying Property and Boot by Taxpayer

A taxpayer who transfers both qualifying property and boot in an exchange and receives both qualifying like-kind property and boot may be taxable on both the boot and the qualifying property transferred. Any realized gain or loss on the transfer of the nonqualifying property must be recognized because that property is not eligible for nonrecognition under *IRC Section 1031*. n390 The taxpayer is deemed to have received an amount equal to the nonqualifying property's fair market value on the date of the exchange. n391

Any gain realized on the transfer of the qualifying property must be recognized to the extent of the boot received. n392 No loss realized on the transfer of the qualifying property, however, may be recognized. n393 Both the qualifying and nonqualifying properties are treated as being transferred for a pro rata share (based on the value of the properties transferred by the taxpayer) of each of the properties received. n394

[3] Assumption of Liabilities

[a] In General

When another party in an exchange assumes a liability of the taxpayer as part of the exchange, the amount of the liability assumed is treated as money--and therefore boot--received by the taxpayer on the exchange. n395 This is true whether or not the assumption of liability results in recognition of gain or loss to the taxpayer. n396

The amount of liability assumed in an exchange is determined under *IRC Section 357(d)*. Except as may be provided otherwise in the regulations, a recourse liability is treated as having been assumed under that provision if, based on all facts and circumstances, the transferee has agreed to, and is expected to, satisfy the liability, whether or not the transferor has been relieved of the liability. n397

Under *IRC Section 357(d)*, except as may be provided by the regulations, a nonrecourse liability is generally treated as having been assumed by the transferee of any asset subject to that liability. n398 The amount of the nonrecourse liability treated as assumed, however, is reduced by the lesser of the following: n399

- the amount of the nonrecourse liability which an owner of other assets not transferred to the transferee and also subject to that liability has agreed with the transferee to, and is expected to, satisfy; or
- the fair market value of those other nontransferred assets, determined without regard to *IRC Section 7701(g)* (which treats the fair market value as being not less than the amount of any nonrecourse indebtedness to which the property is subject).

Note:

The *IRC Section 357(d)* boot rules at first glance apply only to assumptions of a taxpayer's liabilities, and not to the acquisition of a property that is subject to a liability. n400 The statutory clarification of when liability is assumed, however, as discussed above, has the effect of including under *IRC Section 357(d)* specified recourse and nonrecourse liabilities when property subject to those liabilities is transferred as part of the transaction. n401

What the above rules end up meaning is that any mortgage relief received by the taxpayer in an exchange will be treated as cash. As such, it is boot, which will affect the taxpayer's basis in the replacement property and will require recognition of any gain realized on the exchange to the extent of the boot received unless it is offset. n402

The retention of a mortgage liability on property by a party to the exchange is not treated as boot to the taxpayer. In one ruling, the taxpayer exchanged a portion of an overriding royalty interest in oil and gas leases for a fee interest in a ranch that was encumbered with an outstanding mortgage. The exchange party transferred the ranch subject to the mortgage, but remained personally liable for the outstanding mortgage indebtedness. The taxpayer retained a security interest in the overriding royalties to ensure that the exchange party would fulfill its agreement to pay off the mortgage debt. The IRS ruled that the exchange party's personal liability for the prior outstanding mortgage was not boot to the taxpayer, because it was not a satisfaction of a debt previously owed by the taxpayer. n403

[b] Offsetting Assumptions of Liability

If the taxpayer does not assume any liabilities in connection with replacement property received in a like-kind exchange, the entire amount of liabilities the other party to the exchange assumes in connection with the property relinquished by the taxpayer is treated as boot to the taxpayer. n404 If the taxpayer has also assumed liabilities in connection with the replacement property received in the exchange, however, the liabilities assumed by the parties to the exchange must be netted in order to determine the amount of boot received by the taxpayer. In short, the liabilities assumed by the taxpayer with respect to the replacement property must be offset against the boot the taxpayer received in the form of liabilities assumed on the relinquished property by the other party in the exchange. n405

If two properties are exchanged, both subject to mortgages, the mortgages are netted and only the party receiving net mortgage relief receives boot. The amount of boot received is the difference between the exchanged boot amounts. n406 Any mortgage taken into account in the netting must be a bona fide mortgage, but as long as the mortgage has substance, the Tax Court has been lenient in allowing it to be offset. In one case it allowed an offset against a recently acquired mortgage that was placed on the property shortly before an exchange, apparently in order to equalize the net values of the properties being exchanged. n407

It is critical to note that boot received by the taxpayer in the form of cash or other property (other than an assumption of liabilities) is **not** reduced by boot transferred by the taxpayer in the form of assumption of liabilities. However,

consideration *given* by the taxpayer in the form of cash or other property *is* offset against consideration received in the form of an assumption of liabilities. n408

Planning Tip:

A taxpayer who is "trading up," that is, receiving property in an exchange that is worth more than the property transferred, can eliminate recognition of gain by receiving boot only in the form of mortgage relief. If the taxpayer's equity in the property to be relinquished exceeds the other party's equity in the replacement property, the taxpayer must receive additional consideration to balance the exchange. If the compensation is in cash or other nonqualifying property, the taxpayer must recognize gain to the extent of that boot, despite the fact that the actual investment in qualifying property has been increased rather than cashed out. n409

The parties to an exchange may wish to reconcile unequal equities in the properties and equalize the liabilities they each assume as part of the exchange. There are several possible ways to do this, and some appear to be safer than others. The statutory framework and regulations provide expressly for each party assuming the mortgage liability of the other. n410

Options other than a straightforward swapping of mortgage assumptions will also work. For example, the taxpayer may have the exchange party increase the mortgage on the replacement property the taxpayer will receive in the exchange, and the taxpayer may then assume that liability as part of the exchange. As long as the mortgage obtained by the exchange party is bona fide and has independent economic significance, the acquisition of the additional mortgage debt and the taxpayer's assumption of it as part of the exchange should be respected. The Tax Court specifically approved this type of arrangement in *Garcia*, and the IRS has acquiesced in the decision. In the case, the court said it was simply beside the point that the debt was assumed in contemplation of the exchange and at the taxpayer's insistence. Therefore, the court held that taxpayer's assumption of the liability in the exchange could be offset against the mortgage liabilities that the exchange partner assumed on property relinquished by the taxpayer in the exchange. n411

If a mortgage cannot be assumed by another party for some reason, other equity equalizing options may be available. For example, the exchange party could pay off the taxpayer's existing mortgage, rather than assume it, and the taxpayer could obtain a new mortgage to finance the replacement property. The IRS approved of this in a ruling in which an exchange party used its own funds to pay off the taxpayer's mortgage on the property the taxpayer was relinquishing in the exchange. (The exchange party was financing its acquisition by bond financing, which precluded it from assuming the taxpayer's existing mortgage on the property.) The IRS ruled that the taxpayer could net this form of liability relief against the new liability the taxpayer incurred in acquiring replacement property. n412

Boot-netting has also been upheld in an exchange if the exchange party advances cash to enable the taxpayer to pay off a mortgage on the property to be relinquished in the exchange, but this is acceptable only if the contractual arrangement between the parties clearly requires that the cash be used to pay off the mortgage. If the taxpayer has any discretion over the use of the cash, it will be treated as taxable boot. n413

The IRS has also allowed a taxpayer to offset liabilities the exchange party assumed on the relinquished property against boot that the taxpayer paid to the exchange party in the form of a refinancing of the mortgage on the replacement property. The taxpayer executed a note using the replacement property as collateral, and the exchange party's mortgage was paid off with the proceeds of the note. n414

Taxpayers have had less luck placing additional mortgages on the property they intend to relinquish in the exchange, especially if the increased mortgage is placed on the property at a time proximate to the exchange or if the mortgage is taken out as part of the exchange. The IRS has ruled that these mortgages cannot be included in the boot-netting of assumptions of liabilities. n415 There is authority for taking into account these mortgages, however, if they are shown to be unrelated to the exchange or the netting of liabilities. In one case, the taxpayer refinanced an apartment building with an independent lender one week after entering into a sales agreement (later converted into an exchange) for the building. The taxpayer had reasons for refinancing that were unrelated to the exchange and the court held that the proceeds from the loan were not boot. The Tax Court rejected the Service's argument that the taxpayer was merely cashing out his investment in the property with the loan. n416

Although there is no direct authority in point, the rationale in *Fredericks* might arguably support post-exchange borrowings on replacement property shortly after the property is received in an exchange. The IRS position would likely be that loan proceeds acquired soon after an exchange are in fact taxable cash boot connected with and received in the exchange.

Note:

The regulations under *IRC Section 1031(d)* still make reference to consideration in the form of a transfer of "property subject to a liability." This reference fails to reflect the statutory change that struck that language from *IRC Section 1031(d)*. n417 The regulation should be read as stating that consideration involving an assumption (as determined under *IRC Section 357(d)*) of liability is to be treated as "other property or money" under *IRC Section 1031(b)*. n418 As noted above, the statutory clarification of when liability is assumed has the effect of including under *IRC Section 357(d)* many transfers of property subject to a liability. Thus, these transfers of property subject to a liability would also be included as "other property or money" under *IRC Section 1031(b)*. n419

[c] Partnership Liabilities in Like-Kind Exchanges Involving Multiple Years

The IRS has issued a ruling that gives its position with respect to a like-kind exchange by a partnership in which property subject to a liability is relinquished in one taxable year of the partnership and property subject to a liability is received in the following taxable year. The ruling holds that the liabilities encumbering the relinquished property and the liabilities encumbering the replacement property must be netted for purposes of *IRC Section 752* (which deals with determining a partner's share of partnership liabilities). The year in which the netting must take place differs, depending on whether there is a net increase or decrease in the liabilities. n419.1

If there is a net decrease in the liabilities (i.e. the liabilities connected with the relinquished property are greater than the liabilities connected with the replacement property), the decrease in a partner's share of partnership liability must be taken into account for purposes of *IRC Section 752(b)* in the first taxable year of the partnership involved in the exchange, since the excess is attributable to the transfer of the relinquished property subject to the relinquished liability in that year. Any deemed distribution of money to the partners in the first taxable year of the partnership is treated as an advance or drawing of money to the extent of each partner's distributive share of partnership income for that year. n419.2 Any gain recognized by the partnership on the exchange under *IRC Section 1031(b)* from the net decrease in liability is included in the partners' distributive share of partnership income for the partnership's first taxable year involving the exchange. The amount treated as an advance or drawing of money is taken into account by the partners at the end of that year (rather than on the date of the exchange). n419.3

There is also a netting if the partner's share of replacement liabilities exceeds the partner's share of the relinquished liabilities. Only the net increase in liabilities is taken into account for purposes of

determining a partner's share of partnership liabilities under *IRC Section 752(a)*. In contrast, however, if there is a net increase in the liabilities (i.e. the liabilities connected with the replacement property are greater than the liabilities connected with the relinquished property), the increase in a partner's share of partnership liabilities must be taken into account for purposes of *IRC Section 752(a)* in the second taxable year of the partnership involved in the exchange, since the excess is attributable to the receipt of the replacement property subject to the replacement liabilities in that year. n419.4 Finally the ruling holds that if the relinquished liabilities and the replacement liabilities are nonrecourse, then the partnership minimum gain (generally, the amount the partnership would realize if it disposed of the property subject to a nonrecourse liability for no consideration other than full satisfaction of that liability) n419.5 on the last day of the first taxable year of the partnership involved in the exchange is computed by using the replacement property and the replacement nonrecourse liability. n419.6

Example 1:

P is a general partnership with two equal partners that reports on the calendar year. P owns Property 1, which has a fair market value of \$300 and is subject to a liability of \$100. P has an adjusted basis of \$80 in Property 1. P enters into an agreement for a deferred like-kind exchange. Pursuant to the agreement, P transfers Property 1 on October 16, Year 1, subject to the \$100 liability. On January 17, Year 2, P receives Property 2, which has a fair market value of \$260, subject to a liability of \$60. As a result of the exchange, P has a net decrease in liability of \$40.

The IRS treats the \$100 relinquished property liability as being offset by the \$60 replacement property liability in determining the amount of money or other property P receives. The difference is property or other money for purposes of recognizing gain under *IRC Section 1031(b)*. n419.7 P therefore must recognize \$40 in Year 1. n419.8 The gain is allocated \$20 to each partner as that partner's distributive share in Year 1. Furthermore, each partner is treated as receiving a deemed distribution of \$20 from the partnership in Year 1. n419.9

Example 2:

P is a general partnership with two equal partners that reports on the calendar year. P owns Property 1, which has a fair market value of \$300 and is subject to a liability of \$100. P has an adjusted basis of \$80 in Property 1. P enters into an agreement for a deferred like-kind exchange. Pursuant to the agreement, P transfers Property 1 on October 16, Year 1, subject to the \$140 liability. On January 17, Year 2, P receives Property 2, which has a fair market value of \$340, subject to a liability of \$140. Thus, P has a net increase in liability of \$40.

P realizes \$300 on the exchange [the fair market value of the replacement property (\$340) increased by the relinquished liability (\$100), and decreased by the replacement liability (\$140)]. P's adjusted basis in the relinquished property is \$80, resulting in a realized gain of \$220. In determining the amount of money or other property P received for purposes of determining gain under *IRC § 1031(b)*, however, the relinquished liability of \$100 is offset by the replacement liability of \$140. Therefore, P is not treated as having received money or other property. Accordingly, P recognizes no gain in Year 1. Furthermore, each partner is treated as having made a contribution to the partnership of \$20 in Year 2. n419.10

COMMENT:

Revenue Ruling 2003-56 admirably clarifies the coordination of the *IRC Section 1031* deferred exchange rules with the rules under *IRC Section 752* dealing with a partner's share of partnership liabilities when a like-kind exchange by the partnership straddles two taxable years. The ruling provides relative certainty on the tax effect of the exchange on the partners. n419.11

FOOTNOTES:

(n1)Footnote 376. *IRC § 1031(a)*; see § 8.11 for a discussion of the exchange requirement and § 8.13 for a discussion of "like-kind" requirement.

(n2)Footnote 377. *IRC § 1031(d)*; see § 8.21 for a discussion of the basis of replacement property.

(n3)Footnote 378. *IRC § 1031(b)*.

(n4)Footnote 379. *IRC § 1031(d)*; see § 8.21 for a discussion.

(n5)Footnote 380. *Goldberg v Commr, TC Memo 1997-74, aff'd 2001-1 USTC P 50,155 (9th Cir 2000)*.

(n6)Footnote 381. See *IRC § 1031(b)*; see [a], above, for a discussion.

(n7)Footnote 382. *IRC § 1031(c)*; *Treas Reg § 1.1031(b)-1(a)*.

(n8)Footnote 383. *IRC § 1031(d)*; see § 8.21 for a discussion.

(n9)Footnote 384. *IRC § 1031(c)*.

(n10)Footnote 385. *Treas Reg § 1.1031(a)-1(a)*.

(n11)Footnote 386. *IRC § 1031(a)*.

(n12)Footnote 387. *IRC § 1001(c)*.

(n13)Footnote 388. *Treas Reg § 1.1031(d)-1(e)*.

(n14)Footnote 389. *IRC § 1001(a)*.

(n15)Footnote 390. *IRC § 1001(c)*.

(n16)Footnote 391. *Treas Reg § 1.1031(d)-1(e)*.

(n17)Footnote 392. *IRC § 1031(b)*.

(n18)Footnote 393. *IRC § 1031(c)*.

(n19)Footnote 394. *Treas Reg § 1.1031(j)-1*.

(n20)Footnote 395. *IRC § 1031(d)*.

(n21)Footnote 396. *Treas Reg § 1.1031(d)-2*.

(n22)Footnote 397. *IRC § 357(d)(1)(A)*.

(n23)Footnote 398. *IRC § 357(d)(1)(B)*.

(n24)Footnote 399. *IRC § 357(d)(2)*.

(n25)Footnote 400. *IRC § 357(a)*. For transfers occurring before October 19, 1998, both the assumption of a liability and the acquisition from the taxpayer of property subject to a liability were not treated as boot (see *IRC § 357(a)*, *before amendment by Pub L No 106-36*).

(n26)Footnote 401. See *IRC § 357(d)*.

- (n27)Footnote 402. *IRC § 1031(b), (d)*; see [b], below, for a discussion of liability offsets.
- (n28)Footnote 403. *Ltr Rul 7935126* .
- (n29)Footnote 404. *IRC § 1031(d)*.
- (n30)Footnote 405. *Treas Reg §§ 1.1031(b)-1(c), 1.1031(d)-2*.
- (n31)Footnote 406. *Treas Reg § 1.1031(b)-1(c)*.
- (n32)Footnote 407. *Garcia v Commr, 80 TC 491 (1983)* , acq 1984-1 CB 1 ; cf *Long v Commr, 77 TC 1045 (1981)* (reallocation of existing liabilities among partners not respected).
- (n33)Footnote 408. See *Treas Reg § 1.1031(d)-2, Ex (2)(c)*.
- (n34)Footnote 409. *IRC § 1031(b)*.
- (n35)Footnote 410. *IRC § 1031(d); Treas Reg § 1.1031(d)-2*.
- (n36)Footnote 411. *Garcia v Commr, 80 TC 491 (1983)* , acq 1984-1 CB 1 ; cf *Long v Commr, 77 TC 1045 (1981)* (reallocation of existing liabilities among partners shortly before an exchange was not respected).
- (n37)Footnote 412. *Ltr Rul 9853028* .
- (n38)Footnote 413. *Barker v Commr, 74 TC 555 (1980)* ; *Commr v North Shore Bus Co, 143 F2d 114 (2nd Cir 1944)* .
- (n39)Footnote 414. *TAM 8003004* .
- (n40)Footnote 415. *Ltr Rul 8434015* .
- (n41)Footnote 416. *Fredericks v Commr, TC Memo 1994-27* .
- (n42)Footnote 417. See *IRC § 1031(d), before amendment by Pub L No 106-36*.
- (n43)Footnote 418. See *Treas Reg § 1.1031(b)-1(c)*.
- (n44)Footnote 419. *Id.*
- (n45)Footnote 419.1. *Rev Rul 2003-56, 2003-1 CB 985* .
- (n46)Footnote 419.2. *Rev Rul 2003-56, 2003-1 CB 985* , citing *Rev Rul 94-4, 1994-1 CB 195* .
- (n47)Footnote 419.3. *Rev Rul 2003-56, 2003-1 CB 985* .
- (n48)Footnote 419.4. *Rev Rul 2003-56, 2003-1 CB 985* .
- (n49)Footnote 419.5. See *Treas Reg § 1.704-2(d)*.
- (n50)Footnote 419.6. *Rev Rul 2003-56, 2003-1 CB 985* .
- (n51)Footnote 419.7. *Rev Rul 2003-56, 2003-1 CB 985* ; see *Treas Reg § 1.1031(b)-1(c)*.
- (n52)Footnote 419.8. *Rev Rul 2003-56, 2003-1 CB 985* ; see *IRC § 752(b); Treas Reg § 1.1031(k)-1(j)(3)*, Example (5).

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(n53)Footnote 419.9. *Rev Rul 2003-56, 2003-1 CB 985* ; see *Rev Rul 94-4, 1994-1 CB 195* .

(n54)Footnote 419.10. *Rev Rul 2003-56, 2003-1 CB 985* , citing *Treas Reg § 1.1031(j)*.

(n55)Footnote 419.11. *Rev Rul 2003-56, 2003-1 CB 985* .



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.21

§ 8.21 Basis of Replacement Property Received in Like-Kind Exchange

[1] Basis of Replacement Property

[a] In General

The taxpayer's basis in like-kind property received in a Section 1031 exchange is the same as that of the property relinquished by the taxpayer, decreased by the amount of money received, and increased by the amount of gain (or decreased by the amount of loss) recognized on the exchange. n420 The taxpayer's basis in the replacement property is also increased by any additional cash consideration the taxpayer pays for the property. n421 Expenses of the exchange that are paid by the taxpayer, such as brokerage commissions, are also added to the taxpayer's basis in the replacement property. n422

The above basis rules are straightforward and easy to apply. In the vast majority of like-kind exchanges, however, non-cash boot is transferred by one or both parties, or taxpayers assume liabilities on replacement property that is received in the exchange, or transfer property upon which the transferee assumes liability. Computation of basis becomes more difficult when these items are taken into account, as discussed in [b] through [e], below. n423 The exchange of multiple properties also increases the complexity of the basis computations. n424

[b] Taxpayer Transfers Boot

If the taxpayer transfers qualifying property and non-cash boot in an exchange and receives only qualifying like-kind replacement property, the taxpayer's basis in the replacement property is the sum of the taxpayer's adjusted bases in both the qualifying relinquished property and the boot transferred. This sum is increased by any gain recognized, or decreased by any loss recognized, on the transfer of the boot. The taxpayer's basis in the replacement property is also increased by any cash paid by the taxpayer in the transaction. n425

Example (1):

T transfers a qualifying property with an adjusted basis of \$50 and a fair market value of \$100, plus \$50 cash, in exchange for a qualifying like-kind replacement property worth \$150. T receives no boot. T does not recognize any gain on the exchange. Therefore, T's basis in the replacement property received is \$100, the sum of T's adjusted basis in the relinquished property at the time of the exchange plus \$50

additional cash consideration paid.

Example (2):

Assume the same facts as in preceding Example (1) except that instead of cash boot, T transfers in the exchange stock with a fair market value of \$50 and an adjusted basis to T of \$10. T realizes and recognizes a gain of \$40 on the transfer of the stock. T's basis in the replacement property is \$100, which is the sum of T's adjusted bases in the relinquished properties ($\$10 + \$50 = \$60$) plus the amount of gain recognized on the exchange (\$40). If T's adjusted basis in the stock is \$60 instead of \$40, \$10 of taxable loss is realized and recognized. T's basis in the replacement property is \$100, which is the sum of the T's adjusted bases in the relinquished properties ($\$50 + \$60 = \$110$) minus the loss recognized on the exchange (\$10). n426

If a taxpayer receives more than one qualifying property in the exchange, the basis is allocated between the qualifying properties received in proportion to their fair market values. n427

[c] Taxpayer Receives Cash Boot

If the only boot received by the taxpayer in an exchange is cash, the taxpayer's basis in the qualifying replacement property received in the exchange is equal to the taxpayer's adjusted basis in the relinquished property on the date of the exchange, less the amount of money received, plus the amount of gain recognized on the exchange. n428

Example (1):

T transfers a real property with an adjusted basis of \$50,000 and fair market value of \$120,000 for like-kind replacement property worth \$100,000 plus \$20,000 in cash. T recognizes \$20,000 of the \$70,000 realized gain in the exchange. n429 T's basis in the replacement property is \$50,000, which is T's adjusted basis in the relinquished property (\$50,000), less the \$20,000 cash received, plus the \$20,000 gain recognized in the transaction.

Example (2):

Assume the same facts as in preceding Example (1) except that T's adjusted basis in the relinquished property is \$110,000. T's realized gain on the transaction is \$10,000 ($\$120,000$ amount realized less $\$110,000$ basis). The realized gain is recognized because the amount of boot received exceeds the amount of realized gain. T's basis in the replacement property is \$100,000 ($\$110,000$ adjusted basis in relinquished property, less \$20,000 cash received, plus the \$10,000 gain recognized in the transaction. n430

If a taxpayer receives more than one like-kind replacement property along with the cash boot, the basis must be allocated among the replacement properties in proportion to their fair market values on the date of the exchange. n431

[d] Taxpayer Receives Noncash Boot

A taxpayer who transfers in an exchange only qualifying property and who receives in return both like-kind qualifying replacement property and noncash boot must recognize any realized gain to the extent of the fair market value of the boot received. n432

The taxpayer's total basis in all the property received in the exchange (both the like-kind replacement property and the non-cash boot) is the sum of the taxpayer's adjusted basis at the time of the exchange in the property relinquished, plus the amount of recognized gain. This total basis must be allocated among all the properties received in the exchange,

including both the like-kind replacement property and the noncash boot. That basis is first allocated to the boot to the extent of its fair market value on the date of the exchange. The remaining basis is allocated to the like-kind replacement property. n433

Example:

T transfers qualifying real estate with an adjusted basis of \$50,000 and a fair market value of \$120,000 for like-kind real estate worth \$100,000 plus stock worth \$20,000 at the time of the exchange. T realizes a gain of \$70,000 on the exchange, but recognizes a gain of only \$20,000. The total basis that T must allocate between the replacement property and the stock is \$70,000 (\$50,000 adjusted basis in the relinquished property plus \$20,000 gain recognized on the exchange). Of this \$70,000 basis, the fair market value of the stock at the time of the exchange, or \$20,000, must be allocated to the stock. The remainder, \$50,000, must be allocated to the like-kind real estate. n434

[e] Taxpayer Both Transfers and Receives Boot

A taxpayer who transfers both qualifying property and boot in an exchange and receives both qualifying property and boot must make separate gain and loss computations, which in turn affect the computation of basis in the like-kind replacement property and boot received. Gain or loss must be recognized on the transfer of the boot because the boot is not entitled to nonrecognition under *IRC Section 1031*. n435 Similarly, any gain (but not loss) that realized on the transfer of the qualifying relinquished property will be recognized to the extent of the boot received. n436

The major issue is determining how much boot the taxpayer is deemed to receive. Logically, a taxpayer should be permitted to reduce the amount of taxable boot received by the amount of boot transferred to the other party. In other words, the taxpayer should be taxable only to the extent of net boot. The regulations, however, have adopted this logic in some respects, but not others. The regulations allow a netting only for certain items, as follows: n437

- Boot received in the form of mortgage relief (i.e. liabilities on the qualified relinquished property that are assumed by another party to the exchange) may be reduced by the amount of liabilities the taxpayer has assumed in connection with property received in the exchange. In other words, assumed liabilities may be offset against each other.
- Consideration given by the taxpayer in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities.
- Boot received by the taxpayer in the form of cash or other property is **not** reduced by boot transferred by the taxpayer in the form of assumption of liabilities.
- Boot received by the taxpayer in the form of cash or nonqualifying property is not reduced by boot transferred by the taxpayer in the form of cash or other nonqualifying property.

The above boot allocation rules can cause unexpected problems, especially if the equities in the qualifying properties exchanged are unequal.

Example (1):

T has a building with adjusted basis of \$50,000 and a fair market value of \$100,000. The building is encumbered with a nonrecourse mortgage of \$30,000. T exchanges the building with X for like-kind replacement property with a fair market value of \$150,000. The replacement property is encumbered with a nonrecourse mortgage of \$80,000. Although there is no express agreement as to whether T or X

will assume the mortgage liability on the property each receives in the exchange, under *IRC Section 357(d)*, T and X are each treated as having assumed the nonrecourse liability on the property each receives in the exchange.

As the equities in the exchanged properties are both \$70,000, the exchange is an equal one, requiring no additional property to balance it. T is treated as having paid boot of \$80,000, by assuming the mortgage on the replacement property. T has received \$30,000 of boot, in the form of the nonrecourse mortgage on the relinquished property that is assumed by X. The boot figures are netted, so T is treated as having paid \$50,000 boot and received none. Therefore, although T realizes \$50,000 on the transaction, T recognizes no gain. T's basis in the replacement property is \$50,000, which is the amount of T's adjusted basis in the relinquished property. Because T has not treated as having received any boot, there is no decrease in basis to reflect money received, and there is no increase in basis related to gain because T does not recognize any gain on the transaction.

Example (2):

Assume the same facts as in preceding Example (1), T's building has the same adjusted basis of \$50,000, the same fair market value of \$100,000, and continues to be encumbered with a nonrecourse mortgage of \$30,000. T's equity in the property is therefore \$70,000. T exchanges the building with Z for like-kind replacement property with a fair market value of \$150,000. Z's property, however, is subject to a nonrecourse mortgage of \$100,000. Z's equity in the property is therefore only \$50,000. Again, both T and Z are treated as having assumed the nonrecourse liability on the property each receives in the exchange. T also receives \$20,000 cash in order to balance the differing equities in the properties.

T has assumed a larger mortgage liability (\$100,000) than the mortgage liability assumed by Z (\$30,000). Nevertheless, the \$20,000 cash boot received by T is not reduced by the boot transferred by Z in the form of assuming the nonrecourse mortgage on the replacement property. T's realized gain on the exchange is still \$50,000 [(\$150,000 + \$30,000 + \$20,000) less (\$50,000 + \$100,000)]. However, T must recognize \$20,000 of that gain, equal to the amount of cash boot received. n438

T's basis in the replacement property is \$50,000, which is the amount of T's adjusted basis in the relinquished property (\$50,000) less \$20,000 cash boot received, plus \$20,000 gain recognized in the exchange. Note that, after the exchange, T could use the \$20,000 cash boot to reduce the mortgage on the replacement property to \$80,000, thus producing the same economic result as in the preceding example. n439

[2] Basis of Non-Cash Boot Received in the Exchange

A taxpayer's basis in any non-cash boot received in a Section 1031 exchange is its fair market value at the time of the exchange. n440 If non-cash boot is received in an exchange, the taxpayer's total basis is first allocated to the boot to the extent of its fair market value, and the remainder of the basis is allocated to the like-kind properties received in the exchange, in accordance with their fair market values at the time of the exchange. n441

[3] Effect of Assumptions of Liability on Basis

If another party to the exchange assumes a liability of the taxpayer, that assumption is considered to be money received by the taxpayer. n442 The amount of a taxpayer's liabilities that are assumed by the other party (or the net amount, if there is an offset of assumed liabilities) therefore decreases the taxpayer's adjusted basis in the replacement property. Any gain recognized by the taxpayer on the exchange, however, increases the taxpayer's adjusted basis in the replacement property. Therefore, there may be a wash or partial wash with respect to the taxpayer's basis in the replacement property resulting from the assumption of liabilities and the corresponding recognition of gain that is

required. n443

[4] Allocation of Basis to Multiple Replacement Properties

A taxpayer who receives more than one qualifying replacement property in an exchange must allocate the substituted basis among them in proportion to their fair market values on the date of the exchange. n444

Example:

T exchanges a parcel of real estate with an adjusted basis of \$100,000 and a fair market value at the time of the exchange of \$200,000 for two like-kind replacement properties, one with a fair market value of \$150,000 and one with a fair market value of \$50,000. No boot is transferred in the exchange, nor are any liabilities assumed with respect to the properties by either party. T's total basis in the replacement properties is \$100,000. T's basis in the first replacement property is \$75,000, [$\$100,000 \times (150,000/200,000)$] and his basis in the second replacement property is \$25,000 [$\$100,000 \times (50,000/200,000)$]. The same result would occur if T relinquished two properties that had a total adjusted basis at the time of the exchange of \$100,000. n445

[5] Allocation When Assets Constitute a Trade or Business

If a like-kind exchange involves a transfer of assets that constitute a trade or business, and the transferee's basis in the assets is determined wholly by reference to the consideration paid for those assets, the exchange may constitute an "applicable asset acquisition" under *IRC Section 1060*. n446 In that case, detailed regulations under *IRC Section 1060* specify the manner of allocating consideration to different assets in the exchange. n447

If an applicable asset acquisition involves non-recognition of gain or loss on the transfer of some of the assets, as in a like-kind exchange under *IRC Section 1031*, all of the assets transferred--including the non-recognition assets--are taken into account in determining whether the group of assets constitutes a trade or business. n448

The allocation of consideration, however, is done without taking into account either the non-recognition assets or the amount of money or other property that is treated as transferred in exchange for the non-recognition assets (together, the nonrecognition exchange property). In other words, the like-kind property and other property or money that are treated as transferred in exchange for the like-kind property are excluded from the allocation rules of *IRC Section 1060*. n449

The basis in and gain or loss recognized with respect to the non-recognition exchange property are determined under the same rules that otherwise apply to the exchange. The amount of the money and other property treated as exchanged for non-recognition assets is the amount by which the fair market value of the nonrecognition assets transferred by one party exceeds the fair market value of the non-recognition assets transferred by the other (to the extent of the money and the fair market value of property transferred in the exchange). n450

The money and other property that are treated as transferred in exchange for the non-recognition assets (and which are not included among the assets to which *IRC Section 1060* applies) are allocated using the residual method and are considered to come from specified classes of assets in a specific order. n451

[6] Payment of Taxpayer's Mortgage in Lieu of Assumption

Instead of assuming the taxpayer's mortgage, n452 the other party to the exchange may choose to pay off the taxpayer's mortgage, in whole or in part. Assume that a taxpayer transfers qualifying property worth \$100, subject to a nonrecourse mortgage of \$30, and in the exchange receives property worth \$150, subject to a nonrecourse mortgage of \$80. There is no express agreement as to whether the taxpayer will assume the mortgage liability on the property received in the exchange, nor is there an express agreement as to whether the other party in the exchange will assume

the mortgage on the property transferred by the taxpayer in the exchange. Both the taxpayer and the other party in the exchange are treated as having assumed the nonrecourse liability on the property each received in the exchange. n453

As discussed above, the taxpayer recognizes no gain on the transfer because the mortgage assumed by the taxpayer exceeds the mortgage relief received, and no boot other than mortgage relief is received. n454 The party receiving the qualifying property from the taxpayer can, of course, pay off all or part of the \$30 mortgage on that property after the exchange. Instead, the exchange party could transfer \$30 in cash to the taxpayer at the time of the exchange, pursuant to an agreement requiring the taxpayer to pay off the mortgage before transferring the qualifying property. The payment of the \$30 under these circumstances will qualify as mortgage relief to the taxpayer, just as if the other party had first assumed the mortgage and paid it off after the exchange. n455

[7] Depreciation of MACRS Property Acquired in a Like-Kind Exchange

[a] In General

Final regulations cover the proper depreciation of property acquired in *IRC Section 1031* like-kind exchanges. n456 While much of their focus is on non-real estate property, the discussion here is directed to their application to real estate acquired in like-kind exchanges.

The final regulations supersede prior temporary regulations, and generally apply to a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004. n457 For a like-kind exchange of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may apply the final regulations or rely on prior guidance issued by the IRS in *Notice 2000-4*. n457.1 In either case, a choice will necessitate seeking IRS consent for a change of accounting method. n457.2

Notice 2000-4 instructed taxpayers how to depreciate replacement MACRS property when the exchanged property was also MACRS property. The notice stated that replacement MACRS property placed in service after January 3, 2000, was to be depreciated over the remaining recovery period of, and using the same depreciation method and convention as, the relinquished MACRS property and that any excess of the basis in the replacement MACRS property over the adjusted basis in the relinquished MACRS property was to be treated as newly purchased MACRS property. *Notice 2000-4* also stated that regulations would be issued to address these transactions. n458 The regulations discussed below are the result, and they make *Notice 2000-4* obsolete after February 27, 2004.

[b] Application of Regulations to MACRS Property

The regulations instruct taxpayers how to determine the annual depreciation allowance for MACRS property (i.e. depreciable property placed in service after December 31, 1986) that is acquired in a like-kind exchange. The regulations also apply to like-kind exchanges involving MACRS property that is replaced with other MACRS property in a transaction between members of the same affiliated group. The regulations do not apply to a like-kind exchange if (1) the allowance for depreciation of either the relinquished or replacement property is computed under a depreciation system other than MACRS, or (2) the special rules relating to like-kind exchanges of tax-exempt use property n458.1 apply. n458.2

If replacement MACRS property is acquired by a taxpayer in a like-kind exchange, the depreciation treatment of the replacement MACRS property by previous owners has no effect on the determination of depreciation allowances for the replacement MACRS property in the hands of the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property for property that was depreciated using ACRS by the previous owner must use the MACRS depreciation described in the final regulations because the replacement property will become MACRS property in the hands of the acquiring taxpayer. In addition, elections made by previous owners in determining

depreciation allowances for the replacement MACRS property have no effect on the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property that the taxpayer depreciates under the general depreciation system of *IRC § 168(a)* for other MACRS property that the previous owner elected to depreciate under the alternative depreciation system n458.3 does not have to continue using the alternative depreciation system for the replacement MACRS property. n458.4 Final regulations clarify that taxpayers cannot depreciate land that is acquired in a like-kind exchange for MACRS property. n458.5

[c] General Rule for Depreciation of Exchanged Basis

The regulations provide rules for determining the applicable recovery period, depreciation method, and convention used to determine the depreciation allowances for the replacement MACRS property with respect to so much of the taxpayer's basis (as determined under the like-kind exchange rules) in the replacement MACRS property as does not exceed the taxpayer's adjusted depreciable basis in the relinquished MACRS property (exchanged basis). In general, the exchanged basis is depreciated over the remaining recovery period of, and using the depreciation method and convention of, the relinquished MACRS property (general rule). n458.6

This general rule applies if the replacement MACRS property has the same or a shorter recovery period or the same or a more accelerated depreciation method than the relinquished MACRS property. n458.7 This could occur, for example, if replacement property were residential rental property with a recovery period of 27.5 years and the relinquished property were nonresidential real property with a recovery period of 39 years. n458.8 Therefore, the general rule can adversely affect taxpayers engaging in like-kind exchanges by requiring depreciation of replacement MACRS property over the longer recovery period of the relinquished MACRS property. To avoid this problem, the regulations allow taxpayers to elect not to apply the general rule, but instead to treat the replacement MACRS property as MACRS property placed in service by the acquiring taxpayer at the time of replacement. n458.9

The general rule does not apply if the replacement MACRS property has a longer recovery period or less accelerated depreciation method than the relinquished MACRS property. In that case, the taxpayer's exchanged basis in the relinquished MACRS property is depreciated beginning in the year of replacement over the remainder of the recovery period that would have applied to the replacement MACRS property if the replacement MACRS property had originally been placed in service when the relinquished MACRS property was placed in service by the acquiring taxpayer. n458.10 Similarly, if the depreciation method of the replacement MACRS property is less accelerated than that of the relinquished MACRS property, then the taxpayer's exchanged basis in the relinquished MACRS property is depreciated beginning in the year of replacement using the less accelerated depreciation method of the replacement MACRS property that would have applied to the replacement MACRS property if the replacement MACRS property had originally been placed in service when the relinquished MACRS property was placed in service by the acquiring taxpayer. n458.11

For taxpayers who use the optional depreciation tables to determine depreciation allowances for the replacement MACRS property instead of the formulas, n458.12 the regulations provide guidance on choosing the applicable optional table and explain the modifications that must be made to compute depreciation allowances for the replacement MACRS property. Taxpayers who used an optional depreciation table for the relinquished MACRS property are not required to use an optional table for the depreciable exchanged basis of the replacement property. n458.13

Regulations also deal with the depreciation convention to be used. For MACRS nonresidential real property and residential rental property, the exchanged basis must be depreciated using the mid-month convention. n458.13.1 Regarding the recovery period of the replacement property, the replacement MACRS property is treated as placed in service at the time of replacement under the convention that applies to the replacement MACRS property (i.e. the mid-month convention for MACRS nonresidential real property and residential rental property). The remaining recovery period of the replacement MACRS property at the time of replacement is the excess of the recovery period for the replacement MACRS property over the period of time that the replacement MACRS property would have been in

service if it had been placed in service when the relinquished MACRS property was placed in service and removed from service at the time of disposition of the relinquished MACRS property. This period is determined by using the convention that applied to the relinquished MACRS property to determine the date that the relinquished MACRS property is deemed to have been placed in service and the date that it is deemed to have been disposed of. The length of time the replacement MACRS property would have been in service is determined by using these dates and the convention that applies to the replacement MACRS property. n458.13.2

If, using the convention that applies to the relinquished MACRS property, the remaining recovery period of the relinquished MACRS property at the beginning of the year of disposition is less than the number of months between the first of that year and the time of disposition, the entire basis in the relinquished MACRS property is deductible in the year of disposition and the exchanged basis is zero. n458.13.3

Example:

A1, a calendar-year taxpayer, exchanges Building M, an office building, for Building N, a warehouse, in a like-kind exchange. Building M is relinquished in July 2004 and Building N is acquired and placed in service in October 2004. A1 did not make any elections under *IRC Section 168* for either Building M or Building N. The unadjusted depreciable basis of Building M was \$4,680,000 when placed in service in July 1997. Since the recovery period and depreciation method for Building N (39 years, straight line method) are the same as the recovery period and depreciation method for Building M (39 years, straight line method), Building N is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, Building M. Applying the applicable convention, Building M is deemed disposed of on July 15, 2004, and Building N is placed in service on October 15, 2004. Thus, Building N will be depreciated using the straight line method over a remaining recovery period of 32 years beginning in October 2004 (the remaining recovery period of 32 years and 6.5 months at the beginning of 2004, less the 6.5 months of depreciation taken prior to the disposition of the exchanged MACRS property (Building M) in 2004). For 2004, the year in which the transaction takes place, the depreciation allowance for Building M is $(\$120,000)(6.5/12)$ which equals \$65,000. The depreciation allowance for Building N for 2004 is $(\$120,000)(2.5/12)$ which equals \$25,000. For 2005 and subsequent years, Building N is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, Building M. Thus, the depreciation allowance for Building N is the same as Building M, namely \$10,000 per month. n458.14

[d] Rules for Depreciation of Excess Basis

Any excess basis in replacement MACRS property over the taxpayer's exchanged basis in the relinquished MACRS property is referred to as the excess basis. n458.14.1 The excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer in the year of replacement. The depreciation allowances for the excess basis are determined by using the applicable recovery period, depreciation method, and convention prescribed under *IRC Section 168* for the replacement MACRS property at the time of replacement. However, if replacement MACRS property is disposed of during the same taxable year the relinquished MACRS property is placed in service by the acquiring taxpayer, no depreciation deduction is allowable for either MACRS property. n458.15

[e] Special Rules for Deferred Transactions

A taxpayer who disposes of relinquished MACRS property before acquiring the replacement MACRS property cannot take depreciation on the relinquished MACRS property during any intervening period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property. Accordingly, the recovery period for the replacement MACRS property is suspended during this period. n458.16 The final regulations reserve on providing specific guidance as to whether an intermediary (such as an exchange accommodation titleholder) is entitled

to depreciation. n458.17

[f] Acquisition Prior to Disposition

When replacement MACRS property is acquired and placed in service by a taxpayer before the relinquished MACRS property is disposed of (for example, under threat of condemnation), the regulations allow the taxpayer to depreciate the unadjusted depreciable basis of the replacement MACRS property until the taxpayer disposes of the relinquished MACRS property. At the time of disposition of the relinquished MACRS property, the taxpayer determines the exchanged basis and the excess basis of the replacement MACRS property and begins to depreciate the depreciable exchanged basis of the replacement MACRS property in accordance with the rules for depreciation of exchanged basis. n458.18 The depreciable excess basis of the replacement MACRS property continues to be depreciated by the taxpayer in accordance with the rules for excess basis. In the year of disposition of the relinquished MACRS property, the taxpayer must include in taxable income the excess of the depreciation deductions allowable on the unadjusted depreciable basis of the replacement MACRS property over the depreciation deductions that would have been allowable to the taxpayer on the depreciable excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer (taking into account the applicable convention) to the time of disposition of the relinquished MACRS property. n458.18.1

[g] Transactions Involving Land or Other Nondepreciable Property

Land or other nondepreciable property acquired in a like-kind exchange for MACRS property is not depreciable, and is not within the scope of the regulations. If MACRS property or both MACRS property and land or other nondepreciable property are acquired in a like-kind exchange for land or other nondepreciable property, the basis of the replacement MACRS property is treated as property placed in service by the acquiring taxpayer in the year of replacement. n458.19

[h] Election Not To Apply Regulations

In order to ease computational and administrative difficulties that could result from having to track different depreciation components of one asset, taxpayers may elect to have the regulations not apply. n458.20 A taxpayer who makes that election must treat the entire basis (i.e. both the exchanged and excess basis) of the replacement MACRS property as being placed in service by the acquiring taxpayer at the time of replacement. Consistent with this treatment, the taxpayer treats the relinquished MACRS property as disposed of at the time of the disposition of the relinquished MACRS property. n458.21

A separate election is required for each like-kind exchange. n458.21.1 The election must be made in the manner provided for on Form 4562, Depreciation and Amortization, and its instructions, n458.21.2 and must be made by the due date (including extensions) of the taxpayer's Federal tax return for the year of replacement. n458.22 The election is made for each member of a consolidated group by the common parent of the group, by the partnership (and not by the partners separately) in the case of a partnership, or by the S corporation (and not by the shareholders separately) in the case of an S corporation. n458.22.1 The election may be revoked only with the consent of the Commissioner, which will be granted only in extraordinary circumstances. n458.23

[i] Additional First Year Depreciation

Previously issued regulations n458.24 provide that the exchanged basis (referred to as the "carryover basis" in these regulations) and the excess basis, if any, of the replacement MACRS property (referred to as the "acquired MACRS property" in these regulations) is eligible for the additional first year depreciation deduction provided under prior *IRC Section 168(k)* or *IRC Section 1400L(b)* if the replacement MACRS property is qualified property, n458.25 or 50-percent bonus depreciation property under prior law. n458.26 However, if qualified property or 50-percent bonus depreciation property is placed in service by the taxpayer and then disposed of by that taxpayer in a like-kind exchange in the same taxable year, the relinquished MACRS property (referred to as the "exchanged MACRS property" in these

regulations) is not eligible for the additional first year depreciation deduction. n458.26.1 However, the exchanged basis (and excess basis, if any) of the replacement MACRS property may be eligible for the additional first year depreciation deduction. The rules provided under these regulations for additional first-year depreciation n458.27 apply without regard to whether the taxpayer applies or elects not to apply the MACRS depreciation regulations for property acquired in a like-kind exchange. n458.28

[j] Exchanges of Multiple Properties

The determination of the basis of property acquired in a like-kind exchange involving multiple properties is described in regulations. n458.29 The IRS and Treasury Department believe that issues related to allocation of basis among multiple properties involved in like-kind exchanges or involuntary conversions for purposes of depreciation are covered in those regulations under *IRC Section 1031*; therefore, the regulations under *IRC Section 168(i)* do not address these issues. n458.30

FOOTNOTES:

(n1)Footnote 420. *IRC § 1031(d)*.

(n2)Footnote 421. *Treas Reg § 1.1031(d)-1(a)*.

(n3)Footnote 422. *Rev Rul 72-456, 1972-2 CB 468 ; Blatt v Commr, TC Memo 1994-48 .*

(n4)Footnote 423. See *Treas Reg § 1.1031(d)-1, (d)-2*.

(n5)Footnote 424. See *Treas Reg § 1.1031(j)-1*; see § 8.23[5] for a discussion.

(n6)Footnote 425. *IRC § 1031(d)*; *Treas Reg § 1.1031(d)-1(e)*.

(n7)Footnote 426. *IRC § 1031(a), (b), (c), (d)*.

(n8)Footnote 427. *Rev Rul 68-36, 1968-1 CB 357 ; see [4], below, for a discussion.*

(n9)Footnote 428. *IRC § 1031(d)*; *Treas Reg § 1.1031(d)-1(b)*.

(n10)Footnote 429. *IRC §§ 1001(b), 1031(b)*.

(n11)Footnote 430. *IRC § 1031(d)*; *Treas Reg § 1.1031(d)-1(b)*.

(n12)Footnote 431. *Rev Rul 68-36, 1968-1 CB 357 .*

(n13)Footnote 432. *IRC § 1031(b)*.

(n14)Footnote 433. *IRC § 1031(d)*.

(n15)Footnote 434. *Id.*

(n16)Footnote 435. *IRC §§ 1001(c), 1031(a)*.

(n17)Footnote 436. *IRC § 1031(b), (c)*.

(n18)Footnote 437. *Treas Reg §§ 1.1031(b)-1(c), 1.1031(d)-2, Ex (2)(c)*.

(n19)Footnote 438. *Treas Reg § 1.1031(d)-2, Ex 2(b)*.

(n20)Footnote 439. See *IRC §§ 357(d)(1)(B), 1031(b), (d)*.

(n21)Footnote 440. *IRC § 1031(d); Treas Reg § 1.1031(d)-1(c).*

(n22)Footnote 441. *IRC § 1031(d).*

(n23)Footnote 442. *IRC § 1031(d); Treas Reg § 1.1031(b)-1(c);* for discussion, see § 8.20[3].

(n24)Footnote 443. *IRC § 1031(d).*

(n25)Footnote 444. *Rev Rul 68-36, 1968-1 CB 357 .*

(n26)Footnote 445. *Id.*

(n27)Footnote 446. See *IRC § 1060(c).*

(n28)Footnote 447. *Treas Reg § 1.1060-1(b)(8).*

(n29)Footnote 448. *Id.*

(n30)Footnote 449. *Temp Treas Reg § 1.1031(d)-1T; Treas Reg § 1.1060-1(b)(8).*

(n31)Footnote 450. *Treas Reg § 1.1060-1(b)(8).*

(n32)Footnote 451. *Id.*; see *Treas Reg § 1.1060-1(d), Ex 1.*

(n33)Footnote 452. See *IRC §§ 357(d), 1031(d).*

(n34)Footnote 453. See *IRC §§ 357(d)(1)(B), 1031(d).*

(n35)Footnote 454. *IRC § 1031(b);* see § 8.20[3][b].

(n36)Footnote 455. *Barker v Commr, 74 TC 555, 569 (1980) .*

(n37)Footnote 456. *Treas Reg § 1.168(i)-6;* the regulations also apply to property acquired in involuntary conversions under *IRC § 1033;* see Chapter 8A for a discussion.

(n38)Footnote 457. *Treas Reg § 1.168(i)-6(k)(1).*

(n39)Footnote 457.1. *Treas Reg § 1.168(i)-6(k)(2).*

(n40)Footnote 457.2. *Treas Reg § 1.168(i)-6(k)(2)(i), (ii).*

(n41)Footnote 458. *Notice 2000-4, 2000-1 CB 313 .*

(n42)Footnote 458.1. See *Treas Reg § 1.168(h)-1.*

(n43)Footnote 458.2. *Treas Reg § 1.168(i)-6(a).*

(n44)Footnote 458.3. See *IRC § 168(g)(7).*

(n45)Footnote 458.4. *Treas Reg § 1.168(i)-6(c)(2).*

(n46)Footnote 458.5. *Treas Reg § 1.168(i)-6(d)(2)(i).*

(n47)Footnote 458.6. *Treas Reg § 1.168(i)-6(c)(3)(ii) .*

(n48)Footnote 458.7. *Treas Reg* § 1.168(i)-6(c)(3), (4)(ii).

(n49)Footnote 458.8. See *IRC* § 168(c).

(n50)Footnote 458.9. *Treas Reg* § 1.168(i)-6(i)(1), (j); see § 8.21[7][h], below, for a discussion of the election.

(n51)Footnote 458.10. *Treas Reg* § 1.168(i)-6(c)(3)(iii), (4)(i).

(n52)Footnote 458.11. *Treas Reg* § 1.168(i)-6(c)(3)(iii), (4)(iii).

(n53)Footnote 458.12. See Rev Proc 87-57, 1987-2 CB 687, § 8.

(n54)Footnote 458.13. *Treas Reg* § 1.168(i)-6(e).

(n55)Footnote 458.13.1. *Treas Reg* § 1.168(i)-6(c)(4)(v).

(n56)Footnote 458.13.2. *Treas Reg* § 1.168(i)-6(c)(5)(ii)(A).

(n57)Footnote 458.13.3. *Treas Reg* § 1.168(i)-6(c)(5)(i)(B); see *Treas Reg* § 1.168(i)-6(c)(6), Ex 5.

(n58)Footnote 458.14. *Treas Reg* § 1.168(i)-6(c)(6), Ex 1.

(n59)Footnote 458.14.1. *Treas Reg* § 1.168(i)-6(b)(8).

(n60)Footnote 458.15. *Treas Reg* § 1.168(i)-6(d)(1)(i).

(n61)Footnote 458.16. *Treas Reg* § 1.168(i)-6(c)(5)(iv)(A).

(n62)Footnote 458.17. See *Treas Reg* § 1.168(i)-6(c)(5)(iv)(B), which is reserved.

(n63)Footnote 458.18. *Treas Reg* § 1.168(i)-6(d)(4); see *Treas Reg* § 1.168(i)-6(c); see § 8.21[7][c], above, for the general rule.

(n64)Footnote 458.18.1. *Treas Reg* § 1.168(i)-6(d)(4).

(n65)Footnote 458.19. *Treas Reg* § 1.168(i)-6(d)(2)(i), (ii).

(n66)Footnote 458.20. *Treas Reg* § 1.168(i)-6(i)(1), (j).

(n67)Footnote 458.21. *Treas Reg* § 1.168(i)-6(i)(1).

(n68)Footnote 458.21.1. *Treas Reg* § 1.168(i)-6(j)(1).

(n69)Footnote 458.21.2. *Treas Reg* § 1.168(i)-6(j)(1), (3).

(n70)Footnote 458.22. *Treas Reg* § 1.168(i)-6(j)(2).

(n71)Footnote 458.22.1. *Treas Reg* § 1.168(i)-6(j)(1).

(n72)Footnote 458.23. *Treas Reg* § 1.168(i)-6(j)(4).

(n73)Footnote 458.24. See *Treas Reg* §§ 1.168(k)-1, 1.1400L(b)-1.

(n74)Footnote 458.25. See *IRC* § 168(k)(2), before amendment by Pub Law No 110-185.

(n75)Footnote 458.26. *Treas Reg* §§ 1.168(k)-1(f)(5)(i), (iii)(A), 1.1400L(b)-1(f)(5). See *IRC* § 168(k)(4), before repeal by Pub Law No 110-185; the same rule applies to qualified New York Liberty Zone property (see *IRC* § 1400L(b)(2)).

(n76)Footnote 458.26.1. *Treas Reg* §§ 1.168(k)-1(f)(5)(iii)(B), 1.1400L(b)-1(f)(5).

(n77)Footnote 458.27. § 62.21[4], 1.1400L(b)-1.

(n78)Footnote 458.28. *Treas Reg* § 1.168(i)-6(b)(9), (10), 1.168(i)-6(h).

(n79)Footnote 458.29. *Treas Reg* § 1.1031(j)-1.

(n80)Footnote 458.30. See TD 9314 .



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Federal Taxes Affecting Real Estate

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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.22

§ 8.22 Holding Period for Property Received in Like-Kind Exchanges

The holding period of qualifying like-kind replacement property received in a Section 1031 exchange includes the period for which the taxpayer held the relinquished property that was transferred in the exchange. The "tacking" of holding periods applies only if the replacement property has the same basis in whole or in part to the taxpayer as the relinquished property, and if, at the time of the exchange the relinquished property was a capital asset or property used in a trade or business. The so-called tacking of holding periods reflects the policy of Section 1031 that like-kind exchanges represent a continuing investment. n459

When multiple properties with different holding periods are exchanged, holding periods must be determined for each of the properties. In fact, a single property may arguably have different holding periods for different portions of its basis. n460

Boot received in a like-kind exchange has a holding period beginning on the date of the exchange, because its basis is determined by its fair market value on the date of the exchange. n461

FOOTNOTES:

(n1)Footnote 459. *IRC § 1223(1)*.

(n2)Footnote 460. See Rev Rul 62-140, 1962-2 CB 181 .

(n3)Footnote 461. See *IRC §§ 1031(d), 1223(1)*.



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Federal Taxes Affecting Real Estate

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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.23

§ 8.23 Exchanges of Multiple Properties

[1] In General

The application of *IRC Section 1031* generally requires a property-by-property comparison for computing the gain recognized and the basis of property received in a like-kind exchange. The regulations provide an exception for exchanges of multiple properties. n462 Although the exception applies broadly to exchanges of personal property, it can come into play in any exchange of real estate that also includes a transfer of personal property. Typical scenarios would be exchanges involving motels, hotels, and condominiums that include their furnishings or exchanges of entire businesses. n463

It is not necessary that the different types of property be connected or related in use for the exception for exchanged of multiple properties to apply. All that is necessary is that one of the following conditions be present: n464

- the properties involved in the exchange can be separated into more than one "exchange group"; or
- if only one exchange group is created, there is more than one property being transferred or received within that exchange group.

The following steps are involved in applying the regulation:

- First, the properties transferred and the properties received by the taxpayer in the exchange must be separated into exchange groups in the manner provided in the regulations. n465
- Second, all liabilities assumed by the taxpayer as part of the transaction are offset by all liabilities of which the taxpayer is relieved as part of the transaction, with the excess liabilities assumed or relieved then allocated in accordance with the regulations. n466
- Third, the rules of *IRC Section 1031* and the regulations are applied separately to each exchange group to determine the amount of gain recognized in the exchange. n467
- Finally, the rules of *IRC Section 1031* and the regulations are applied separately to each exchange

group to determine the basis of the properties received in the exchange. n468

The regulations provide detailed examples of determinations required under the multiple asset exception. n469

Even though properties exchanged are of like kind and no cash is received in the exchange, it is still possible that some of the gain realized from the transaction must be recognized when multiple properties are exchanged.

For example, assume a taxpayer exchanges Property A and Property B for Property C and Property D. The fair market values of the exchanged properties are as follows:

Property A	\$100	Property C	\$85
Property B	\$250	Property D	\$265
Total	\$350		\$350

Assume also that Property A is of like-kind to Property C (but not to Property D), Property B is of like-kind to Property D (but not Property C), and the exchanging taxpayer has a \$0 adjusted basis in Property A and B. Even though there is an exchange of like-kind properties worth \$350, the taxpayer is considered to have received \$15 of non-like kind property. That is, since Property A, with a fair market value of \$100, was exchanged for Property C, which is worth \$85, the exchanging taxpayer is considered to have received \$15 worth of Property D for Property A and Property D is not of like-kind to Property A. Consequently, the taxpayer has \$15 of gain that is not deferred under *IRC Section 1031*. n469.1

[2] Separation of Properties into Exchange Groups

The exception for multiple property exchanges applies if the properties involved in the exchange can be placed in more than one exchange group. An "exchange group" consists of all properties transferred and received within an exchange that are of a like-kind or like-class. Thus, two or more exchange groups would be likely in an exchange that includes properties that are not like-kind--such as real estate and personal property--but both of which might qualify under *IRC Section 1031*. n470

Different categories of personal property are also placed in different exchange groups. For example, all properties within the same General Asset Class or within the same Product Class are within the same exchange group.

If a property may be placed in more than one exchange group, the taxpayer may include the property in any of those groups. Each exchange group must consist of at least one property transferred and at least one property received in the exchange. n471

The main restriction is that only property otherwise subject to *IRC Section 1031* may be placed within an exchange group. Money or any property that is expressly excluded from the operation of *IRC Section 1031* n472 may not be included within an exchange group. Thus, stock in trade and other property held primarily for sale, inventory, stocks, bonds, notes, other securities or evidences of indebtedness, interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action cannot be placed in an exchange groups. The other notable restriction is that property otherwise eligible for *IRC Section 1031* that is transferred in the exchange, but which is not like-kind or like-class with any other property in the exchange, cannot be placed in an exchange group. n473

Once properties are placed in appropriate exchange groups, the fair market value for each property transferred and each property received must be determined. In addition, the adjusted basis for each property transferred by the taxpayer in the exchange must be determined. n474

In addition, for each exchange group, an exchange group surplus or exchange group deficiency must be calculated. An "exchange group deficiency" is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received in that exchange group (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group). An "exchange group surplus" is the excess of the aggregate fair market value of the properties received in an exchange group (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) over the aggregate fair market value of the properties transferred in that exchange group. n475

If the aggregate fair market value of the properties transferred in all exchange groups differs from the aggregate fair market value of all properties received in all exchange groups, taking liabilities into account, n476 a "residual group" is created. The residual group consists of an amount of money or other property having an aggregate fair market value equal to the difference in the aggregate fair market values between all properties transferred and all properties received. Thus, the residual group will consist either of money or other property transferred in the exchange or money or other property received in the exchange, but not both. Unlike the exchange groups, the residual group *may* include money or other property otherwise expressly excluded from nonrecognition under *IRC Section 1031*. It also may include property otherwise eligible for *IRC Section 1031* that is transferred or received in the exchange, but which is not like-kind or like-class with any other property in the exchange. n477

[3] Treatment of Liabilities

All liabilities assumed by the taxpayer as part of the exchange must be offset against all liabilities of which the taxpayer is relieved as part of the exchange. If the amount of liabilities assumed by the taxpayer exceeds the amount of liabilities of which the taxpayer is relieved, the excess is allocated among the exchange groups (but not to the residual group) in proportion to the aggregate fair market value of the properties received by the taxpayer in each exchange group. The amount of excess liabilities assumed by the taxpayer that are allocated to each exchange group cannot exceed the aggregate fair market value of the properties received in the exchange group. If the amount of liabilities of which the taxpayer is relieved exceeds the amount of liabilities assumed by the taxpayer, the excess is allocated to the residual group. n478

[4] Computation of Gain

The rules of *IRC Section 1031* and regulations are applied separately to each exchange group to determine the amount of any gain that must be recognized in the exchange. This is done by first computing an "exchange group surplus" or "exchange group deficiency" for each exchange group. An exchange group surplus is the excess of the aggregate fair market value of the replacement properties in an exchange group, less any allocated excess liabilities assumed, over the fair market value of the relinquished properties in that exchange group. An exchange group deficiency is the excess of the aggregate fair market value of the relinquished properties in an exchange group over the aggregate fair market value of the properties received, less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group. n479

The amount of gain or loss realized in each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized, or the amount of the "exchange group deficiency," if any. The total amount of gain recognized for the transaction is the sum of the amount of gain recognized from each exchange group. Losses realized with respect to an exchange group are not recognized. n480

Any gains or losses with respect to properties transferred by the taxpayer that are not within any exchange group or the residual group are determined under regular rules outside of *IRC Section 1031*. n481

[5] Determination of Basis of Properties Received

In an exchange of multiple properties, the aggregate bases of properties received in each of the exchange groups (but not the residual group) is the aggregate adjusted bases of the properties transferred within that exchange group, adjusted as follows: n482

- increased by the amount of gain recognized by the taxpayer with respect to that exchange group;
- increased by the amount of the exchange group surplus, or decreased by the amount of the exchange group deficiency; and
- increased by the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group.

The total basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is its fair market value. n483

FOOTNOTES:

(n1)Footnote 462. *Treas Reg § 1.1031(j)-1*.

(n2)Footnote 463. See *Treas Reg § 1.1031(j)-1(a)*.

(n3)Footnote 464. *Treas Reg § 1.1031(j)-1(a)(1)*.

(n4)Footnote 465. *Treas Reg § 1.1031(j)-1(a)(2)(i)*; see [2], below, for a discussion.

(n5)Footnote 466. *Id.*; see [3], below, for a discussion.

(n6)Footnote 467. *Id.*; see [4], below, for a discussion.

(n7)Footnote 468. *Id.*; see [5], below, for a discussion.

(n8)Footnote 469. See *Treas Reg § 1.1031(j)-1(d)*.

(n9)Footnote 469.1. See *Treas Reg § 1.1031(j)-1*; see *Ltr Rul 200901004*, *Ltr Rul 200842019* (exchange of leases, leasehold improvements and office furniture).

(n10)Footnote 470. *Treas Reg § 1.1031(j)-1(b)(2)*.

(n11)Footnote 471. *Treas Reg § 1.1031(j)-1(b)(2)(i)*; see *IRC § 1031(a)(2)*. General asset classes are set forth in *Treas Reg § 1.1031(a)-2(b)(2)* and *Rev Proc 87-56, 1987-2 CB 674*, as updated periodically in various revenue procedures.

(n12)Footnote 472. See *IRC § 1031(a)(2)*.

(n13)Footnote 473. *Treas Reg § 1.1031(j)-1(b)(2)(i)*; see *IRC § 1031(a)(2)*.

(n14)Footnote 474. *Treas Reg § 1.1031(j)-1(b)(1)*.

(n15)Footnote 475. *Treas Reg § 1.1031(j)-1(b)(2)(iv)*.

(n16)Footnote 476. See *Treas Reg § 1.1031(j)-1(b)(2)(ii)*; see [3], below, for a discussion of determination of

liabilities.

(n17)Footnote 477. *Treas Reg § 1.1031(j)-1(b)(2)(iii)*.

(n18)Footnote 478. *Treas Reg §§ 1.1031(j)-1(a)(2)(i), 1.1031(j)-1(b)(2)(ii)*.

(n19)Footnote 479. *Treas Reg § 1.1031(j)-1(b)(2)(iv)*.

(n20)Footnote 480. *Treas Reg § 1.1031(j)-1(b)(3)(i)*.

(n21)Footnote 481. See *IRC § 1001*.

(n22)Footnote 482. *Treas Reg § 1.1031(j)-1(c)*.

(n23)Footnote 483. *Id.*



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.24

§ 8.24 Depreciation Recapture in Section 1031 Exchanges

[1] Application of Recapture Rules to Real Estate

Depreciation recapture is the process by which gain realized on the sale, exchange, or other disposition of property is treated as ordinary income to the extent of all or part of the depreciation deductions previously taken on the property. n484 The recapture provisions operate independently of the nonrecognition provisions of the Internal Revenue Code, and recognition of recapture income may be required even though gain is not otherwise recognized under Section 1031.

Recapture rules apply to like-kind exchanges involving Section 1245 and/or Section 1250 property. n485 Very few types of real property are Section 1245 property, n486 so for most real property any recapture rules that do come into play are those under *IRC Section 1250*, as discussed in [2], below. n487

Under *IRC Section 1250*, any depreciation on real estate that is held for one year or less must be recaptured as ordinary income if the property is disposed of. n488 For any real property held more than one year, however, recapture is required only to the extent that depreciation adjustments exceed those that would have been taken under the straight line method. n489 Real property placed in service after 1986 cannot be depreciated under an accelerated depreciation method. n490 Therefore, on a like-kind exchange of this real property, there will be no amount to be recaptured under *IRC Section 1250*. n491

The depreciation recapture rules of *IRC Section 1245*, rather than *IRC Section 1250*, can come into play for certain real property that was placed in service after 1980 and before 1987. Recapture under Section 1245 applies for any real estate that was classified as "Section 1245 recovery property" under pre-1987 ACRS depreciation rules. n492

"Section 1245 recovery property" includes real property (other than real property for which straight-line depreciation was elected) that had a 15-18-or 19-year recovery period under pre-1987 ACRS depreciation rules, and certain low-income residential property. n493 When Section 1245 recovery property is disposed of in a like-kind exchange, *IRC Section 1245* recapture rules apply, and all depreciation adjustments--not just those in excess of straight line depreciation--are subject to recapture as ordinary income. n494 These rules for recapture are discussed in [3], below.

[2] Section 1250 Recapture in Like-Kind Exchanges

Section 1250 property includes nearly all real estate that is or has been subject to depreciation deductions. This would

include improvements on real estate, such as buildings, but would not include unimproved land, which is not depreciable. n495

If Section 1250 property is exchanged in a transaction in which gain is not recognized in whole or in part under Section 1031, recapture under *IRC Section 1250* may be required if the real estate has been depreciated and has been held for one year or less. Recapture may also be necessary if the property has been held for more than one year and has had depreciation adjustments in excess of straight line depreciation. (This can occur only for real property that was placed in service before 1987.) n496

Any recapture gain that must be recognized is treated as ordinary income. n497 The amount of recapture gain taken into account is limited to the greater of the following: n498

- the amount of gain recognized under Section 1031; or
- the amount by which the recapture amount exceeds the fair market value of Section 1250 property received in the exchange.

Thus, the amount required to be recognized under Section 1250 can exceed the amount required to be recognized under Section 1031, and cause the ordinary income to be recognized in what is ostensibly a tax-free exchange. The second limitation above causes recapture income to be recognized to the extent that the recapture amount exceeds the fair market value of the Section 1250 property received in the exchange. To the extent that the recapture amount is covered by the fair market value of the Section 1250 property received, recognition of recapture income is deferred until the Section 1250 property is sold. n499

Note:

It should be noted that a taxpayer can relinquish Section 1250 property in a like-kind exchange under *IRC Section 1031* without receiving Section 1250 property in return as replacement property. This can occur, for example, when a taxpayer exchanges improved real estate for unimproved land. Although the unimproved land is like-kind to the improved real estate for purposes of *IRC Section 1031*, it is not Section 1250 property that would be taken into account in applying the second limitation above. n500

[3] Dispositions Subject to Recapture Under *IRC Section 1245*

Upon the sale, exchange, or other disposition of property subject to recapture under *IRC Section 1245*, all realized gain must be treated as ordinary income to the extent of the sum of the depreciation deductions taken on the property. n501

Recapture under *IRC Section 1245* applies primarily to personal property. It comes into play for real estate primarily with respect to real estate placed in service between 1980 and 1987 that qualifies as "Section 1245 recovery property." "Section 1245 recovery property" includes real property (other than real property for which straight-line depreciation was elected) that had a 15-18-or 19-year recovery period under pre-1987 ACRS depreciation rules, and certain low-income residential property. n502 Recapture under *IRC Section 1245* applies only to very limited types of real property placed in service after 1986. n503

If property subject to recapture under Section 1245 is disposed of and gain is not recognized in whole or in part under *IRC Section 1031*, the amount of recapture income which must be recognized is limited to the sum of the following: n504

- the gain recognized on the disposition without regard to Section 1245; plus

■ the fair market value of the property acquired which is not Section 1245 property (other than boot causing recognition of gain under *IRC Section 1031*).

FOOTNOTES:

(n1)Footnote 484. *IRC §§ 1245, 1250.*

(n2)Footnote 485. *IRC §§ 1245(b)(4), 1250(d)(4).*

(n3)Footnote 486. *IRC § 1245(a)(3)(B), (C), (D), (E).*

(n4)Footnote 487. *IRC Section 1250.*

(n5)Footnote 488. *IRC § 1250(a)(1), (b)(1).*

(n6)Footnote 489. *IRC § 1250(b)(1).*

(n7)Footnote 490. *IRC § 168(c).*

(n8)Footnote 491. *IRC § 1250(a)(1).*

(n9)Footnote 492. See former *IRC § 1245(a)(5), before repeal* by Pub L No 99-514, § 201(d)(11)(D).

(n10)Footnote 493. *Id.*

(n11)Footnote 494. *IRC § 1245(a)(1), (b)(4).*

(n12)Footnote 495. *IRC § 1250(c); see IRC § 168(a)(3).*

(n13)Footnote 496. *IRC § 1250(a)(1),(b)(1); see IRC § 168(c).*

(n14)Footnote 497. *IRC § 1250(a).*

(n15)Footnote 498. *IRC § 1250(d)(4).*

(n16)Footnote 499. *IRC § 1250(d)(4)(E).*

(n17)Footnote 500. See *IRC § 1250(d)(4)(A)(ii), (d)(4)(C).*

(n18)Footnote 501. *IRC § 1245(a)(1).*

(n19)Footnote 502. See former *IRC § 1245(a)(5), before repeal* by Pub L No 99-514, § 201(d)(11)(D).

(n20)Footnote 503. See *IRC § 1245(a)(3).*

(n21)Footnote 504. *IRC § 1245(b)(4).*



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.25

§ 8.25 Receipt of Installment Obligations Received in Section 1031 Exchanges

[1] In General

A taxpayer who sells property on the installment method n505 reports as gain only a percentage of each payment received. This percentage (the gross profit ratio) is determined by dividing the gross profit to be realized on the transaction by the contract price. As a formula, the gross profit ratio is shown as follows: n506

$$\text{Gross Profit Ratio} = \frac{\text{Gross profit on transaction}}{\text{Contract price}}$$

The installment method of reporting is discussed in detail in Chapter 7.

Special rules for installment reporting apply when a seller receives both like-kind property and an installment obligation in a Section 1031 exchange. The installment obligation is treated as boot requiring recognition of realized gain. n507 The gain is not entirely recognized in the year of the exchange, however, but instead is recognized over the period of time that payments are made under the installment contract. n508

In addition, special rules apply that affect the amount of gain that must be reported on each installment. Two modifications to the above gross profit ratio formula must be made:

- the total contract price (the denominator of the gross profit ratio) does not include the value of the like-kind property permitted to be received on the exchange without recognition of gain; n509 and
- the gross profit on the transaction (the numerator of the fraction) from the exchange does not include any gain that is not recognized by reason of *IRC Section 1031(b)*. n510

Additionally, the like-kind property received on the exchange is not considered a payment in the year of sale. n511 The effect of the above rules is to assure that the taxpayer does not recognize gain until cash or other boot is actually received. n512

Example:

T exchanges real property with an adjusted basis of \$500,000 for like-kind real estate worth \$800,000 and an installment note for \$200,000. Under *IRC Section 1031(b)*, the recognized gain is \$200,000, the amount of the boot. In applying the installment sale rules, the contract price is \$200,000 (\$1,000,000 total price less the \$800,000 value of the like-kind property received). The gross profit is \$200,000 (\$500,000 realized gain less \$300,000 of the gain that is not recognized under *IRC Section 1031*). Therefore, 100 percent (\$200,000/\$200,000) of each payment on the installment note is taxable gain. The receipt of the like-kind property is not treated as a payment for this purpose. Thus, the \$200,000 of recognized gain on the exchange is reported only as payments are received on the note. n513

Note:

The allocation of basis between the replacement property and the installment obligation is uncertain. Regulations proposed in 1984 n514 provided that the taxpayer's basis in the relinquished property was first allocated to the like-kind replacement property received in the exchange to the extent of its fair market value. Any remaining amount was referred to as "excess basis," and was in effect allocated to the installment obligation and other boot. n515 The effect of this allocation of basis to replacement property to the extent of its fair market value (rather than allocating basis according to respective fair market values of the replacement property and the installment obligation) was to maximize the portion of each payment on the installment obligation that is taxable.

The proposed regulations were removed, however, n516 and the IRS has not issued further guidance. A plausible position might be to allocate the taxpayer's basis in the relinquished property to the replacement property, boot, and installment obligation in accordance with their fair market values on the date of the exchange, as is done for allocations among multiple qualifying replacement properties. n517 Another possible position would be to make an allocation under *IRC Section 1031(d)*, which would first allocate basis to boot and the installment obligation to the extent of their fair market values as discussed in § 8.21[2].

[2] Deferred Exchanges

The regulations coordinate the like-kind exchange rules with the installment sale rules when a deferred exchange is involved. n518 Several rules apply, and all assume that a deferred exchange is present, that a qualified intermediary is used, and that the property relinquished by the taxpayer was otherwise qualified property under *IRC Section 1031*.

First, in a deferred exchange using intermediaries, regulations allow taxpayers to treat the receipt of an evidence of indebtedness of the transferee of a qualified intermediary as the receipt of an evidence of indebtedness of the person acquiring the property for purposes of *IRC Section 453*. n519

Second, securing an obligation by cash or a cash equivalent could, absent a rule to the contrary, result in constructive receipt of the amount of the secured obligation. To avoid this occurrence, the regulations provide that if an exchange party's obligation to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, the determination of whether the taxpayer has received a payment for purposes of the installment sale provisions will be made without regard to the fact that security in the form of cash or cash equivalent is held in a qualified escrow account or qualified trust. This rule ceases to apply at the earlier of the following: n520

- the time that the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or the cash equivalent held in the qualified escrow account or qualified trust; n521 or

- at the end of the exchange period.

Finally, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of the installment sale provisions is made as if the qualified intermediary is not the taxpayer's agent. n522

The above exceptions for qualified intermediaries n523 apply only if the taxpayer has a bona fide intent to enter into a deferred exchange of like-kind property at the beginning of the exchange. n524

It appears that this requisite intent may be present, however, even if the like-kind requirement is not in fact met. In a case involving an exchange of timber-cutting rights for realty, it was unclear under state law whether the two interests were of like-kind. The Tax Court did not resolve this issue, but determined that whether or not the like-kind requirement was met, the relevant intent was present. This was in part because of the presence of the following factors: n525

- the exchange agreement expressly made the transaction conditioned on "reasonable cooperation and a tax free exchange qualifying under Section 1031";
- the taxpayer used a qualified escrow account and a proper escrow agent, as required by regulations; n526
- the taxpayer identified and received the replacement properties within the 45-day and 180-day periods as required by *IRC Section 1031(a)(3)*;
- the taxpayer credibly testified that he intended to have a like-kind exchange; and
- in planning the transaction, the taxpayer relied on a well-known timber taxation expert and from his long-time accountant.

FOOTNOTES:

(n1)Footnote 505. See *IRC § 453(a), (c)*.

(n2)Footnote 506. *IRC § 453(c)(6)*.

(n3)Footnote 507. See *IRC § 1031(b)*.

(n4)Footnote 508. *IRC § 453(a)(1), (f)(6)*.

(n5)Footnote 509. *IRC § 453(f)(6)(A)*.

(n6)Footnote 510. *IRC § 453(f)(6)(B)*.

(n7)Footnote 511. *IRC § 453(f)(6)(C)*.

(n8)Footnote 512. See *IRC § 453(f)(6)*.

(n9)Footnote 513. *Id.*

(n10)Footnote 514. See *Prop Treas Reg § 1.453-1(f)*.

(n11)Footnote 515. *Prop Treas Reg § 1.453-1(f)(1)(iii)*.

(n12)Footnote 516. See TD 8270 (November 3, 1989) .

(n13)Footnote 517. See Rev Rul 68-36, 1968-1 CB 357 ; see § 62.21[4] for a discussion of allocation of basis among like-kind qualifying replacement properties.

(n14)Footnote 518. *Treas Reg* §§ 15A.453-1(b)(3)(i), 1.1031(b)-2(b), 1.1031(k)-1(j)(2).

(n15)Footnote 519. *Treas Reg* § 1.1031(k)-1(j)(2)(iii).

(n16)Footnote 520. *Treas Reg* § 1.1031(k)-1(j)(2)(i).

(n17)Footnote 521. See *Treas Reg* § 1.1031(k)-1(g)(3)(iv).

(n18)Footnote 522. *Treas Reg* § 1.1031(k)-1(j)(2)(ii).

(n19)Footnote 523. See *Treas Reg* § 1.1031(k)-1(j)(2)(i),(ii).

(n20)Footnote 524. *Treas Reg* § 1.1031(k)-1(j)(2)(iv).

(n21)Footnote 525. *Smalley v Commr*, 116 TC 450 (2001) .

(n22)Footnote 526. See *Treas Reg* § 1.1031(k)-1(g)(3).



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

1-8 Federal Taxes Affecting Real Estate § 8.26

§ 8.26 Special Rules for Exchanges Between Related Persons

[1] Loss of Nonrecognition on Exchange

Nonrecognition treatment may be lost if a taxpayer exchanges property with a related person in an exchange under which there is nonrecognition of gain or loss under *IRC Section 1031*. Nonrecognition is lost if, within two years after the date of the last transfer that was part of the original exchange, either of the following occurs: n527

- the related party disposes of the property relinquished by the taxpayer; n527.1 or
- the taxpayer disposes of the like-kind replacement property received in the exchange.

The gain or loss must be recognized under this provision as of the date of the subsequent transfer. n528

The running of the two-year testing period n529 is suspended during any period in which the holder of the exchanged property has substantially diminished risk of loss by holding a put with respect to the property, by having another person have a right to acquire the property, or by means of a short sale or a similar transaction. Thus, the two-year holding period cannot be circumvented by such means. n530

IRC Section 1031(f) is intended to deny non-recognition treatment for transactions in which related parties make like-kind exchanges of high-basis property for low-basis property in anticipation of the sale of the low-basis property. In the absence of *IRC Section 1031(f)*, a taxpayer anticipating the sale of low basis property could exchange the low basis property for high basis property owned by a related person, with the related person then selling the property received in the exchange at a reduced gain (or possibly a loss) because of the shift to that property of the related person's high basis in the property relinquished by the taxpayer in the exchange. n530.1 To prevent related parties from circumventing the rules of *IRC Section 1031(f)(1)*, *IRC Section 1031(f)(4)* provides that the nonrecognition provisions of *IRC Section 1031* do not apply to any exchange that is part of a transaction (or a series of transactions) structured to avoid the related party rules of *IRC Section 1031(f)(1)*. This generally occurs when one of the parties is cashing out its investment in real estate. n530.2

Taxpayers cannot avoid the related party rules through the use of qualified intermediaries. The IRS generally frowns on transactions in which a taxpayer exchanges relinquished property in a delayed exchange using a qualified intermediary,

and then has the qualified intermediary acquire replacement property from a related taxpayer. If there is a cash-out of the property or the receipt of cash or non like-kind property by a related taxpayer, gain or loss must be recognized even if the exchange takes place through an unrelated qualified intermediary. n530.3

Example:

Individual A owns real property (Property 1) with a fair market value of \$150x and an adjusted basis of \$50x. Individual B owns real property (Property 2) with a fair market value of \$150x and an adjusted basis of \$150x. Both Property 1 and Property 2 are held for investment. A and B are related persons. C, an individual unrelated to A or B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A or B. Pursuant to their agreement, A transfers Property 1 to QI and QI transfers Property 1 to C for \$150x. Shortly thereafter, QI acquires Property 2 from B, pays B the \$150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

A must recognize gain on the transfer of Property 1, and is not entitled to nonrecognition under *IRC Section 1031*, in light of B's receiving cash for the replacement property. Although the transaction is structured so that A engages in a like-kind exchange with a qualified intermediary (an unrelated third party) instead of B, the end result of the transaction is the same as if A had exchanged property with B followed by a sale from B to C. A's use of a qualified intermediary to circumvent the purposes of the related party rules will be unsuccessful, and A's exchange of Property 1 for Property 2 is a taxable transaction. Under *IRC Section 1001(a)*, A has gain of \$100x, the difference between the amount realized on the exchange (\$150x, the fair market value of Property 2) and A's adjusted basis in the property exchanged (\$50x). n531

The Tax Court has also rejected like-kind exchange treatment for transactions using an intermediary if the transactions are structured to avoid the related party rules. In one case, the taxpayer in a series of planned transactions transferred low basis real properties to a qualified intermediary (QI), which then sold them to unrelated third parties. The QI used the sale proceeds, as well as additional funds from the taxpayer, to purchase like-kind replacement properties for the taxpayer from a corporation related to the taxpayer. The Tax Court held that under *Treas Reg § 1.1031(a)*, the taxpayer was not entitled to defer gains realized on the exchanges, even though all of the transactions otherwise met the general requirements for like-kind exchanges. The court concluded that the transactions were economically equivalent to a direct exchange of properties between the taxpayer and a related person, followed by the related person's sale of the property relinquished by the taxpayer. The court noted that tax savings resulting from the redirection of the proceeds from the sale of the relinquished property to the related person because of the related person's high basis in the property. The Ninth Circuit affirmed the Tax Court's decision. n532 Another case involving a similar shift of low basis for high basis property through an intermediary reached the same result, even though the taxpayer used replacement property from the related person as like-kind property in the exchange only because no other suitable property could be found. That there was not a pre-arranged plan to conduct an exchange with a related person did not prevent the application of *IRC Section 1031(f)* to the exchange. n532.1

If neither the taxpayer nor the related party is cashing out its investment in real property, and no party disposes of replacement property for two years after the exchange, n532.2 however, then the like-kind exchange may be given nonrecognition treatment. n532.2.1 Even if a related party plans to dispose of property relinquished by the taxpayer in an exchange within two years, *IRC Section 1031(f)* may still not preclude nonrecognition if that disposal would not result in a "cashing out" of an investment or shifting of basis between the related parties. n532.2.2

Example:

Trust and S Corporation are related persons within the meaning of *IRC Section 1031(f)(3)*. Trust owns Building 1 and S Corporation owns Building 2. Trust has transferred Building 1, including land and improvements, to an unrelated buyer. Trust wants to defer the recognition of the gain on the transfer of

Building 1. Therefore, Trust will acquire Building 2, including land and improvements, as one of its identified replacement properties in exchange for Building 1 in a transaction intended to qualify for nonrecognition treatment under *IRC Section 1031*. S Corporation will also engage in an exchange of Building 2 for other like-kind property in a transaction intended to qualify for nonrecognition treatment under *IRC Section 1031*.

In another favorable ruling, the IRS found that *IRC Section 1031(f)* did not apply because the taxpayer and the related party were not exchanging properties directly or through a qualified intermediary (QI). The taxpayer was an LLC taxed as a partnership. It owned all of Property D LLC, a disregarded entity that owned real property in its leasing business. The taxpayer agreed to transfer its membership interest in Property D LLC to a taxable REIT subsidiary (TRS) for cash equal to its fair market value. The taxpayer also entered into an agreement with a QI under which it assigned to the QI its rights to receive all proceeds payable by TRS. TRS would pay the proceeds to QI, and the taxpayer would then convey its interest in Property D LLC to TRS. The taxpayer would then identify replacement properties and direct the QI to timely acquire and transfer them to the taxpayer. TRS anticipated selling at least part of the property it acquired within two years. The taxpayer and TRS were related under *IRC Section 1031(f)*. The IRS ruled that the taxpayer and TRS were not exchanging properties either directly or through QI. Prior to the exchange, TRS did not own any property that the taxpayer acquired in the exchange. Rather, TRS merely acquired property by purchasing it for fair market value price from QI. Because there was no transaction or series of transactions structured to avoid the related party rules, *IRC Section 1031(f)(4)* did not come into play, and the 2-year restriction on the disposition of the relinquished or replacement property n532.3 did not apply. n532.4

To facilitate their exchanges, Trust and S Corporation will enter into exchange agreements with a qualified intermediary ("QI"), under which QI will be treated as the seller of Building 1 to Buyer. Moreover, QI will be treated as acquiring Building 2 from S Corporation and transferring it to Trust in exchange for Building 1. Similarly, pursuant to S Corp's exchange agreement, QI will be treated as acquiring property to replace Building 2 ("S Corporation's Replacement Property") and transferring it to S Corporation in exchange for Building 2. S Corporation's Replacement Property is, prior to its transfer to QI, owned by a party that is not related to either Trust or S Corporation. Once all the transactions are completed, Trust will own Building 2, S Corporation will own its, and Buyer will own Building 1. Trust and S Corporation will not dispose of their replacement properties within two years of acquiring them.

IRC Section 1031(f) does not trigger recognition of any gain realized in Trust's exchange of Building 1 for Building 2 or S Corporation's exchange of Building 2 for its replacement property. *IRC Section 1031(f)(1)* does not apply to cause Trust to recognize gain on its disposition of Building 1 because Trust is exchanging property with a qualified intermediary, who is not a related party. Furthermore, because the acquisition by S Corporation of its replacement property is another tax-free exchange under *IRC Section 1031* and not a disposition that cashes out its investment in real estate, Trust's exchange is not structured to avoid the purposes of *IRC Section 1031(f)*, so no recognition of gain is required under *IRC Section 1031(f)(4)*. Upon completion of the series of transactions, both related parties will own property that is like-kind to the property they exchanged. Moreover, neither party will have ever been in receipt of cash or other non-like kind property (other than boot received in the exchange) in return for the relinquished property. n532.5

[2] "Related Person" Defined

A "related person" for purposes of this provision is any person who bears a relationship to the taxpayer as set forth in *IRC Section 267(b)* or *IRC Section 707(b)(1)*. n533 Thus, the term includes the following: n534

- family members (brothers, sisters, spouses, ancestors, and lineal descendants);
- a corporation and a more than 50 percent shareholder;
- corporations in the same controlled group;

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- grantors and trust fiduciaries;
- fiduciaries of different trusts with the same grantor;
- fiduciaries and beneficiaries of the same trust or of different trusts with the same grantor;
- trust fiduciaries and corporations more than 50 percent in value of the outstanding stock of which is owned by or for the trust or the grantor of the trust;
- persons and certain tax exempt organizations controlled by that person and family members;
- a corporation and a partnership if the same persons own more than 50 percent interests;
- two S corporations or an S corporation and a C corporation with more than 50 percent overlapping interests;
- executors or an estate and a beneficiary of the estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest;
- partnerships and partners with more than 50 percent of the capital or profits interest; or
- partnerships in which the same persons own more than 50 percent of the capital or profits interest.

An individual is not considered a related person to a trust whose trustees are the spouse of that individual's deceased sibling, and that deceased sibling's children. n534.1

[3] Excluded Dispositions

The following dispositions do not trigger the application of the related party nonrecognition rule: n535

- any disposition that occurs after the death of the taxpayer or of the related person;
- any disposition in a compulsory or involuntary conversion, if the exchange occurred before any threat or other indication of the imminence of the conversion was known;
- any disposition that does not have as one of its principal purposes the avoidance of federal income tax; n536 or
- any disposition occurring more than two years after the original exchange. n537

The "non-tax avoidance exception" for dispositions that do not have as one of their principal purposes the avoidance of federal income tax n537.1 generally applies only to the following: n537.2

- transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of those properties;
- dispositions of property in nonrecognition transactions; and

- transactions that do not involve the shifting of basis between properties.

FOOTNOTES:

(n1)Footnote 527. *IRC § 1031(f)(1)*.

(n2)Footnote 527.1. The cutting of timber on timberland is not a disposition of the underlying real estate for this purpose [*Ltr Rul 200541037*].

(n3)Footnote 528. *IRC § 1031(f)(1)*.

(n4)Footnote 529. See *IRC § 1031(f)(1)(C)*.

(n5)Footnote 530. *IRC § 1031(g)*.

(n6)Footnote 530.1. See *Teruya Brothers, Ltd & Subsidiaries v Commr*, 124 TC 45 (2005) , *affd* 580 F3d 1038, 2009 US App Lexis 20022 (9th Cir 2009) , *cert denied* 2010 US LEXIS 1247 (2010) ; *Ocmulgee Fields, Inc v Commr*, 132 TC No 6 (2009) .

(n7)Footnote 530.2. See *Rev Rul 2002-83, 2002-49 IRB 927 ; Ltr Rul 200616005* .

(n8)Footnote 530.3. *Rev Rul 2002-83, 2002-49 IRB 927 ; IRC § 1031(f)*; see *TAM 9748006* .

(n9)Footnote 531. *Rev Rul 2002-83, 2002-49 IRB 92* .

(n10)Footnote 532. *Teruya Brothers, Ltd & Subsidiaries v Commr*, 124 TC 45 (2005) , *affd* 580 F3d 1038, 2009 US App Lexis 20022 (9th Cir 2009) , *cert denied* 2010 US LEXIS 1247 (2010) .

(n11)Footnote 532.1. *Ocmulgee Fields, Inc v Commr*, 132 TC No 6 (2009) .

(n12)Footnote 532.2. See *IRC § 1031(f)(1)(C)*.

(n13)Footnote 532.2.1. *Ltr Rul 200616005* .

(n14)Footnote 532.2.2. *Ltr Rul 201027036* .

(n15)Footnote 532.3. See *IRC § 1031(f)(1)(C)*.

(n16)Footnote 532.4. *Ltr Rul 200709036* .

(n17)Footnote 532.5. *Ltr Rul 200616005* .

(n18)Footnote 533. *IRC § 1031(f)(3)*.

(n19)Footnote 534. *IRC §§ 267(b), 707(b)(1), 1031(f)(3)*.

(n20)Footnote 534.1. *Ltr Ruls 200919027, 200920032*.

(n21)Footnote 535. *IRC § 1031(f)(1)(C), (2), (4)*.

(n22)Footnote 536. See *TAM 200126007* (detailed discussion of *IRC § 1031(f)(4)*); *IRS FSA 200137003* .

(n23)Footnote 537. See *IRS FSA 200137003* (even if parties intended from the beginning to dispose of replacement property after the two-year period, IRS ruled that this intent does not require recognition of the original gain in the exchange unless the exchange was a sham).

(n24)Footnote 537.1. *IRC § 1031(f)(2)(C)*.

(n25)Footnote 537.2. See Rev Rul 2002-83, *2002-49 IRB* 927 ; CCA 201013038 ; HR Rep No 247, at 1341; S Print No 56, at 152.



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CHAPTER 8 Tax-Deferred Like-Kind Exchanges

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§ 8.27 Disposition of Principal Residence in Like-Kind Exchange

[1] In General

The IRS has issued a pro-taxpayer revenue procedure that provides guidance when both *IRC Section 121* and *IRC Section 1031* apply to a single exchange of property. n538 Neither statute addresses their dual application to a single exchange, as when a taxpayer exchanges a residence containing a home office, or a former residence, for property held for the production of income or used in a trade or business. Both *IRC Sections 121* and *1031* can come into play because *IRC Section 121* does not require the property to be the taxpayer's principal residence on the sale or exchange date. All that is required is that the taxpayer have used the house as a principal residence for at least 2 years during the 5-year period prior to the exchange. n539 If those requirements are met, and all or a portion of the property has been converted to use in a trade or business (including a home office) or is held for investment at the time of the exchange, *IRC Section 1031* may then also come into play.

Revenue Procedure 2005-14 indicates that, in certain cases, a homeowner may benefit from both the home-sale exclusion and the like-kind deferral. The revenue procedure makes clear that to benefit from both provisions and from the guidance set forth in the revenue procedure, the property must have been used consecutively or concurrently as a home and a business (e.g. rental residence) at the time of the exchange. In other words, *Revenue Procedure 2005-14* applies only if (1) the property meets the ownership and use requirements of *IRC Section 121*, and (2) at the time of the exchange, at least a portion of the property is used in a trade or business or is held for investment. n540

The revenue procedure sets forth an ordering rule for applying *IRC Sections 121* and *1031*, an application of *IRC Section 1031* to depreciation recapture amounts that are not excluded under *IRC Section 121*, the manner in which boot is taken into account in applying *IRC Section 1031*, and a method for computing the basis of replacement property received in an exchange. n541 The application of the rules vary, depending on whether (1) the entire house is a rental property, (2) the property contains a home office, or (3) the business property is separate from the dwelling unit or a part of it. The revenue procedures also provides six detailed examples with those factual variations, illustrating the treatment of gain recognition, depreciation, and boot. n542

[2] Application of Revenue Procedure 2005-14

The manner in which *IRC Sections 121* and *1031* apply to an exchange is as follows: n543

A. Computation of Gain

1. *IRC Section 121* is applied to gain realized before applying *IRC Section 1031*.
2. *IRC Section 1031* is then applied to gain attributable to depreciation. The principal residence exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. n544 Nevertheless, *IRC Section 1031* may apply to defer recognition of that gain.
3. In applying *IRC Section 1031*, cash or other non-like-kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to the extent that the boot exceeds the gain excluded under *IRC Section 121* with respect to the relinquished business property.

B. Computation of Basis

In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under *IRC Section 121* is treated as gain recognized by the taxpayer. Thus, under *IRC Section 1031(d)*, the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under *IRC Section 121*.

[3] Examples Illustrating Revenue Procedure 2005-14

Revenue Procedure 2005-14 provides six examples explaining the interactions of *IRC Sections 121* and *1031* in a qualifying exchange. In each example, the taxpayer is assumed to be an unmarried individual, and the property or a portion of it has been used in the taxpayer's trade or business or held for investment within the meaning of *IRC Section 1031(a)* as well as used as a principal residence as required under *IRC Section 121*. The examples are as follows: n545

Example 1. (i) Taxpayer A buys a house for \$210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of \$20,000. In 2006, A exchanges the house for \$10,000 of cash and a townhouse with a fair market value of \$460,000 that A intends to rent to tenants. A realizes gain of \$280,000 on the exchange.

(ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both *IRC Sections 121* and *1031*. *IRC Section 121* does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, n546 A may exclude gain under *IRC Section 121*. Because the house is investment property at the time of the exchange, A may also defer gain under *IRC Section 1031*.

(iii) A applies *IRC Section 121* to exclude \$250,000 of the \$280,000 gain before applying the nonrecognition rules of *IRC Section 1031*. A may defer the remaining gain of \$30,000, including the \$20,000 gain attributable to depreciation, under *IRC Section 1031*. Although A receives \$10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of *IRC Section 1031(b)* only to the extent the boot exceeds the amount of excluded gain.

(iv) A's basis in the replacement property is \$430,000, which is equal to the basis of the relinquished property at the time of the exchange (\$190,000) increased by the gain excluded under *IRC Section 121* (\$250,000), and reduced by the cash A receives (\$10,000).

Example 2. (i) Taxpayer B buys a property for \$210,000. The property consists of two separate dwelling units, n547

including both a house and a guesthouse. From 2001 until 2006, B uses the house as B's principal residence and uses the guesthouse as an office in B's trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B's replacement properties is \$360,000. The fair market value of the replacement residence is \$240,000 and the fair market value of the replacement business property is \$120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of \$30,000 for the business use. B realizes gain of \$180,000 on the exchange.

(ii) Under *IRC Section 121*, B may exclude gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guesthouse.ⁿ⁵⁴⁸ However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis, which is 1/3 of \$210,000 basis, or \$70,000, adjusted by \$30,000 depreciation) under *IRC Section 1031*. These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	\$360,000	\$240,000	\$120,000
Basis	\$210,000	\$140,000	\$70,000
Depreciation adjustment	\$ 30,000		\$ 30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000
Realized gain	\$180,000	\$100,000	\$ 80,000
Gain excluded under § 121	\$100,000	\$100,000	
Gain deferred under § 1031	\$80,000		\$ 80,000

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under *IRC Section 121* and B receives no boot and recognizes no gain or loss in the exchange, B's basis in the replacement business property is equal to B's basis in the relinquished business property at the time of the exchange (\$40,000). B's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000).

Example 3. (i) Taxpayer C buys a property for \$210,000. The property consists of a house that constitutes a single dwelling unit.ⁿ⁵⁴⁹ From 2001 until 2006, C uses 2/3 of the house (by square footage) as C's principal residence and uses 1/3 of the house as an office in C's trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C's trade or business. The total fair market value of C's replacement properties is \$360,000. The fair market value of the replacement residence is \$240,000 and the fair market value of the replacement business property is \$120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of \$30,000 for the business use. C realizes gain of \$180,000 on the exchange.

(ii) Under *IRC Section 121*, C may exclude the gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000) because C meets the ownership and

use requirements for that portion of the property.

(iii) The remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis, which is 1/3 of \$210,000 basis, or \$70,000, adjusted by \$30,000 depreciation) is allocable to the business portion of the house (the office). C applies *IRC Section 121* before applying the non-recognition rules of *IRC Section 1031*. C may exclude \$50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. n550 C may not exclude that portion of the gain (\$30,000) attributable to depreciation deductions, but may defer the remaining gain of \$30,000 under *IRC Section 1031*. These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	\$360,000	\$240,000	\$120,000
Basis	\$210,000	\$140,000	\$70,000
Depreciation adjustment	\$ 30,000		\$30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000
Realized gain	\$180,000	\$100,000	\$ 80,000
Gain excluded under § 121	\$150,000	\$100,000	\$ 50,000
Gain deferred under § 1031	\$30,000		\$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000). C's basis in the replacement business property is \$90,000, which is equal to C's basis in the relinquished business property at the time of the exchange (\$40,000), increased by the gain excluded under *IRC Section 121* attributable to the relinquished business property (\$50,000).

Example 4. (i) The facts are the same as in Example 3 except that C also receives \$10,000 of cash in the exchange and the fair market value of the replacement business property is \$110,000, which is \$10,000 less than the fair market value of the business portion of the relinquished property (\$120,000).

(ii) Under *IRC Section 121*, C may exclude the gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000).

(iii) The remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. C applies *IRC Section 121* to exclude gain before applying the nonrecognition rules of *IRC Section 1031*. C may exclude \$50,000 of the gain allocable to the business portion of the house but may not exclude the \$30,000 of gain attributable to depreciation deductions. n551 C may defer the \$30,000 of gain under *IRC Section 1031*. Although C receives \$10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of *IRC Section 1031(b)* only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	\$360,000	\$240,000	\$110,000 + 10,000
Basis	\$210,000	\$140,000	\$70,000
Depreciation adjustment	\$ 30,000		\$ 30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000
Realized gain	\$180,000	\$100,000	\$ 80,000

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Gain excluded under § 121	\$150,000	\$100,000	\$ 50,000
Gain deferred under § 1031	\$ 30,000		\$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000). C's basis in the replacement business property is \$80,000, which is equal to C's basis in the relinquished business property (\$40,000), increased by the gain excluded under *IRC Section 121* (\$50,000), and reduced by the cash (\$10,000) received.

Example 5. (i) The facts are the same as in Example 3 except that the total fair market value of the replacement properties is \$540,000. The fair market value of the replacement residence is \$360,000, the fair market value of the replacement business property is \$180,000, and C realizes gain of \$360,000 on the exchange.

(ii) Under *IRC Section 121*, C may exclude the gain of \$220,000 allocable to the residential portion of the house (2/3 of \$540,000 amount realized, or \$360,000, minus 2/3 of \$210,000 basis, or \$140,000).

(iii) The remaining gain of \$140,000 (1/3 of \$540,000 amount realized, or \$180,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. C excludes the gain before applying the nonrecognition rules of *IRC Section 1031*. C may exclude \$30,000 of the gain allocable to the business portion, at which point C will have excluded the maximum limitation amount of \$250,000. n552 C may defer the remaining gain of \$110,000 (\$140,000 realized gain minus the \$30,000 gain excluded under *IRC Section 121*), including the \$30,000 gain attributable to depreciation, under *IRC § 1031*. These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	\$ 540,000	\$360,000	\$180,000
Basis	\$ 210,000	\$140,000	\$70,000
Depreciation adjustment	\$ 30,000		\$30,000
Adjusted basis	\$180,000	\$140,000	\$40,000
Realized gain	\$360,000	\$ 220,000	\$140,000
Gain excluded under § 121	\$250,000	\$220,00	\$30,000
Gain deferred under § 1031	\$110,000		\$110,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$360,000). C's basis in the replacement business property is \$70,000, which is equal to C's basis in the relinquished business property (\$40,000), increased by the amount of the gain excluded under *IRC Section 121* (\$30,000).

Example 6. (i) The facts are the same as in Example 3 except that the total fair market value of the replacement properties is \$750,000. The fair market value of the replacement residence is \$500,000, the fair market value of the replacement business property is \$250,000, and C realizes gain of \$570,000 on the exchange.

(ii) The gain allocable to the residential portion is \$360,000 (2/3 of \$750,000 amount realized, or \$500,000, minus 2/3 of \$210,000 basis, or \$140,000). C may exclude gain of \$250,000 from gross income under *IRC Section 121*. C must include in income the gain of \$110,000 allocable to the residential portion that exceeds the *IRC Section 121(b)* exclusion limitation amount.

(iii) The remaining gain of \$210,000 (1/3 of \$750,000 amount realized, or \$250,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. C may defer the \$210,000 of gain, including the \$30,000 gain attributable to depreciation, under *IRC Section 1031*. These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	\$750,000	\$500,000	\$250,000
Basis	\$210,000	\$140,000	\$70,000
Depreciation adjustment	\$ 30,000		\$ 30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000
Realized gain	\$570,000	\$360,000	\$210,000
Gain excluded under § 121	\$250,000	\$250,000	
Gain deferred under § 1031	\$210,000		\$ 210,000
Gain Recognized	\$110,000	\$110,000	

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$500,000). C's basis in the replacement business property is \$40,000, which is equal to C's basis in the relinquished business property at the time of the exchange.

[4] Safe Harbor for Exchange of Dwelling Units Used for Personal Purposes

In general, the gain or loss from an exchange of personal residences cannot be deferred under *IRC Section 1031* because the residences are not property held for productive use in a trade or business or for investment. This general rule applies both for exchanges involving principal residences as well as for secondary or vacation homes. n553 Courts have rejected arguments that residences have been held for investment rather than personal purposes because they were expected to appreciate in value. The mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence. n554

In recognition of the fact that many taxpayers hold dwelling units primarily for the production of current rental income, but also use them occasionally for personal purposes, the IRS has provided a safe harbor under which it will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under *IRC Section 1031*, even though a taxpayer occasionally uses the dwelling unit for personal purposes. n555

To meet the safe harbor, the dwelling unit must meet the qualifying use standards set for the in the revenue procedure. The standards differ, depending on whether the dwelling unit is relinquished property or replacement property. A dwelling unit that a taxpayer intends to be relinquished property in an *IRC Section 1031* exchange qualifies as property held for productive use in a trade or business or for investment if the following requirements are met: n556

- The dwelling unit must be owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and
- Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange, (1) the taxpayer must rent the dwelling unit to another person or persons at a fair rental for 14 days or more, and (2) the period of the taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day). n557

A dwelling unit that a taxpayer intends to be replacement property in an *IRC Section 1031* exchange qualifies as property held for productive use in a trade or business or for investment if the following requirements are met: n558

- The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and
- Within the qualifying use period, in each of the two 12-month periods immediately after the exchange, (1) the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and (2) the period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends. n559

Specific definitions apply for purposes of the safe harbor. "Personal use" of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under *IRC Section 280A(d)(2)*, except that for purposes of the safe harbor, personal use of a dwelling unit includes periods of personal use by the taxpayer before and after a qualified rental of a principal residence. n560 Whether a dwelling unit is rented at a "fair rental" is determined based on all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account. n561

If a taxpayer files a federal income tax return and reports a transaction as an like-kind exchange under *IRC Section 1031*, based on the expectation that a dwelling unit will meet the qualifying use standards for replacement property, and subsequently determines that the dwelling unit does not meet those standards, the taxpayer, if necessary, should file an amended return and not report the transaction as a like-kind exchange. n562

The safe harbor is used only to determine whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under *IRC § 1031*. A taxpayer using the safe harbor must satisfy all other statutory and regulatory requirements for a like-kind exchange. n563

The safe harbor is effective for exchanges occurring on or after March 10, 2008. No inference is intended with respect to the federal income tax treatment of exchanges of dwelling units occurring prior to the effective date of this revenue procedure. n564

FOOTNOTES:

(n1)Footnote 538. *Rev Proc 2005-14, 2005-1 CB 528*, effective Jan 27, 2005, but taxpayers may elect to apply it in any open tax years [see *IRC § 6511*].

(n2)Footnote 539. *IRC § 121(a)*.

(n3)Footnote 540. See *Rev Proc 2005-14*, § 3, *2005-7 IRB 528*.

(n4)Footnote 541. *Rev Proc 2005-14*, § 4, *2005-7 IRB 528*.

(n5)Footnote 542. *Rev Proc 2005-14*, § 5, *2005-7 IRB 528*.

(n6)Footnote 543. *Rev Proc 2005-14* , § 4, 2005-7 IRB 528 .

(n7)Footnote 544. *IRC § 121(d)(6)*.

(n8)Footnote 545. *Rev Proc 2005-14* , § 5, 2005-7 IRB 528 .

(n9)Footnote 546. See *IRC § 121(a)*.

(n10)Footnote 547. See *Treas Reg § 1.121-1(e)(2)*.

(n11)Footnote 548. *Treas Reg § 1.121-1(e)*.

(n12)Footnote 549. See *Treas Reg § 1.121-1(e)(2)*.

(n13)Footnote 550. *Treas Reg § 1.121-1(e)*.

(n14)Footnote 551. *Treas Reg § 1.121-1(e)*.

(n15)Footnote 552. *Treas Reg § 1.121-1(e)*.

(n16)Footnote 553. *Rev Rul 59-229*, 1959-2 CB 180 ; *Rev Proc 2005-14* , § 2.05, 2005-1 CB 528 ; *Starker v US*, 602 F2d 1341, 1350 (9th Cir 1979) ; *Treas Reg § 1.1031(a)-(1)(a)(1)*.

(n17)Footnote 554. *Moore v Commissioner*, TC Memo 2007-134 ; *Starker v US*, 602 F2d 1341, 1350 (9th Cir 1979) .

(n18)Footnote 555. *Rev Proc 2008-16*, 2008-10 IRB 547 .

(n19)Footnote 556. *Rev Proc 2008-16* , § 4.02(1), 2008-10 IRB 547 .

(n20)Footnote 557. *Rev Proc 2008-16* , § 4.02(1), 2008-10 IRB 547 .

(n21)Footnote 558. *Rev Proc 2008-16* , § 4.02(2), 2008-10 IRB 547 .

(n22)Footnote 559. *Rev Proc 2008-16* , § 4.02(2), 2008-10 IRB 547 .

(n23)Footnote 560. *Rev Proc 2008-16* , § 4.03, 2008-10 IRB 547 ; see *IRC § 280A(d)(4)*.

(n24)Footnote 561. *Rev Proc 2008-16* , § 4.04, 2008-10 IRB 547 .

(n25)Footnote 562. *Rev Proc 2008-16* , § 4.05, 2008-10 IRB 547 .

(n26)Footnote 563. *Rev Proc 2008-16* , § 4.06, 2008-10 IRB 547 .

(n27)Footnote 564. *Rev Proc 2008-16* , § 5, 2008-10 IRB 547 .



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CHAPTER 8A Involuntary Conversions of Real Estate *

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CHAPTER 8A Involuntary Conversions of Real Estate *

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§ 8A.00 Introduction

A taxpayer experiences an involuntary conversion when there is a compulsory or involuntary loss of all or part of a property as a result of destruction, theft, seizure or condemnation. As the taxpayer generally has no control over an involuntary conversion, *IRC Section 1033* provides relief from the usual result of gain recognition (measured by the excess of cash or fair market value of property received at the time of conversion over the adjusted basis of property lost). n1 However, the nonrecognition provisions of *IRC Section 1033* do not apply to losses; losses will be recognized in the year incurred. n2

Almost any type of property can be seized or destroyed in an involuntary conversion, including personal property, real property, air rights, n2.1 investment property, depreciable property, inventory, and property held for sale to customers in the ordinary course of a trade or business. n2.2 A right to use real property, as opposed to a title interest in the property itself, may also be involuntarily converted. n2.3

Even intangibles may be subject to condemnation--municipal authorities have suggested that sports franchises of teams considering a move might be subject to condemnation. The governing statute is remedial in nature and broad in scope, and neither *IRC Section 1033* nor the regulations thereunder limit the type of property that may benefit from *IRC Section 1033* if involuntarily converted. *IRC Section 1033* nevertheless may overlap with other nonrecognition provisions of the Code. For example, a taxpayer may report the involuntary conversion of a personal residence as either an involuntary conversion or as a sale or exchange of a personal residence. Similarly, an involuntary conversion may also qualify as an *IRC Section 1031* tax-deferred exchange. n3

Involuntary conversions also include dispositions as a result of requisition or condemnation or the threat or imminence thereof or of theft, destruction in whole or in part, seizure, or sale due to acreage limitations of reclamation laws. n4 An arson can constitute an involuntary conversion. n5 Although theft or destruction of property is not difficult to determine (e.g., hail losses, fire, lightning damage, flood destruction, and the voluntary sale of timber after being uprooted by a hurricane), n6 not all involuntary losses of property will result in a qualifying involuntary conversion. The following forced dispositions have been held not to be involuntary conversions:

- (1) foreclosure sale;
- (2) sale of land to pay paving assessment;

(3) condemnation by public health or safety officials (not a taking for public use); and

(4) sale of stock under state court order. n7

Conversions or sales of property where an owner has a choice of keeping the property or converting or selling it also do not usually qualify as involuntary conversions. n8 This is because *IRC Section 1033* defers only gains resulting from compulsory or involuntary conversions; the conversion into money or other property must occur from circumstances beyond the taxpayer's control. n8.01 If a taxpayer takes voluntary action to cause the conversion of the taxpayer's property into other property or money, the conversion does not qualify as an involuntary conversion, and deferral under *IRC Section 1033* is not available. Thus, an owner who voluntarily consented to the subsequent conversion of part of his property for the purpose of constructing a school as a condition to receiving approval for the development of his remaining property was not entitled to use *IRC Section 1033* with regard to the sale of the land on which the school would be constructed. n8.02

In one case, however, a forest products manufacturer was allowed to defer gain under *IRC Section 1033* for an early harvest of damaged trees, even though it chose to process the damaged trees into the end product that it regularly sold in the course of its business. The taxpayer was allowed to defer only that portion of the gain attributable to the difference between its basis and the amount it would have recognized had it sold the damaged trees on the open market instead of further processing them into finished products. The court held that the further processing by the taxpayer did not prevent the early harvest of the trees from qualifying as an involuntary conversion. n8.1

Involuntary conversions due to condemnations and sales under threat of condemnation have prompted extensive litigation. Condemnation is the exercise of legal power by the government to take privately owned property for necessary public use, with or without the owner's consent, upon payment of a reasonable price to the owner. n9 In Revenue Ruling 63-221, n10 the Service ruled that a threat or imminence of condemnation exists when a property owner has been informed by an authorized government official that a decision has been made to acquire his property, and the property owner reasonably believes that condemnation proceedings will be instituted if a voluntary sale is not negotiated. n11 This rule applies even if the proposed condemning authority lacks currently available funds to make the acquisition. n12 The Service indicated in another ruling that an involuntary conversion results even though the condemning agency does not yet have, but could readily obtain, condemnation authority. However, the seller must be aware of the identity of the condemning agency. n13

A total condemnation or threat of condemnation of an entire property is not required for an involuntary conversion to occur. An easement or threat of one that would substantially deprive a taxpayer of a beneficial interest in the land constitutes an involuntary conversion. In one ruling, the IRS ruled that an easement allowing the government a perpetual right to flood the taxpayer's farm was an involuntary conversion. n13.1 A voluntary sale to the Army Corps of Engineers after the Corps threatened to impose an easement that would prohibit any further significant development or timber operations, restrict current outdoor and recreational use of the property tourist operations, and allow flooding of the property was also held to be an involuntary conversion. n13.2 A sale of a fishing resort to the United States after Congress passed a law prohibiting the use of motorboats on the lake is also an involuntary conversion. n13.3

Sales to third parties may be permissible. n14

Any reasonable threat of condemnation that causes a taxpayer to dispose of property may result in the application of *IRC Section 1033*. n15 A threat or imminence of condemnation exists when a public body having the authority to condemn land or to institute condemnation proceedings indicates, by public resolution or public act, that specifically designated property located within a given geographical area will be condemned. It is not required that the taxpayer receive this knowledge officially. n16 An actual condemnation need not take place in order for *IRC Section 1033* to apply. It is sufficient if the taxpayer has a reasonable belief that a condemnation is likely to occur. n16.1

Property that is subject to an involuntary conversion or condemnation action need not be sold to or acquired by the condemning authority for *IRC Section 1033* to apply. Although most sales under threat of condemnation are made to an agent of the government body seeking the property, n17 a sale to a third party will qualify for relief under *IRC Section 1033*. In one ruling, the IRS found that a sale of property to a third party qualified for relief under *IRC Section 1033* when the sale was made after the city had taken all administrative steps to approve a comprehensive development project that included the property within it. The IRS ruled that the sale was under threat of condemnation because the only step left to be taken by the city was the institution of condemnation proceedings. n17.1 A similar ruling had the same result when the taxpayer sold property to a designated developer of an urban renewal area; the property was in the urban renewal area, and the area was under threat of condemnation from the redevelopment authority. n17.2

In another case, the taxpayer owned the only property on a block that was not owned by a private financial institution. He refused several offers to sell his property to the institution, which needed his property to build a new structure. The financial institution then requested from the city attorney an opinion as to whether the city would condemn the land under its urban development authority. Before receiving a definitive response, the parties negotiated and concluded the sale. The court held that the taxpayer had a reasonable belief that his property would be condemned and, therefore, the sale to the nongovernmental body was under threat of condemnation. n18

The Tax Court has also held that a taxpayer may treat the proceeds from condemned property and other real property in the aggregate as involuntary conversion proceeds if the properties constitute one economic unit or have a substantial economic relationship to each other. n19 For instance, a taxpayer owns Property A and Property B, both of which are operated as one business activity. A government authority condemns Property A, which also reduces the business utility of Property B. The condemnation of A and the sale of B both qualify as involuntary conversions if the taxpayer properly reinvests both proceeds. However, the Service has disallowed involuntary conversion treatment to a taxpayer who voluntarily sold property claimed to be in an "economic unit" with condemned property owned by a related party (his father). n20

FOOTNOTES:

(n1)Footnote 1. *IRC § 1033(a)*.

(n2)Footnote 2. *Treas Reg § 1.1033(a)-1(a)*.

(n3)Footnote 2.1. See Chief Counsel Memorandum 200246015 (the ruling gives a detailed discussion of general tax principles regarding cash payments made by an airport authority to settle a class action suit brought by landholders near the airport).

(n4)Footnote 2.2. See *IRC § 1033; Treas Reg § 1.1033(a)-1*.

(n5)Footnote 2.3. Ltr Ruls 200239009 , 200239012 (both rulings involving the involuntary conversion of a nonexclusive right to use and enjoy a facility).

(n6)Footnote 3. See *8A.02[1], [2], infra*.

(n7)Footnote 4. *IRC § 1033(c), (d), (e)*.

(n8)Footnote 5. *CG Willis, Inc v Commr*, 41 TC 468 (1964) , *affd per curiam*, 342 F2d 996 (3d Cir 1965) ; see *Ltr Rul 200109005* .

(n9)Footnote 6. *Rev Rul 59-8, 1959-1 CB 202 ; Rev Rul 56-436, 1956-2 CB 520 ; Rev Rul 80-175, 1980-2 CB 230 ; Willamette Industries, Inc v Commr*, 118 TC 126 (2002) .

(n10)Footnote 7. *Cooperative Publishing Co v Commr*, 115 F2d 1017 , 40-2 USTC P 9823, 25 AFTR 1123 (9th

Cir 1940) ; *Rev Rul 57-314, 1957-2 CB 523* ; *Rev Rul 56-420, 1956-2 CB 519* ; *Rev Rul 55-717, 1955-2 CB 298* .

(n11)Footnote 8. *CG Willis, Inc v Commr, 41 TC 468 (1964)* , *aff'd 342 F2d 996 (3d Cir 1965)* ; *Kurata v Commr, TC Memo 1997-252* .

(n12)Footnote 8.01. See *CG Willis, Inc v. Commr, 41 T.C. 468, 474 (1964)* , *aff'd per curiam 342 F2d 996 (3rd Cir 1965)* .

(n13)Footnote 8.02. *Rev Rul 69-654, 1969-2 CB 162* . See *Ltr Rul 201015015* (taxpayer who under eminent domain had to grant certain easement interests and was subject to a later potential condemnation of fee rights could use *IRC § 1033* to defer gain on proceeds received).

(n14)Footnote 8.1. *Willamette Industries, Inc v Commr, 118 TC 126 (2002)* .

(n15)Footnote 9. *Condemnations of Private Property for Public Use, Treas Pub No 549 (1974)*.

(n16)Footnote 10. *1963-2 CB 332* .

(n17)Footnote 11. *Id.* See *Maixner v Commr, 33 TC 191 (1959)* ; *Carson Est Co v Commr, 22 TCM 425, TC Memo 1963-90* .

(n18)Footnote 12. *Rev Rul 69-303, 1969-1 CB 201* ; *Ltr Rul 9450025* .

(n19)Footnote 13. *Rev Rul 74-8, 1974-1 CB 200* .

(n20)Footnote 13.1. *Rev Rul 72-433, 1972-2 CB 470* .

(n21)Footnote 13.2. *Ltr Rul 200219006* .

(n22)Footnote 13.3. *Rev Rul 82-147, 1982-2 CB 190* .

(n23)Footnote 14. See *Ltr Rul 200145001* (threat of condemnation found to exist when taxpayer sold property to developer competing for urban renewal project).

(n24)Footnote 15. *Johnson v Commr, TC Memo 1998-448* .

(n25)Footnote 16. *Rev Rul 81-180, 1981-2 CB 161* ; *Ltr Rul 200518066* .

(n26)Footnote 16.1. *Johnson v Commr, TC Memo 1998-448* (property was sold under threat of condemnation where public authority had the power to condemn, even though it had not taken form action approving condemnation of the property); *Ltr Rul 200518066* (sale to third party after city had taken all administrative steps to approve a comprehensive development project including the property was under threat of condemnation; the only step left to be taken by the city was the institution of condemnation proceedings); *S & B Realty Co v Commr, 54 TC 863 (1970)* .

(n27)Footnote 17. See *Creative Solutions, Inc v US, 320 F2d 809 (5th Cir 1963)* ; *SH Kress & Co v Commr, 40 TC 142 (1963)* , *acq 1965-1 CB 4* .

(n28)Footnote 17.1. *Ltr Rul 200518066* .

(n29)Footnote 17.2. *Rev Rul 81-180, 1981-2 CB 161* ; also see *Ltr Rul 9425018* ; *Ltr Rul 200145001* .

(n30)Footnote 18. *Balistrieri v Commr, TC Memo 1979-115* .

(n31)Footnote 19. *Masser v Commr, 30 TC 741 (1958)* , *acq 1959-2 CB 5* ; *Rev Rul 59-361, 1959-2 CB 183* ; *Ltr*

Rul 8132121 .

(n32)Footnote 20. *Rev Rul 69-53, 1969-1 CB 199 .*

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CHAPTER 8A Involuntary Conversions of Real Estate *

*1-8A Federal Taxes Affecting Real Estate § 8A.01***§ 8A.01 Deferral of Gain Recognition****[1] In General**

When property is directly converted into property "similar or related in service or use" through an exchange, nonrecognition of gain is mandatory. n21

However, if property is converted into cash through a condemnation award, insurance proceeds, etc., the owner can elect to defer gain if the property involuntarily converted is replaced within the allotted replacement period. n22 The owner must recognize gain to the extent the proceeds received exceed the cost of the replacement property. The cost of the replacement property is determinative, not the purchaser's equity interest therein (i.e., the taxpayer may finance the acquisition of the replacement property). The excess of the condemnation proceeds or other award received over the cost of the replacement property must be recognized as gain. n23

Example:

A warehouse with a basis of \$200,000 is destroyed by fire, and insurance proceeds of \$350,000 are received. The following examples set forth the amount of gain recognized, assuming the reinvestment of all or a part of the proceeds within the allowable time period:

	Examples		
	A	B	C
Cost of replacement property	\$.....1 50,000	\$.....3 00,000	\$.....4 00,000
Proceeds received	\$.....3 50,000	\$.....3 50,000	\$.....3 50,000
Less: Basis of old property	200,000	200,000	200,000
Gain on conversion (1)	\$.....1 50,000	\$.....1 50,000	\$.....1 50,000
Proceeds	\$.....3	\$.....3	\$.....3

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received	50,000	50,000	50,000
Cost of replacement property	150,000	300,000	400,000
Limit on gain recognized (2)	\$.....2 00,000	\$.....5 0,000	\$.....0
Gain recognized:			
The lesser of (1) or (2)	\$.....1 50,000	\$.....5 0,000	\$.....0

In one case, the issue was whether insurance proceeds were used solely to replace the involuntarily converted property with similar property. ⁿ²⁴ The taxpayers' home suffered significant damage, and the taxpayers used insurance proceeds to make repairs. The IRS argued that the taxpayers made improvements, not replacements, because they installed windows and kitchen items of better quality than the items that were destroyed. They also installed air conditioning and planted trees on the property. The IRS therefore argued that *IRC Section 1033* did not apply because the settlement proceeds were not used solely to replace the damaged property. The Tax Court rejected the argument and held that *de minimis* enhancements could be made to the property without violating the statutory use of funds requirement. The line where the quality of replacement property could violate *IRC Section 1033* is unclear, but in situations of this kind it would appear that as long as insurance proceeds are used, in substantial part, to restore property to its original condition, taxpayers can defer gain under *IRC Section 1033*. ^{n24.1} Amounts allocated to relocation costs for property are treated as part of the cost of replacement property, and are eligible for deferral under *IRC Section 1033*. ⁿ²⁵

Insurance proceeds that are received for reasons other than to compensate for an involuntary conversion itself are not eligible for nonrecognition and deferral of gain under *IRC Section 1033*, even if they are related to the conversion. Thus, insurance payments made to cover injury or threat of injury to third parties resulting from environmental contamination that involuntarily converts property are not eligible for nonrecognition under *IRC Section 1033*. ^{n25.1} Nor are insurance payments for lost profits and fixed charges paid in connection with an involuntary conversion. ^{n25.2} Interest payments paid in connection with an involuntary conversion are also not subject to *IRC Section 1033*. ^{n25.3}

Planning Guide:

Taxpayers can take steps so that condemnation awards or insurance payments can qualify for deferral under *IRC § 1033*. To the extent possible, negotiations with condemning authorities and contract clauses in insurance policies should clearly designate and seek to maximize recoveries as payment for the acquisition of property or as payment for the loss of the use of property. Amounts allocated to these items will usually be eligible for deferral under *IRC § 1033*, whereas any recovery allocated to a claim of lost profits or other type of damages will not be. ^{n25.4} The IRS and courts look to the terms of contracts, the type of damages requested in administrative documents or in negotiations, and allegations in court documents to determine if a particular award or part of it is eligible for deferral under *IRC § 1033*. ^{n25.5}

As usual, mortgages add complexity to the determination of gain recognition. A taxpayer must use all the proceeds when purchasing replacement property, without reduction for satisfaction of a mortgage or other lien on the converted property. ⁿ²⁶ The Ninth Circuit has held, however, that where the encumbrance is not a personal liability of the property owner, the nonrecognition provisions are satisfied when the owner reinvests an amount equal to his equity. ⁿ²⁷ As the circuit courts disagree on this matter, the question remains unsettled. This reinvestment amount rule generally applies irrespective of whether the debt is paid personally by the taxpayer or is paid by another party (such as the

insurer) directly to the mortgagee. For example, assume fire destroys A's warehouse, worth \$400,000 and subject to a mortgage debt of \$150,000. Although the insurer pays \$250,000 to A and the balance of \$150,000 directly to the mortgagee, A must purchase \$400,000 in replacement property to avoid recognition of gain. A may, of course, borrow to finance the replacement property to any extent without tax repercussions. In a different context, the Board of Tax Appeals, the predecessor of the Tax Court, held that the reduction of mortgage indebtedness on business property with condemnation proceeds from adjacent business property will not qualify for nonrecognition under *IRC Section 1033*.ⁿ²⁸

To defer recognition of gain under the involuntary conversion provisions, a taxpayer is only required to reinvest the net proceeds. Net proceeds are the total proceeds reduced by (1) expenses of securing the award, including attorneys' fees and other costs, and (2) any special assessments levied against remaining property as a result of improvements, such as a street or sewer on the condemned portion.ⁿ²⁹ For example, in securing a \$100,000 award, A paid his attorney \$5,000 and paid expert witnesses \$2,000. A must only reinvest \$93,000 to avoid recognition of gain. Additionally, a taxpayer need not trace the proceeds of a conversion to the replacement assets. Thus, one may acquire a replacement asset within the requisite time period under threat of condemnation before the actual receipt of the award.ⁿ³⁰

The gain deferral provisions of *IRC Section 1033* may not be available to a taxpayer who receives the proceeds for business interruption insurance upon an involuntary conversion. However, a recovery for the loss of use and occupancy of the involuntarily converted property will trigger the gain deferral provisions.ⁿ³¹ If the taxpayer recovers insurance for lost profits, revenues, or rentals, the proceeds are taxed as ordinary income.ⁿ³²

[2] Severance Damages

Severance damages are generally awarded to a condemnee for harm caused to his property remaining with him after a portion of the property has been condemned. An amount awarded specifically for severance damages will not enter into the computation of gain or loss on the condemned portion of the property.ⁿ³³

The amount and treatment of severance damages are determined as follows:ⁿ³⁴

(1) First, "net" severance damages must be ascertained. Net severance damages are computed by reducing the gross amount received as severance damages by:

(a) the applicable portion of the total expenses incurred in obtaining the combined severance and condemnation award; and

(b) any unpaid special assessment against the remaining property.

(2) Net severance damages are applied to reduce the basis of the retained property.ⁿ³⁵

(3) Any severance damages in excess of the basis of the retained property are taxable when not reinvested.ⁿ³⁶

The nature of the gain, whether capital or ordinary, depends upon the nature of the asset. The gain will not be taxed as a long-term capital gain if the property has not been held for the required time period or if the property owner is a dealer and the land is held for resale. In situations where severance damages are paid and improved property is involved, recapture of depreciation may be a consideration.ⁿ³⁷

Example:

A has a large parcel of property upon which she has a factory and parking lot. The county decides to make the highway bordering A's property into a four-lane highway and condemns part of A's parking lot

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and a corner of the factory. A receives a condemnation award as follows:

Award Received:

For property taken	\$.....15 0,000
For damages to property re- tained	50,000_____ _____
Gross Award	\$.....20 0,000
Less: Assessment for improved road	10,000_____ _____
Total cash received by A	\$.....19 0,000_____ _____ _____ _____

The cost of obtaining the combined award was \$4,000 for attorneys' fees. The basis of the property retained is \$900,000, and the basis of the property taken was \$100,000. A's gain and her basis in the remaining property are computed as follows:

Gain on Condemnation:

Amount received for property taken	\$150,000
Less: Allocable portion of at- torneys' fees--75% ♦	3,000_____ _____ _____
Net Award	\$147,000
Less: Basis of property taken	100,000_____ _____ _____
Gain: Taxable unless all of the net award (\$147,000) is rein- vested in replacement property	\$..... 47,00 0_____ _____ _____ _____
Basis Reduction in Property Retained:	
Basis of property retained	\$900,000
Severance damages	\$..... 50,00 0

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Less:

Assessment for improved road	(10,000)	
Portion of legal fees--25% ♦	(1,000)	

Applied to reduce basis	\$.....	(.....)
	39,00	39,000
	0	
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
Adjusted basis of property retained		\$861,000

♦ Allocation is made based upon the percentage of each portion of the award to the total award.

For a taxpayer to allocate part of the condemnation proceeds to severance damages, the Service has held that the condemnation award document must expressly state and itemize the amounts attributed to various portions. n38 The courts have allowed a taxpayer to submit evidence upon which to base an allocation if records indicate severance damages have been paid but no specific amount is stated in the award. n39 However, because the Service considers such allocations impermissible, litigation may be required to sustain such an allocation. Consequently, the taxpayer should request that severance damages be specifically set out in the award.

Although the Service's position has been more stringent than the courts' conclusions, it has liberalized its treatment of severance damages. A 1973 Revenue Ruling held that *IRC Section 1033* nonrecognition applies to severance damages received from a condemnation destroying the usefulness of retained property when the retained property was sold to acquire replacement property at a cost exceeding the sum of the condemnation award, severance damages, and sales proceeds. n40 Similarly, a district court has held that, when severance damages are part of a condemnation award, the Service may have authority to divide the award between compensation for the property taken and damages to the remainder, but this allocation does not affect the availability of involuntary conversion treatment. The Service took the position that severance damages were not deferrable under the involuntary conversion provisions except when the property purchased with the severance damages is adjacent to the damaged property and the damages are used to restore the usability of the damaged land. n41 The court rejected this argument, holding that there is no authority authorizing the Service to treat severance damages any differently from its treatment of the proceeds of condemnation. The Service now holds that severance damages reinvested in "like-kind" property may be accorded nonrecognition treatment under *IRC Section 1033(g)(1)*. n42

FOOTNOTES:

(n1)Footnote 21. *IRC § 1033(a)(1)*.

(n2)Footnote 22. *IRC § 1033(a)(2)(A)*. See § 8.02 [5], *infra* for a discussion of the replacement period under *IRC § 1033*.

(n3)Footnote 23. *IRC § 1033(a)(2)*.

(n4)Footnote 24. See *IRC § 1033(a)(2)(A)*.

(n5)Footnote 24.1. *Allen v Commr, TC Memo 1998-406* .

(n6)Footnote 25. *Rev Rul 58-396, 1958-2 CB 403* (cost of moving taxpayer's residence to new site treated as replacement property cost); *Graphic Press, Inc. v Commr, 523 F2d 585 (9th Cir 1975)* (cost of moving heavy equipment); *Ltr Rul 200445004* (costs of relocating utility property).

(n7)Footnote 25.1. *TAM 20032217*.

(n8)Footnote 25.2. *Rev Rul 73-477, 1973-2 CB 302* .

(n9)Footnote 25.3. *Kieselbach v Commr, 317 US 399 (1943)* ; *Estate of Walter v Commissioner, TC Memo 1971-244* (court allocated portion of lump-sum payment received by taxpayer from State to proceeds for property, severance damages, and interest); *Tiefenbrunn v Commr, 74 TC 1566 (1980)* .

(n10)Footnote 25.4. See *Treas Reg § 1.1033(a)-2(c)(8)*.

(n11)Footnote 25.5. See *Ltr Rul 199952082* . See Lynn, "Tax Planning for Involuntary Conversions," *109 Tax Notes* 69 (10/03/05).

(n12)Footnote 26. *Treas Reg § 1.1033(a)-2(c)(11)*.

(n13)Footnote 27. *Commr v Babcock, 259 F2d 689 , 58-2 USTC P 9855, 2 AFTR2d 5819 (9th Cir 1958)* . *Babcock* was distinguished in *Harsh Investment Corp v US, 323 F Supp 409 , 70-2 USTC P 9638 (D Ore 1970)*.

(n14)Footnote 28. *Rev Rul 70-98, 1970-1 CB 169* .

(n15)Footnote 29. *Petit v Commr, 8 TC 228 (1947)* , *acq*; *Connally v Commr, 32 BTA 920 (1935)* ; *Washington Market Co v Commr, 25 BTA 576 (1923)* , *acq*; *Rev Rul 71-476, 1971-2 CB 308* . *Ltr Ruls 200239009, 200239012*.

(n16)Footnote 30. *IRC § 1033(a)(2)(B)*.

(n17)Footnote 31. *William Furniture Co v Commr, 45 BTA 928 (1941)* .

(n18)Footnote 32. *Treas Reg § 1.1033(a)-2(c)(8)*; *Rev Rul 73-477, 1973-2 CB 302* .

(n19)Footnote 33. *Rev Rul 68-37, 1968-1 CB 359* .

(n20)Footnote 34. *Condemnations, Treas Pub No 334 (1994)*.

(n21)Footnote 35. *Inaja Land Co, Ltd v Commr, 9 TC 727 (1947)* .

(n22)Footnote 36. *GCM 23698, 1943 CB 340* .

(n23)Footnote 37. See Ch 5, *supra*.

(n24)Footnote 38. *Rev Rul 59-173, 1959-1 CB 201* .

(n25)Footnote 39. *Johnston v Commr, 42 TC 880 (1964)* ; *Beeghly v Commr, 36 TC 154 (1961)* , *acq 1962-1 CB 3*.
Contra *Lapham v US, 178 F2d 994, 50-1 USTC P 9153 , 38 AFTR 1255 (2d Cir 1950)* .

(n26)Footnote 40. *Rev Rul 73-35, 1973-1 CB 367* .

(n27)Footnote 41. *McKittrick v US, 373 F Supp 471 , 74-1 USTC P 9264 (SD Ohio 1974)*.

(n28)Footnote 42. *Rev Rul 83-49, 1983-1 CB 191* . See § 8.01, *supra*, for a discussion of like-kind property.

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Federal Taxes Affecting Real Estate

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CHAPTER 8A Involuntary Conversions of Real Estate *

1-8A Federal Taxes Affecting Real Estate § 8A.02

§ 8A.02 Similar Property Requirement

[1] Relationship to Like-Kind Property Test

Generally, to defer recognition of gain under *IRC Section 1033*, the taxpayer must either reinvest the proceeds of an involuntary conversion in replacement property "similar or related in service or use" to the property converted or use the proceeds to acquire a controlling stock interest in a corporation holding such qualifying replacement property. n43 In addition, *IRC Section 1033(g)* provides special rules that allow certain converted real property to be replaced with "like-kind property." *IRC Section 1033* does not operate to the exclusion of the similar or related in service or use rule.

■ *Federally Declared Disaster Areas.* Where an involuntary conversion occurs with respect to property held for productive use in a trade or business or for investment located in a disaster area and converted as a result of a federally declared disaster, n43.1 *any* tangible property of a type held for productive use in a trade or business is treated as "property similar or related in service or use" to the property involuntarily converted for purposes of *IRC Section 1033*. n44 Note that while the involuntarily converted property may be property held for productive use in a trade or business *or for investment*, the replacement property subject to the amendment must be of a type held for productive use in a trade or business, with no mention of property held for investment. n45 The legislative history does not elaborate on this seeming incongruity.

The relationship between the like-kind test, usually used in the context of *IRC Section 1031*, and the similar or related in service or use test is codified in *IRC Section 1033(g)*:

"[I]f real property ... held for productive use in trade or business or for investment is ... involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted."

When *IRC Section 1033(g)* applies, the taxpayer has a choice of whether to use the "similar or related in service or use" standard n46 or the "like-kind" standard n46.1 in choosing replacement property. n46.2 For example, in *Davis v. United States*, n47 the government condemned certain agricultural properties, and the taxpayer reinvested the proceeds in improvements on previously owned industrial land. The district court held that the reinvestment was of a "like-kind" and, therefore, qualified for nonrecognition. This holding was contrary to the Service's position that improvements to owned land are not like-kind. The Ninth Circuit nonetheless affirmed on the grounds that the reinvestment was in property similar or related in use and, consequently, found it unnecessary to determine the like-kind test. However, this

"liberal" interpretation of the similar or related-in-use test may not necessarily be followed by other circuits.

As seen below, this relationship has led courts to adopt the like-kind test for replacement property if real property is condemned or sold under threat of condemnation.

Planning Tip:

The similarity of *IRC Sections 1031* and *1033* provides taxpayers with the choice of treatment if real property is involuntarily converted. Pursuant to *IRC Section 1031*, a taxpayer can dispose of property while deferring the gain or loss inherent in the property by exchanging the property for like-kind replacement property. However, if a taxpayer suffers a loss on a conversion, it may be advantageous to treat the transaction as an *IRC Section 1033* involuntary conversion since losses are deferred under *IRC Section 1031*.

[2] Restrictions on Replacement Property

[a] Based on Purpose of Ownership

In determining whether replacement property qualifies as an involuntary conversion for nonrecognition, courts have stratified treatment depending on the type of property owner involved. This stratification is summarized as follows:

(1) For all involuntary conversions except condemnations or threats of condemnation:

(a) owner-users (e.g., operators and users of a manufacturing plant) must invest in replacement property having the same end use (e.g., another manufacturing plant, not a warehouse); n48

(b) owner-investors (e.g., owners and lessors of an office building) must invest in replacement property having the same business purpose (e.g., another property held out for lease). n49

(2) For all condemnations or threats of condemnation of business or investment real property, the qualification of the replacement property may be determined under *IRC Section 1033* or under the like-kind rules of tax-deferred exchanges whereby business or investment property may be replaced with other business or investment property. n50

If an owner-user's property is converted in a way other than condemnation or threat thereof (item (1) above), a functional use test is applied to determine whether replacement property is "similar or related in use or service." Both the converted property and the replacement property must have a close functional similarity and have closely related physical characteristics and similar end uses to be considered similar or related. n50.1 For example, a hardware store that was destroyed by arson was held to be similar in use or kind to the replacement property, which was also operated as a hardware store. n51

In contrast, the replacement of a light manufacturing plant with a wholesale grocery warehouse, unimproved real estate with improved real estate, or a building lease with machinery would not qualify for nonrecognition. As an example of the Service's strict interpretation in this area, *Revenue Ruling 76-319* held that a recreational bowling center was not similar or related in service or use to a billiard center since their physical characteristics differed. n52 The replacement of a condemned parcel of real estate with a partnership interest in a partnership that purchases real estate also does not qualify for nonrecognition under *IRC Section 1033*. n53

However, the above stated distinction between owner-users and owner-investors is not well defined. Indeed, the owner-investor need only have the same business purpose for the replacement property. The following excerpt from *Revenue Ruling 64-237*, n54 explains the owner-investor's requirement regarding replacement property:

"In considering whether replacement property acquired by an investor is similar in service or use to the converted property, attention will be directed primarily to the similarity in the relationship of the services or uses which the original and replacement properties have to the taxpayer-owner. In applying this test, a determination will be made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what such properties demand of the taxpayer in the way of management, services, and relations to his tenants."

For example, where the taxpayer is a lessor, who rented out the converted property for a light manufacturing plant, and then rents out the replacement property for a wholesale grocery warehouse, the nature of the taxpayer-owner's service or use of the properties may be similar although that of the end users changes. The two properties will be considered as similar or related in service or use where, for example, both are rented and where there is a similarity in the extent and type of the taxpayer's management activities, the amount and kind of services rendered by him to his tenants, and the nature of his business risks connected with the properties.

In contrast, the IRS has ruled that a taxpayer who uses insurance proceeds from the destruction of an apartment building to purchase a motel cannot take advantage of *IRC Section 1033* because, in changing from a lessor of apartments to an operator of a motel, the taxpayer's relationship to the properties has substantially altered. Because of the difference in services required with respect to the properties, the motel was not similar or related in service or use to the apartment building. n55

If the end use of the property does not change, a taxpayer apparently may use the proceeds of an involuntary conversion to rearrange existing plant facilities or to remodel currently owned buildings. The Service has held that proceeds can be used to remodel other facilities owned prior to conversion as long as they can be used in a manner similar to the property converted. n56

Thus, it is the service or use that the properties have to the taxpayer that is relevant, regardless of whether the taxpayer is a user or investor. If the taxpayer is an owner-lessor of either the original or the replacement property, and uses or operates the other, the relationship of the original and replacement properties to the taxpayer will be substantially different. n57

The Service has ruled that a timely acquired fee simple property interest qualifies under *IRC Section 1033(a)* as replacement property similar or related in service to an involuntarily converted 15-year leasehold if the fee property is to be used in the same business and for the identical purpose as the condemned leasehold. n58 A replacement of a 10-year n59 or 20-year n60 leasehold with fee simple property has also been held to qualify under § 8.A08[3]. The IRS has also ruled that fee simple property can qualify as replacement property for involuntarily converted easements. n60.1

A lessee under a long-term lease may replace its leasehold interest with a fee interest in real property under *IRC Section 1033* if the property where the leasehold is located is condemned. n61 The same does not hold true, however, if the property is destroyed by a fire or other casualty, rather than condemned. In that case, the lessee has not suffered an involuntary conversion of its leasehold. Rather the loss is only to improvements on the property. Thus, a lessee who uses insurance proceeds received from a fire on leased property to purchase other property in fee cannot use *IRC Section 1033* to defer recognition of gain on receipt of the proceeds, because the property destroyed by the fire and insured by the insurance policy is the lessee's tangible property, not the leasehold itself. Notwithstanding the damage to the property, the lessee's leasehold interest remains intact; therefore, the fee interest in the property purchased does not qualify as replacement property to the leasehold interest. n62

[b] Replacement of Condemned Property

If business or investment in real property is converted from condemnation or threat thereof, the taxpayer may apply either the similar use test or the "like-kind" test to the replacement property. A taxpayer benefits if the property falls in this category as the like-kind rule is generally more liberal than the "similar or related in use or service" test. Thus, the proceeds from condemned real property may be invested in "like-kind" property, which may be either investment real estate or real estate used in the taxpayer's business. n62.1 See § 8.01, above, for further discussion of the "like-kind" type of replacement. See § 8.02[2][a] above for a further discussion of "like-kind" in connection with Presidentially Declared Disasters.

In 1971, the Service issued *Revenue Ruling 71-41*, n63 which seems to modify the general proposition that all forms of real estate held for productive use in a trade or business or for investment are like-kind with other real estate so held, as in the case of *IRC Section 1031*. In this ruling, a taxpayer owned and rented out a warehouse and land that was condemned by the state at a gain to the taxpayer. The taxpayer used the condemnation proceeds to erect a gas station on other land currently owned by him, and he then rented the gas station to an oil company. The Service ruled the taxpayer did not qualify for the liberal "like-kind" test as "the replacement property" (gas station without land) and the property converted (land and warehouse) were not properties of a "like kind." The Service did not elaborate on this conclusion but added that the gas station qualified for involuntary conversion treatment regardless, based on the "similar or related in service or use" test. n64

[c] Improved Dealer-Owned Property

While real property owned by dealers is generally subject to the provisions of involuntary conversions, problems may arise when the converted property has also been improved. When improved dealer property has been converted, the replacement property must pass the narrow end-use test (the strict interpretation of the "similar or related in use or service" rule) rather than the broader "like-kind" test. n65

[d] Acquisition from Related Persons

Deferral of gain under *IRC Section 1033* is denied in some cases if the replacement property is purchased from a related party. n66 The deferral generally is denied for the following taxpayers: n67

- (1) C corporations;
- (2) partnerships (and presumably LLCs) in which one or more C corporations own more than 50 percent of the capital interest or profits interest in the partnership at the time of the involuntary conversion; and
- (3) effective for involuntary conversion occurring after June 8, 1997, any other taxpayer (including an individual), if, with respect to property that is involuntarily converted for the year, the taxpayer has aggregate realized gains exceeding \$100,000. In the case of a partnership or S corporation, this annual \$100,000 limit applies to both the entity and to the partner or shareholder.

With respect to the ownership requirement in (2) above, the ownership of capital or profits interests in the partnership can be direct or indirect (determined in accordance with *IRC Section 707(b)(3)*). n68 The disqualification does not apply to the extent that the related person acquired the replacement property or stock from an unrelated person during the period described in *IRC Section 1033(a)(2)(B)*. n69 Thus, the transfer of replacement property among related entities will not trigger disqualification, provided the property is timely acquired by one of those entities from an unrelated party. Applying this rationale, the IRS in a complex technical advice memorandum ruled that property acquired by a taxpayer through the merger of a related entity qualified as replacement property. n69.1 The term "related person" is defined by cross reference to *IRC Sections 267(b)* and *707(b)(1)*. n70

[3] Who May Make the Replacement

Generally, the owner of the involuntary converted property makes the election for nonrecognition of gain and reinvests in the replacement property, but there are a number of exceptions.

[a] Decedents' Estates

The courts and the Service conflict as to the treatment of decedents' estates. The Service has held that, when a property owner receives the proceeds of an involuntary conversion, but dies before making a suitable replacement, her personal estate representative cannot reinvest the proceeds and thereby avoid gain recognition. ⁿ⁷¹ Previously, however, the court in *Estate of Goodman v. Commissioner* ⁿ⁷² held that a personal representative can reinvest and qualify for nonrecognition. In 1974, the Tax Court held that, when a surviving spouse completed an involuntary conversion commenced by the taxpayer, the conversion *did not qualify* for the nonrecognition treatment because the spouse purchased the replacement property in her own name rather than in the name of the estate, which she apparently could have done as executrix. ⁿ⁷³

[b] Trusts

The Service and Tax Court have also found *IRC Section 1033* applicable to trusts. The Service has held that, when the grantor of a reversionary trust is treated as the owner of the trust and is taxable on any gains realized on the sale of trust property, the grantor is the "taxpayer" for *IRC Section 1033* purposes and may make an election to have the nonrecognition provisions apply. ⁿ⁷⁴ In *Estate of Gregg v. Commissioner*, ⁿ⁷⁵ the taxpayer placed property in a revocable grantor trust prior to its condemnation. The grantor died before completing replacement of the condemned property; accordingly, the grantor's surviving spouse and the executor jointly elected *IRC Section 1033* involuntary conversion treatment, and the trust completed the replacement. The court held that *IRC Section 1033* applied to the grantor, and the trustee was acting on behalf of the grantor. Thus, replacements made after the grantor's death qualified the initial disposition for nonrecognition.

The IRS has also ruled that a testamentary trust's acquisition of qualifying replacement property meets the requirements of *IRC Section 1033(g)* regarding productive use of the property in a trade or business, even though by its own terms the trust would soon terminate, and the acquired property would be distributed to a trust beneficiary. ^{n75.1}

[c] Partners and Partnerships

In the case of partnerships, generally only the partnership, not the partners, may make the election and defer the gain when the partnership has property involuntarily converted. ⁿ⁷⁶

The IRS has privately ruled that two partnerships formed by a partnership whose property was involuntarily converted are a continuation of the original partnership, and therefore are entitled to nonrecognition and can re-invest condemnation proceeds under *IRC Section 1033* under the election made by the original partnership. ^{n76.1}

[d] Shareholders of Corporations

IRC Section 1033 nonrecognition is not available to a sole individual shareholder who, on complete liquidation of his corporation following condemnation of its property, received the condemnation proceeds awarded the corporation and reinvested them in similar property. ⁿ⁷⁷

However, a corporate parent may reinvest under Treas Reg § 1.1033(b) following the liquidation under *IRC Section 332* of a subsidiary that experienced an involuntary conversion. ⁿ⁷⁸

[e] Single Member LLCs

The IRS has ruled that a single-member LLC owned by the taxpayer may purchase replacement property in exchange for property that was owned separately by the taxpayer, and still qualify for deferral of gain under *IRC Section 1033*.ⁿ⁷⁹ This is an exception to the usual rule that the replacement property must be purchased by the taxpayer.ⁿ⁸⁰ In the ruling, two LLCs owned by the taxpayer purchased replacement property. Neither LLC was a corporation under federal regulations, and each was treated as a sole proprietorship for federal income tax purposes.ⁿ⁸¹ The IRS's rationale was that the LLCs were single-member LLCs owned by the taxpayer, and that, under federal regulations, they would be disregarded as entities separate from the taxpayer for federal tax purposes.ⁿ⁸² The IRS cautioned that or final regulations pertaining to this issue might be issued in the future. To the extent any such regulations were inconsistent with any conclusion in this ruling, they would modify or revoke the ruling.ⁿ⁸³

[4] Structuring Transactions Under *IRC Section 1033*

In an involuntary conversion, no gain is recognized to the extent the taxpayer uses proceeds of the conversion to acquire control of a corporation that owns qualifying replacement property.ⁿ⁸⁴ One has control if he owns at least 80 percent of the combined voting power of all classes of stock and at least 80 percent of the total number of shares of all other classes of stock.ⁿ⁸⁵ The acquired corporation must own the similar or related property (i.e., the qualifying replacement property) at the time control is acquired.ⁿ⁸⁶

Structuring certain transactions involving property transfers within *IRC Section 1033* requires caution. In *Templeton v. Commissioner*,ⁿ⁸⁷ a taxpayer, upon learning that Tract A would be condemned, transferred Tract B, which he owned jointly with his son and daughter, to a newly formed corporation. He then used his condemnation proceeds to acquire control of the corporation. The court held that the transaction did not qualify for nonrecognition because the taxpayer did not establish that he acquired the stock "for the purpose of" replacing the condemned property. On the other hand, *Revenue Ruling 84-29* indicates that a transfer of assets (which were purchased in accordance with *IRC Section 1033*) to a taxpayer's newly organized subsidiary will qualify since the taxpayer never lost "control of the assets."ⁿ⁸⁸

In the case of an acquisition of stock of an affiliated corporation, *IRC Section 1033* requires the acquired stock's "cost" to be measured by its unadjusted basis pursuant to *IRC Section 1012*, and the acquisition of stock to be treated as a "purchase." If one corporation acquires the stock of a commonly controlled "sister" corporation subject to *IRC Section 304(a)*, the acquired stock is treated as if it is received as a contribution to capital if the acquisition results in a deemed dividend.ⁿ⁸⁹ As a contribution to capital, the basis of the stock acquired is not its cost, so that the stock will not qualify as *IRC Section 1033* replacement property. Conversely, a subsidiary's purchase of its parent's stock for replacement purposes using the proceeds from an involuntary conversion should qualify as the parent corporation is not deemed to have received a taxable constructive dividend.ⁿ⁹⁰

FOOTNOTES:

(n1)Footnote 43. *IRC § 1033(a)(2)(A)*.

(n2)Footnote 43.1. See *IRC §§ 165(h)(3)(C), 1033(h)(3)*.

(n3)Footnote 44. *IRC § 1033(h)(2)*.

(n4)Footnote 45. *IRC § 1033(h)(2)*.

(n5)Footnote 46. See *IRC § 1033(a)(2)(A)*.

(n6)Footnote 46.1. See *IRC § 1033(g)*.

(n7)Footnote 46.2. *Ltr Rul 200219006* ; see *Rev Rul 64-237, 1964-2 CB 319* ; *Rev Rul 83-49, 1983-1 CB 191* .

(n8)Footnote 47. *411 F Supp* 964, 76-1 *USTC* P 9418, 37 *AFTR2d* 76-1447 (D Haw 1976) , *affd* 589 *F2d* 446, 79-1 *USTC* P 9142, 43 *AFTR2d* 79-584 (9th Cir 1979) .

(n9)Footnote 48. *Rev Rul* 64-237, 1964-2 *CB* 319 .

(n10)Footnote 49. *Rev Rul* 70-399, 1970-2 *CB* 164 .

(n11)Footnote 50. *IRC* § 1033(g). See also § 8.01[2], *supra*.

(n12)Footnote 50.1. *Rev Rul* 64-237, 1964-2 *CB* 319 ; *Ltr Ruls* 200239009, 200239012 (both rulings applying the test to a nonexclusive right of use and enjoyment of property).

(n13)Footnote 51. *Ltr Rul* 200109005 .

(n14)Footnote 52. 1976-2 *CB* 242 .

(n15)Footnote 53. *Sandoval, Jr v Commr, TC Memo* 2000-189 .

(n16)Footnote 54. 1964-2 *CB* 319 ; see *Liant Record, Inc v Commr*, 303 *F2d* 326 (6th Cir 1962) ; *Capitol Motor Car Co v Commr*, 314 *F2d* 469 (6th Cir 1963) ; *Ziegler v US*, 254 *F Supp* 202 (D Colo 1966) ; *Rev Rul* 70-399, 1970-2 *CB* 165 ; *Rev Rul* 76-391, 1976-2 *CB* 243 ; *Rev Rul* 79-261, 1979-2 *CB* 295 .

(n17)Footnote 55. *Ltr Rul* 9723032 .

(n18)Footnote 56. *Rev Rul* 67-254, 1967-2 *CB* 269 ; *Ltr Rul* 8329014 ; *Ltr Rul* 9620010 (acquisition of fee interest with respect to shopping center leased and managed by taxpayer, and improvements to that property, are like-kind reinvestments for proceeds of condemned shopping center owned in fee).

(n19)Footnote 57. See *Liant Record, Inc v Commr*, 303 *F2d* 326 (6th Cir 1962) ; *Capitol Motor Car Co v Commr*, 314 *F2d* 469 (6th Cir 1963) ; *Ziegler v US*, 254 *F Supp* 202 (D Colo 1966) ; *Rev Rul* 64-237, 1964-2 *CB* 319 ; *Rev Rul* 70-399, 1970-2 *CB* 165 ; *Rev Rul* 76-391, 1976-2 *CB* 243 ; *Rev Rul* 79-261, 1979-2 *CB* 295 .

(n20)Footnote 58. *Rev Rul* 83-70, 1983-1 *CB* 189 .

(n21)Footnote 59. *Ltr Rul* 9706004 .

(n22)Footnote 60. *Davis Regulator Co v Commr*, 36 *BTA* 437 (1937) , *acq* 1937-2 *CB* 7 .

(n23)Footnote 60.1. *Ltr Rul* 201015015 (the ruling does not specify the type of easement involved).

(n24)Footnote 61. *Davis Regulator Company v Commr*, 36 *BTA* 437 (1937) , *acq* 1937-2 *CB* 7 ; *Rev Rul* 83-70, 1983-1 *CB* 189 .

(n25)Footnote 62. *Woodall v Commr, TC Memo* 1991-15 , *affd* 964 *F2d* 361 (5th Cir 1992) ; *FSA* 200127001 .

(n26)Footnote 62.1. *IRC* § 1033(g)(1); see *Ltr Rul* 200219006 .

(n27)Footnote 63. 1971-1 *CB* 242 .

(n28)Footnote 64. A similar result was reached in two 1976 Revenue Rulings involving construction on land already owned. *Rev Ruls* 76-390, 76-391, 1976-2 *CB* 243 .

(n29)Footnote 65. *Ltr Ruls* 8252073 , 8252151 .

- (n30)Footnote 66. *IRC § 1033(i)(1)*.
- (n31)Footnote 67. *IRC 1033(i)(2)*.
- (n32)Footnote 68. *IRC § 1033(i)(2)(B)*.
- (n33)Footnote 69. *IRC § 1033(i)(1)*.
- (n34)Footnote 69.1. *TAM 200411001* .
- (n35)Footnote 70. *IRC § 1033(i)(3)*.
- (n36)Footnote 71. *Rev Rul 64-161, 1964-1 CB 298* .
- (n37)Footnote 72. *199 F2d 895 , 52-2 USTC P 9556, 42 AFTR 877 (3d Cir 1952)* .
- (n38)Footnote 73. *Est of Jayne v Commr, 61 TC 744 (1974)* .
- (n39)Footnote 74. *Rev Rul 70-376, 1970-2 CB 164* .
- (n40)Footnote 75. *69 TC 468 (1977)* .
- (n41)Footnote 75.1. *Ltr Rul 200528011* .
- (n42)Footnote 76. *Est of Demirjian v Commr, 54 TC 1691 (1970) , affd 457 F2d 1, 72-1 USTC P 9281, 29 AFTR2d 72-741 (3d Cir 1972)* .
- (n43)Footnote 76.1. *Ltr Rul 200921009* .
- (n44)Footnote 77. *EE Murphy v Commr, TC Memo 1996-59, 71 TCM 2080 ; Rev Rul 73-72, 1973-1 CB 368 . Ltr Rul 9630010 . See Ltr Rul 7805003 ; Rev Rul 84-29, 1984-1 CB 181 for treatment when replacement property is transferred to a subsidiary.*
- (n45)Footnote 78. *IRC § 381(c)(13)*.
- (n46)Footnote 79. *Ltr Rul 199945038* .
- (n47)Footnote 80. *See IRC § 1033(a)(2)(A)*.
- (n48)Footnote 81. *See Treas Reg § 301.7701-2(b)*.
- (n49)Footnote 82. *See Treas Reg §§ 301.7701-2(a), 301.7701-2(c)(2), 301.7701-3(b)*.
- (n50)Footnote 83. *Ltr Rul 9945038* .
- (n51)Footnote 84. *IRC § 1033(a)(2)(A)*.
- (n52)Footnote 85. *IRC § 1033(a)(2)(E)(i)*.
- (n53)Footnote 86. *IRC § 1033(a)(2)(A)*. Acquiring control with the intent to later purchase replacement property is not sufficient. *Rev Rul 77-422, 1977-2 CB 307* .
- (n54)Footnote 87. *66 TC 509 (1976) , affd per curiam 78-1 USTC 9382, 573 F2d 866 ; 41 AFTR2d 78-1186 (4th Cir 1978)*.

(n55)Footnote 88. *1984-1 CB 181* .

(n56)Footnote 89. *IRC § 304(a)(1)(B)*.

(n57)Footnote 90. *IRC § 304(a)(2)*. See also *Broadview Lumber Co v Commr*, 75- 2 *USTC P 9832 (1976)*, *affd* 561 *F2d 698*, 77-2 *USTC P 9615*, 40 *AFTR2d 77-5650 (7th Cir 1977)* .

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CHAPTER 8A Involuntary Conversions of Real Estate *

1-8A Federal Taxes Affecting Real Estate § 8A.03

§ 8A.03 Basis Computation

Generally, if property is converted directly into replacement property as the result of an involuntary conversion, the basis of the replacement property is equal to the basis of the original property, decreased by money received and not reinvested in replacement property, and increased by the amount of gain (or decreased by the amount of loss) a taxpayer recognizes in connection with the conversion. n91

However, if property is involuntarily converted into money or property not similar or related, the basis of property acquired as replacement property is its cost less any deferred gain (i.e., gain not recognized). n92 If the property purchased consists of more than one piece of property, the basis determined under the prior sentence must be allocated to the purchased properties in proportion to their respective costs. n93

The basis reduction and allocation rules are applied first solely to Section 1250 properties and to unrecognized Section 1250 recapture gain, and then to all purchased properties (including the Section 1250 properties) and to remaining unrecognized gain. n94 The unrecognized Section 1250 recapture gain in respect of the acquired property includes the amount of additional depreciation attributable to the Section 1250 property that was disposed of. The amount is equal to the amount of gain that escaped taxation on the disposition. n95

A special basis rule applies when the replacement property is stock in a corporation to which a basis reduction is required. n96 In that case, the basis of the property held by the corporation at the time the taxpayer acquired control n97 generally must be reduced by the same amount by which the taxpayer reduces its basis in the stock. n98 The corporation's adjusted basis in its assets will not be reduced, in the aggregate, below the taxpayer's basis in its stock (determined after the appropriate basis adjustment for the stock). n99 In addition, the basis of any individual asset will not be reduced below zero. n100 The basis reduction first is applied to: (1) property that is similar or related in service or use to the converted property, then (2) to other depreciable property, then (3) to other property. n101

The application of these rules can be demonstrated by the following examples:

Example 1:

Assume that a taxpayer owned a commercial building with an adjusted basis of \$100,000 that was involuntarily converted, causing the taxpayer to receive \$1 million in insurance proceeds. Further assume that the taxpayer acquires, as replacement property, all of the stock of a corporation, and the sole asset of

the corporation is a building with a value and an adjusted basis of \$1 million. Under the provision, for *IRC Section 1033* to apply, the taxpayer would reduce its basis in the stock to \$100,000 (as under present law) and the corporation would reduce its adjusted basis in the building to \$100,000.

Example 2:

Assume the same facts as in Example 1, except that on the date of acquisition, the corporation has an adjusted basis of \$100,000 (rather than \$1 million) in the building. Under the new provision, the taxpayer reduces its basis in the stock to \$100,000 (as under present law) and the corporation is not required to reduce its adjusted basis in the building.

Planning Tip:

Taking corporate stock as replacement property, rather than acquiring property owned by the corporation directly, can have disastrous tax consequences because of the double taxation that can result. Because both the taxpayer's basis in the corporate stock and the corporation's basis in its assets are reduced, a liquidating distribution by the corporation can result in double taxation--the taxpayer must recognize gain on the

redemption of the reduced-basis stock, n102 and the corporation must recognize gain on the distribution of the reduced-basis distributed property. n103

By acquiring the replacement property directly, the taxpayer avoids having to pay the tax due from the corporation on the liquidation in exchange for a reduced basis in the property.

FOOTNOTES:

(n1)Footnote 91. *IRC § 1033(b)(1)*.

(n2)Footnote 92. *IRC § 1033(b)(2)*.

(n3)Footnote 93. *IRC § 1033(b)(2)*.

(n4)Footnote 94. *IRC § 1250(d)(4)(D)*.

(n5)Footnote 95. *IRC § 1250(d)(4)(E)*.

(n6)Footnote 96. *IRC § 1033(b)(3)*, eff for involuntary conversions occurring after 8/20/96.

(n7)Footnote 97. See *IRC § 1033(a)(2)(E)* for a definition of "control".

(n8)Footnote 98. *IRC § 1033(b)(3)(A)*.

(n9)Footnote 99. *IRC § 1033(b)(3)(B)*.

(n10)Footnote 100. *IRC § 1033(b)(3)(D)(i)*.

(n11)Footnote 101. *IRC § 1033(b)(3)(C)*.

(n12)Footnote 102. *IRC § 331(a)*.

(n13)Footnote 103. *IRC § 336(a)*.

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CHAPTER 8A Involuntary Conversions of Real Estate *

1-8A Federal Taxes Affecting Real Estate § 8A.04

§ 8A.04 Holding Period

The holding period of property acquired as replacement property includes the holding period of the property it replaces, provided that the property is used in a business or investment. n104

FOOTNOTES:

(n1)Footnote 104. *IRC § 1223(1)(A)*.

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CHAPTER 8A Involuntary Conversions of Real Estate *

1-8A Federal Taxes Affecting Real Estate § 8A.05

§ 8A.05 Period of Replacement

Generally, the taxpayer must replace the converted property within two years from the close of the taxable year in which any gain from the conversion is realized. n105 However, the replacement period is three years in the case of government condemnation of business investment real property held for productive use in trade or business or for investment. n106

Real property that is stock in trade or held by the taxpayer primarily for sale does not qualify for the 3-year replacement period. n106.1 A taxpayer may request an extension of the deferral period. n107 Multiple replacement periods with respect to a single condemnation are not permitted, even if conversion proceeds are received on different dates. An extension of the deferral period should be requested when all or a portion of proceeds from a condemnation may be received after the regular replacement period expires. n108 The date of the conversion in the event of a condemnation is the date the condemning authority takes possession of the condemned property. n109

In the case of certain federally declared disasters, the time under *IRC Section 1033(a)(2)(B)* to rebuild or buy a principal residence is four years. n110 This rule is applicable to residences situated in disaster areas determined by the President to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. n111 Extensions of time beyond the four-year period may be applied for pursuant to statutory authority. n112

For property that was involuntarily converted within the New York Liberty Zone as a result of the terrorist attacks that occurred on September 11, 2001, the replacement period is five years. The five-year replacement period is available only if substantially all of the use of the replacement property is in New York City. n112.1

FOOTNOTES:

(n1)Footnote 105. *IRC § 1033(a)(2)(B)*.

(n2)Footnote 106. *IRC § 1033(g)(4)*.

(n3)Footnote 106.1. *IRC § 1033(g)(1), (4)*; see *Ltr Rul 200219006*.

(n4)Footnote 107. *IRC § 1033(a)(2)(B)(ii)*.

(n5)Footnote 108. See *Shipes, Jr v Commr*, *TC Memo* 1997-304 ; *In re Mahon et al*, 98-2 *USTC* P 50,684 (US Bkcy Ct, MD Fla 1998); *Stewart & Co v Commr*, 57 *TC* 122 (1971) ; *Feinberg v Commr*, 45 *TC* 635 (1966) , *affd* 377 *F2d* 21 (8th Cir 1967) .

(n6)Footnote 109. *RJ Wilson v Commr*, *TC Memo* 1996-418 , applying Maryland law.

(n7)Footnote 110. *IRC* § 1033(h)(1)(B).

(n8)Footnote 111. *IRC* §§ 165(h)(3)(C), 1033(h)(3).

(n9)Footnote 112. *IRC* § 1033(a)(2)(B)(ii). See also *Rev Rul* 60-69, 1960-1 *CB* 294 .

(n10)Footnote 112.1. *IRC* § 1400L(g).

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CHAPTER 8A Involuntary Conversions of Real Estate *

1-8A Federal Taxes Affecting Real Estate § 8A.06

§ 8A.06 Election Requirement

In a case where property is converted into money or property not similar or related in service or use to the converted property, the nonrecognition provisions of *IRC Section 1033* are not mandatory. Taxpayers make the election to recognize or defer the gain from involuntary conversions by either reporting or omitting to report the gain in the tax return for the year of conversion. n113 The filing of a return in which *IRC Section 1033* is not elected is itself an election not to apply *IRC Section 1033*. n114 In the case of a partnership, the election must be made by the partnership and not by partners individually. n115 An election, in whatever form made, is effective only for the year in which it is made, and not for a taxable year for which a return has already been filed. Thus, an election cannot be made for a prior year for which a return not making the election was filed. n116 A taxpayer who elects to report the gain may file a claim for refund for any year in which gain from the involuntary conversion is realized; that claim would have to be filed within the regular period of limitations set forth in *IRC Section 6511* (generally the later of 3 years from the date the return is filed or 2 years from the time the tax is paid). n117

When an election to defer the gain has been made and:

- (1) no replacement property has been purchased;
- (2) conversion proceeds have not been completely utilized; or
- (3) replacement property has been acquired after the replacement period has expired,

it is necessary to file an amended return reporting the gain in the year of the conversion. n118

When the replacement property is acquired, it must be identified as such in the tax return for the year of its acquisition. n119 It is important that details regarding the purchase of replacement property take place and be reported currently. Taxpayers cannot use hindsight either in electing *IRC Section 1033(a)* or in designating replacement property; thus, taxpayers cannot ordinarily designate property as replacement property some time after the replacement property is acquired. n120

Where replacement property has been identified, however, and the taxpayer desires to designate other property as a replacement before the replacement period expires, the Service has ruled that the taxpayer may not substitute. However,

where the replacement property is found not to qualify, substitution within the required period is acceptable. n121

FOOTNOTES:

(n1)Footnote 113. *IRC § 1033(a)(2)(A); Treas Reg § 1.1033(a)-2(c).*

(n2)Footnote 114. See *FSA 200147053* .

(n3)Footnote 115. *Rev Rul 66-191, 1966-2 CB 300 ; McManus v Commr, 583 F2d 443 (9th Cir 1978) ; see TAM 199907029* .

(n4)Footnote 116. *Treas Reg § 1.1033(a)-2(c)(2); FSA 200147053* .

(n5)Footnote 117. *Rev Rul 73-127, 1963-2 CB 333 ; FSA 200147053* .

(n6)Footnote 118. *Treas Reg § 1.1033(a)-2(c)(2).*

(n7)Footnote 119. *Id.*

(n8)Footnote 120. *Feinberg v Commr, 45 TC 635 (1966) , aff'd 337 F2d 21 (8th Cir 1967) ; Rev Rul 83-89, 1983-1 CB 190 ; GCM 38694 ; FSA 200147053* .

(n9)Footnote 121. *Rev Rul 83-39, 1983-1 CB 14* .

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CHAPTER 8A Involuntary Conversions of Real Estate *

1-8A Federal Taxes Affecting Real Estate § 8A.07

§ 8A.07 Depreciation Recapture

The ordinary income recapture provisions under *IRC Sections 1245 and 1250* override the provisions of *IRC Section 1033* n122 and may cause income to be recognized upon an involuntary conversion. These rules must be reviewed carefully to ensure that a deferral of income will result.

Generally, when depreciable personal property is involuntarily converted, there may be a recapture of depreciation. The amount of depreciation recapture is treated as ordinary income. In the case of an involuntary conversion, the recapture is limited to the amount of gain recognized plus the fair market value of nondepreciable personal property received in the conversion.

Recapture of depreciation may also be applicable upon the involuntary conversion of depreciable real property such as buildings. If the cost of nonresidential property is depreciated in a manner other than straight-line, all gain will be ordinary income to the extent of all previous depreciation taken. In the case of an involuntary conversion, this recapture is limited to the greater of the following:

- (1) gain recognized upon disposition plus the fair market value of corporate stock acquired as replacement property; n123 or
- (2) the excess of the recaptured depreciation (without regard to the above limitation) over the fair market value of depreciable real property acquired in the conversion. n124

Depreciation recapture is discussed more fully in Chapters 5 and 6.

FOOTNOTES:

(n1)Footnote 122. *IRC §§ 1245(a)(1), 1250(a)(1).*

(n2)Footnote 123. *IRC § 1250(d)(4)(B).*

(n3)Footnote 124. *IRC § 1250(d)(4)(C).*

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CHAPTER 8A Involuntary Conversions of Real Estate *

1-8A Federal Taxes Affecting Real Estate § 8A.08

§ 8A.08 Depreciation of MACRS Property Acquired in Involuntary Conversions

[1] In General

Regulations cover the proper depreciation of property acquired in involuntary conversions. n124.1 While much of their focus is on non-real estate property, the discussion here is directed to their application to involuntarily converted real estate.

The final regulations supersede prior temporary regulations, and generally apply to an involuntary conversion or like-kind exchange of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004. n124.2 For an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may apply these final regulations or rely on prior guidance issued by the IRS in *Notice 2000-4*. n124.3 In either case, a choice to will necessitate seeking IRS consent for a change of accounting method. n124.4

Notice 2000-4 instructed taxpayers how to depreciate replacement MACRS property when the involuntarily converted property was also MACRS property. The notice stated that replacement MACRS property placed in service after January 3, 2000, was to be depreciated over the remaining recovery period of, and using the same depreciation method and convention as, the relinquished MACRS property and that any excess of the basis in the replacement MACRS property over the adjusted basis in the relinquished MACRS property was to be treated as newly purchased MACRS property. *Notice 2000-4* also stated that regulations would be issued to address these transactions. n124.5 The regulations discussed below are the result, and they make *Notice 2000-4* obsolete after February 27, 2004.

[2] Application of Regulations to MACRS Property

The regulations instruct taxpayers how to determine the annual depreciation allowance for MACRS property (i.e. depreciable property placed in service after December 31, 1986) acquired in an involuntary conversion. The regulations also apply to involuntary conversions involving MACRS property that is replaced with other MACRS property in a transaction between members of the same affiliated group. The regulations do not apply to property acquired in an involuntary conversion to replace property whose depreciation allowance is computed under a depreciation system other than MACRS. n124.6

The depreciation treatment used by previous owners in determining depreciation allowances for the replacement

MACRS property is not relevant. In addition, elections made by previous owners in determining depreciation allowances of the replacement MACRS property have no effect on the acquiring taxpayer. n124.7 Regulations clarify that taxpayers cannot depreciate land that is acquired in an involuntary conversion for MACRS property. n124.8

[3] General Rule for Depreciation of Exchanged Basis

Regulations provide rules for determining the applicable recovery period, depreciation method, and convention used to determine the depreciation allowances for the replacement MACRS property with respect to so much of the taxpayer's basis (as determined under the involuntary conversion rules) in the replacement MACRS property as does not exceed the taxpayer's adjusted depreciable basis in the relinquished MACRS property (exchanged basis). In general, the exchanged basis is depreciated over the remaining recovery period of, and using the depreciation method and convention of, the relinquished MACRS property (general rule). n124.9 It should be noted that the term "relinquished MACRS property" in this context refers to the MACRS property that is transferred by the taxpayer in an involuntary conversion. n124.9.1

This general rule applies if the replacement MACRS property has the same or a shorter recovery period or the same or a more accelerated depreciation method than the relinquished MACRS property. n124.10 Therefore, the general rule can adversely affect taxpayers whose property is involuntarily converted by requiring depreciation of replacement MACRS property over the longer recovery period of the relinquished MACRS property. To avoid this problem, the regulations allow taxpayers to elect not to apply the general rule, but instead to treat the replacement MACRS property as MACRS property placed in service by the acquiring taxpayer at the time of replacement. n124.11

The general rule does not apply if the replacement MACRS property has a longer recovery period or less accelerated depreciation method than the relinquished MACRS property. In that case, the taxpayer's exchanged basis in the relinquished MACRS property is depreciated beginning in the year of replacement over the remainder of the recovery period that would have applied to the replacement MACRS property if the replacement MACRS property had originally been placed in service when the relinquished MACRS property was placed in service by the acquiring taxpayer. n124.12 Similarly, if the depreciation method of the replacement MACRS property is less accelerated than that of the relinquished MACRS property, then the taxpayer's exchanged basis in the relinquished MACRS property is depreciated beginning in the year of replacement using the less accelerated depreciation method of the replacement MACRS property that would have applied to the replacement MACRS property if the replacement MACRS property had originally been placed in service when the relinquished MACRS property was placed in service by the acquiring taxpayer. n124.13

For taxpayers who use the optional depreciation tables to determine depreciation allowances for the replacement MACRS property instead of the formulas, n124.14 the regulations provide guidance on choosing the applicable optional table and explain the modifications that must be made to compute depreciation allowances for the replacement MACRS property. Taxpayers who used an optional depreciation table for the relinquished MACRS property are not required to use an optional table for the depreciable exchanged basis of the replacement property. n124.15

Regulations also deal with the depreciation convention to be used. For MACRS nonresidential real property and residential rental property, the exchanged basis must be depreciated using the mid-month convention. n124.15.1 Regarding the recovery period of the replacement property, the replacement MACRS property is treated as placed in service at the time of replacement under the convention that applies to the replacement MACRS property (i.e. the mid-month convention for MACRS nonresidential real property and residential rental property). The remaining recovery period of the replacement MACRS property at the time of replacement is the excess of the recovery period for the replacement MACRS property over the period of time that the replacement MACRS property would have been in service if it had been placed in service when the relinquished MACRS property was placed in service and removed from service at the time of disposition of the relinquished MACRS property. This period is determined by using the convention that applied to the relinquished MACRS property to determine the date that the relinquished MACRS

property is deemed to have been placed in service and the date that it is deemed to have been disposed of. The length of time the replacement MACRS property would have been in service is determined by using these dates and the convention that applies to the replacement MACRS property. n124.15.2

If, using the convention that applies to the relinquished MACRS property, the remaining recovery period of the relinquished MACRS property at the beginning of the year of disposition is less than the number of months between the first of that year and the time of disposition, the entire basis in the relinquished MACRS property is deductible in the year of disposition and the exchanged basis is zero. n124.15.3

Example:

On January 1, 2004, E, a calendar-year taxpayer, acquired and placed in service Canopy V, a gas station canopy. The purchase price of Canopy V was \$60,000. On August 1, 2004, Canopy V was destroyed in a hurricane and was therefore no longer usable in E's business. On October 1, 2004, as part of the involuntary conversion, E acquired and placed in service new Canopy W with the insurance proceeds E received due to the loss of Canopy V. E elected not to deduct the additional first year depreciation for 5-year property placed in service in 2004. E depreciates both canopies under the general depreciation system n124.15.4 by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. No depreciation deduction is allowable for Canopy V in 2004. The depreciation deduction allowable for Canopy W for 2004 is \$12,000 (\$60,000 x the annual depreciation rate of .40 x 1/2 year). For 2005, the depreciation deduction for Canopy W is \$19,200 (\$48,000 adjusted basis x the annual depreciation rate of .40). n124.15.5

[4] Rules for Depreciation of Excess Basis

Any excess basis in replacement MACRS property over the taxpayer's exchanged basis in the relinquished MACRS property is referred to as the excess basis. n124.16 The excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer in the year of replacement. The depreciation allowances for the excess basis are determined by using the applicable recovery period, depreciation method, and convention prescribed under *IRC Section 168* for the replacement MACRS property at the time of replacement. However, if replacement MACRS property is disposed of during the same taxable year the relinquished MACRS property is placed in service by the acquiring taxpayer, no depreciation deduction is allowable for either MACRS property. n124.17

[5] Special Rules for Deferred Transactions

A taxpayer who disposes of relinquished MACRS property before acquiring the replacement MACRS property cannot take depreciation on the relinquished MACRS property during any intervening period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property. Accordingly, the recovery period for the replacement MACRS property is suspended during this period. n124.18

[6] Acquisition Prior to Disposition

When replacement MACRS property is acquired and placed in service by a taxpayer before the relinquished MACRS property is disposed of (for example, under threat of condemnation), the regulations allow the taxpayer to depreciate the unadjusted depreciable basis of the replacement MACRS property until the taxpayer disposes of the relinquished MACRS property. At the time of disposition of the relinquished MACRS property, the taxpayer determines the exchanged basis and the excess basis of the replacement MACRS property and begins to depreciate the depreciable exchanged basis of the replacement MACRS property in accordance with the rules for depreciation of exchanged basis. n124.19 The depreciable excess basis of the replacement MACRS property continues to be depreciated by the taxpayer in accordance with the rules for excess basis. In the year of disposition of the relinquished MACRS property, the taxpayer must include in taxable income the excess of the depreciation deductions allowable on the unadjusted

depreciable basis of the replacement MACRS property over the depreciation deductions that would have been allowable to the taxpayer on the depreciable excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer (taking into account the applicable convention) to the time of disposition of the relinquished MACRS property. n124.19.1

[7] Transactions Involving Land or Other Nondepreciable Property

Land or other nondepreciable property acquired in an involuntary conversion for MACRS property is not depreciable, and is not within the scope of the regulations. If MACRS property or both MACRS property and land or other nondepreciable property are acquired in an involuntary conversion for land or other nondepreciable property, the basis of the replacement MACRS property is treated as property placed in service by the acquiring taxpayer in the year of replacement. n124.20

[8] Election Not To Apply Regulations

In order to ease computational and administrative difficulties that could result from having to track different depreciation components of one asset, taxpayers may elect to have the regulations not apply. n124.21 A taxpayer who makes that election must treat the entire basis (i.e. both the exchanged and excess basis) of the replacement MACRS property as being placed in service by the acquiring taxpayer at the time of replacement. Consistent with this treatment, the taxpayer treats the relinquished MACRS property as disposed of at the time of the disposition of the relinquished MACRS property. n124.22

A separate election is required for each involuntary conversion. n124.23 The election must be made in the manner provided for on Form 4562, Depreciation and Amortization, and its instructions, n124.23.1 and must be made by the due date (including extensions) of the taxpayer's Federal tax return for the year of replacement. n124.23.2 The election is made for each member of a consolidated group by the common parent of the group, by the partnership (and not by the partners separately) in the case of a partnership, or by the S corporation (and not by the shareholders separately) in the case of an S corporation. n124.23.3 The election may be revoked only with the consent of the Commissioner, which will be granted only in extraordinary circumstances. n124.24

[9] Additional First Year Depreciation

Regulations n124.25 provide that the exchanged basis (referred to as the "carryover basis" in these regulations) and the excess basis, if any, of the replacement MACRS property (referred to as the "acquired MACRS property" in these regulations) is eligible for the additional first year depreciation deduction provided under prior *IRC Section 168(k)* or *IRC Section 1400L(b)* if the replacement MACRS property is qualified property, n124.26 or 50-percent bonus depreciation property under prior law. n124.27 However, if qualified property or 50-percent bonus depreciation property is placed in service by the taxpayer and then disposed of by that taxpayer in an involuntary conversion in the same taxable year, the relinquished MACRS property (referred to as the "exchanged or involuntarily converted MACRS property" in these regulations) is not eligible for the additional first year depreciation deduction. n124.27.1 However, the exchanged basis (and excess basis, if any) of the replacement MACRS property may be eligible for the additional first year depreciation deduction. The rules provided these regulations for additional first-year depreciation n124.28 apply without regard to whether the taxpayer applies or elects not to apply the MACRS depreciation regulations for property acquired in an involuntary conversion. n124.29

[10] Involuntary Conversions Involving Multiple Properties

The determination of the basis of multiple properties acquired as a result of an involuntary conversion is described in regulations. n124.30 The IRS and Treasury Department believe that issues related to allocation of basis among multiple properties involved in like-kind exchanges or involuntary conversions for purposes of depreciation are covered in those regulations under *IRC Section 1033*; therefore, the regulations under *IRC Section 168(i)* do not address these issues.

n124.31

FOOTNOTES:

(n1)Footnote 124.1. *TD 9283*, adding *Treas Reg § 1.168(i)-6*; the regulations also apply to property acquired in like-kind exchanges under *IRC § 1031*.

(n2)Footnote 124.2. *Treas Reg § 1.168(i)-6(k)(1)*.

(n3)Footnote 124.3. *Treas Reg § 1.168(i)-6(k)(2)*.

(n4)Footnote 124.4. *Treas Reg § 1.168(i)-6(k)(2)(i), (ii)*.

(n5)Footnote 124.5. *Notice 2000-4, 2000-1 CB 313*.

(n6)Footnote 124.6. *Treas Reg § 1.168(i)-6(a)*.

(n7)Footnote 124.7. *Treas Reg § 1.168(i)-6(c)(2)*.

(n8)Footnote 124.8. *Treas Reg § 1.168(i)-6(d)(2)(i)*.

(n9)Footnote 124.9. *Treas Reg § 1.168(i)-6(c)(3)(ii)*.

(n10)Footnote 124.9.1. *Treas Reg § 1.168(i)-6(b)(2)*.

(n11)Footnote 124.10. *Treas Reg § 1.168(i)-6(c)(3), (4)(ii)*.

(n12)Footnote 124.11. *Treas Reg § 1.168(i)-6(i)(1), (j)*; see § 8A.08[8], below, for a discussion of the election.

(n13)Footnote 124.12. *Treas Reg § 1.168(i)-6(c)(3)(iii), (4)(i)*.

(n14)Footnote 124.13. *Treas Reg § 1.168(i)-6(c)(3)(iii), (4)(iii)*.

(n15)Footnote 124.14. See *Rev Proc 87-57, 1987-2 CB 687*, § 8.

(n16)Footnote 124.15. *Treas Reg § 1.168(i)-6(e)*.

(n17)Footnote 124.15.1. *Treas Reg § 1.168(i)-6(c)(4)(v)*.

(n18)Footnote 124.15.2. *Treas Reg § 1.168(i)-6(c)(5)(ii)(A)*.

(n19)Footnote 124.15.3. *Treas Reg § 1.168(i)-6(c)(5)(i)(B)*.

(n20)Footnote 124.15.4. See *IRC § 168(a)*.

(n21)Footnote 124.15.5. *Treas Reg § 1.168(i)-6(c)(6)*, Ex 6.

(n22)Footnote 124.16. *Treas Reg § 1.168(i)-6(b)(8)*.

(n23)Footnote 124.17. *Treas Reg § 1.168(i)-6(d)(1)(i)*.

(n24)Footnote 124.18. *Treas Reg § 1.168(i)-6(c)(5)(iv)(A)*.

(n25)Footnote 124.19. *Treas Reg § 1.168(i)-6(d)(4)*; see *Treas Reg § 1.168(i)-6(c)*; see § 8A.08[3], above, for the general rule.

(N26)Footnote 124.19.1. *Treas Reg § 1.168(i)-6(d)(4)*.

(n27)Footnote 124.20. *Treas Reg § 1.168(i)-6(d)(2)(i), (ii)*.

(n28)Footnote 124.21. *Treas Reg § 1.168(i)-6(i)(1), (j)*.

(n29)Footnote 124.22. *Treas Reg § 1.168(i)-6(i)(1)*.

(n30)Footnote 124.23. *Treas Reg § 1.168(i)-6(j)(1)*.

(n31)Footnote 124.23.1. *Treas Reg § 1.168(i)-6(j)(1), (3)*.

(n32)Footnote 124.23.2. *Treas Reg § 1.168(i)-6(j)(2)*.

(n33)Footnote 124.23.3. *Treas Reg § 1.168(i)-6(j)(1)*.

(n34)Footnote 124.24. *Treas Reg § 1.168(i)-6(j)(4)*.

(n35)Footnote 124.25. See *Treas Reg §§ 1.168(k)-1, 1.1400L(b)-1*.

(n36)Footnote 124.26. See *IRC § 168(k)(2)*, before amendment by Pub Law No 110-185.

(n37)Footnote 124.27. *Treas Reg §§ 1.168(k)-1(f)(5)(i), (iii)(A), 1.1400L(b)-1(f)(5)*. See *IRC § 168(k)(4)*, before repeal by Pub Law No 110-185 the same rule applies to qualified New York Liberty Zone property (see *IRC § 1400L(b)(2)*).

(n38)Footnote 124.27.1. *Treas Reg §§ 1.168(k)-1(f)(5)(iii)(B), 1.1400L(b)-1(f)(5)*.

(n39)Footnote 124.28. *Treas Reg §§ 1.168(k)-1, 1.1400L(b)-1*.

(n40)Footnote 124.29. *Treas Reg § 1.168(i)-6(b)(9), (10), 1.168(i)-6(h)*.

(n41)Footnote 124.30. *Treas Reg § 1.1033(b)-l*.

(n42)Footnote 124.31. See TD 9314 .

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1-8A Federal Taxes Affecting Real Estate § 8A.09

§ 8A.09 Statute of Limitations Issues in Involuntary Conversions

If a taxpayer elects to defer gain from an involuntary conversion, a special statute of limitations rule applies. The statutory period for assessing a deficiency related to that gain for a taxable year in which any part of the gain on the conversion is realized, does not expire until three years from the date the IRS is notified by the taxpayer of the replacement of the converted property or of an intention not to replace. n125 This has the effect of extending the general 3-year period of limitations under *IRC Section 6501(a)*. n126 The IRS may assess a deficiency within the extended three-year period without regard to any other statutory provisions that would otherwise prevent the assessment. n127

Regulations detail the manner of notification. If a replacement has been made, the notification must contain all the details in connection with the replacement. The notification must be made in the return for the tax year(s) in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires. n128 If proper notification is not given, the statute of limitations does not begin to run, and the IRS may assess a deficiency at any time. n129 The IRS has also ruled that the same extended statute of limitations for assessing a deficiency with respect to a taxpayer's gain on the involuntary conversion applies for partners of the taxpayer and, if the partner is a lower-tier subsidiary, against that partner's parent corporation. n130

When gain is realized from an involuntary conversion of property in more than one taxable year, the statute of limitations does not run until the expiration of the period within which a deficiency may be assessed for last of those taxable years. n131

FOOTNOTES:

(n1)Footnote 125. *IRC § 1033(a)(2)(C)(i)*.

(n2)Footnote 126. See Chief Counsel Memorandum 200315021; *Vaira v Commr*, 52 TC 986, 1003 (1969) , reversed and remanded on other grounds 444 F2d 770 (3rd Cir 1971) .

(n3)Footnote 127. *IRC § 1033(a)(2)(C)(ii)*.

(n4)Footnote 128. *Treas Reg § 1.1033(a)-2(c)(5)*.

(n5)Footnote 129. *IRC § 1033(a)(2)(C)(i)*; *Au Hoy v Commr*, 58 TC 201 (1972) ; *James River Apartments v Commr*, 54 TC 618 (1970) , *affd per curiam* 440 F2d 412 (4th Cir 1971) ; *Vaira v Commr*, 52 TC 986, 1003 (1969) ,

reversed and remanded on other grounds 444 F2d 770 (3rd Cir 1971) .

(n6)Footnote 130. Chief Counsel Memorandum 200315021.

(n7)Footnote 131. *IRC § 1033(a)(2)(D); Treas Reg § 1.1033(a)-2(c)(6).*

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate 9.syn

§ 9.syn Synopsis to Chapter 9: Personal Residences *

§ 9.01 Overview of Relief Provisions and Other Tax Benefits for Personal Residences

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.01

§ 9.01 Overview of Relief Provisions and Other Tax Benefits for Personal Residences

The most significant, and in many cases the only, real estate experience for the vast majority of taxpayers will occur in connection with their personal residences. Many of the tax rules applicable to personal residences are different than those applicable to other types of real estate. In some circumstances, gain realized and received in cash is not subject to tax. n1 Depreciation and realized losses are generally not deductible. n2 Interest expense is subject to different deduction limitations than those applicable to business or investment real estate. n2.1 State or local tax incentives relating to personal residences may exist. n3 Other rules of general applicability do apply to personal residences. Gain realized on the sale or exchange of a taxpayer's residence may result in taxable income if the transaction does not satisfy the statutory requirement of the exclusion provision. n3.1 The taxpayer's holding period will determine whether any gain subject to tax is short-term or long-term capital gain. n4

Legislation enacted in 1997 significantly changed the relief provisions with respect to sales of principal residences. *IRC Section 1034*, relating to rollovers of gain from the sale of principal residences, was repealed, effective generally for sales and exchanges after May 6, 1997. n5 *IRC Section 121*, relating to the exclusion of gain from sales of principal residences, was revised and expanded and now excludes from gross income \$250,000 of gain from the sale of a principal residence (\$500,000 for certain taxpayers filing a joint return). n6 The exclusion under *IRC Section 121* is now available without regard to the taxpayer's age, and the exclusion is no longer a "once in a lifetime" opportunity. The 1997 amendments to *IRC Section 121* are effective generally for sales and exchanges after May 6, 1997. n7

Section 9.02, below, discusses relief provisions under current *IRC Section 121*.

Section 9.03[1], below, discusses the relief provisions available under former *IRC Section 1034*. *Section 9.03[2], below*, discusses the former \$125,000 once-in-lifetime exclusion from income for taxpayers 55 and over who sold their principal residences. n8 The discussion of these repealed provisions has been retained in this treatise since the reader may encounter cases under audit where the repealed provisions were in effect at the time of the applicable sales or exchanges.

FOOTNOTES:

(n1)Footnote 1. *IRC § 121*.

(n2)Footnote 2. *Treas Reg § 1.165-9(a); Blodgett v Commr, TC Memo 2003-212 ; Joseph v Commr, TC Memo*

2004-134 (capital loss carryover denied with respect to taxpayers' transfer to a trust they controlled of a lot on which their residence was to be constructed).

(n3)Footnote 2.1. *IRC § 163(h)*; see § 9.04 for a discussion.

(n4)Footnote 3. A limited first-time homebuyer credit is available for purchases of principal residences in the District of Columbia through 2009. *IRC § 1400C(i)*.

(n5)Footnote 3.1. *IRC § 121*.

(n6)Footnote 4. See *IRC §§ 1(h)*; 1222(1), (3).

(n7)Footnote 5. Pub L No 105-34, § 312(b).

(n8)Footnote 6. *IRC § 121(b)*.

(n9)Footnote 7. Pub L No 105-34, § 312(d)[e].

(n10)Footnote 8. See former *IRC 121*, *before amendment by* Pub L No 105-34.

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.02

§ 9.02 Exclusion of Gain from Sale of Principal Residence

[1] In General

IRC Section 121 excludes from gross income \$250,000 of gain from the sale of a principal residence (\$500,000 for certain taxpayers filing a joint return). n9 Each unmarried or married taxpayer who jointly owns property and who files a separate return is eligible to exclude up to \$250,000 of gain that is attributable to each taxpayer's interest in the property. n9.1 The exclusion is available for any sale or exchange of a principal residence that satisfies the ownership and use requirements discussed below, unless an exclusion has applied to a sale or exchange of a principal residence within the preceding two years. The two-year period is measured from the date of the sale in question. n9.2 In circumstances in which the buyer needs occupancy before the two-year period will have expired, it is possible for the seller to take advantage of the relief provision and still accommodate the buyer by entering into a contract with a closing date after the end of the two-year period and allowing the buyer to rent the property for the interim period. n9.3

Example:

H&P purchase Blackacre on 7/1/95 and immediately use it as their principal residence. On 10/18/97, they purchase Whiteacre, to which they move as their new principal residence, converting Blackacre to a rental property. They sell Blackacre on 6/10/98 in a transaction that takes advantage of *IRC Section 121*. In January, 2000, they put Whiteacre on the market and find a buyer who must move in by 6/1/00. H&P can sign a contract for the sale of Whiteacre with a 6/15/00 closing date, providing that the risk of loss from fire or other casualty remains with them, and lease Whiteacre to the Buyer from 6/1/00 through 6/15/00, for an arm's length rental. The sale of Whiteacre will close (and take place for tax purposes) on 6/15/00, which is more than two years after the sale of Blackacre. H&P occupied each of Blackacre (from 7/1/95-10/18/97) and Whiteacre (from 10/19/97-5/31/00) as their principal residence for more than two years during the five-year period preceding the sale of each property. If other requirements of *IRC Section 121* are met, each sale can take advantage of *IRC Section 121*. n9.4

In determining whether there has been a sale or exchange within the preceding two years, sales or exchanges before May 7, 1997, are not taken into account. n10 The exclusion is available without regard to the taxpayer's age. n11 The exclusion does not apply to any gain attributable to depreciation adjustments n12 for periods after May 6, 1997; such gain must be recognized. n13 Depreciation adjustments allocable to any portion of the property to which the *IRC*

Section 121 exclusion does not apply, however, are not taken into account. n14 The statute is silent about recapture of pre-May 7, 1997 depreciation. The IRS has ruled, however, that a portion of the gain attributable to those depreciation deductions must be recaptured under Treas Reg § 1.121-l(b)(2). n14.1

[2] Ownership Requirement

To qualify for the exclusion, the taxpayer must have owned the property for at least two years of the five-year period ending on the date of the sale or exchange. n15 The ownership requirement may be satisfied by establishing ownership for 24 full months or 730 days. The requirements of ownership and use may be satisfied during non-concurrent periods, provided that both ownership and use requirements are met on the date of the sale or exchange. n15.1

If a residence is held by a trust, a taxpayer is treated as the owner and seller during the period that the taxpayer is treated as the owner of the trust or the portion of the trust that includes the residence under the grantor trust provisions. Therefore, a sale of the residence by the trust is eligible for the *IRC Section 121* exclusion. n15.2 Similar treatment applies if the residence is owned by a single-member entity that is disregarded as an entity separate from its owner. In that case, the owner is treated as owning the residence for purposes of satisfying the 2-year ownership requirement, n15.3 and the sale or exchange by the entity will be treated as if made by the owner. n15.4

The IRS takes the position that residences owned by a partnership or limited partnership are not eligible for the exclusion under *IRC Section 121*, n15.5 even if a grantor trust owns nearly all of the partnership interests. n15.6 The Tax Court has also held that a residence held by a family partnership was not entitled to the exclusion. n15.6.1

[3] Use as Principal Residence Requirement

[a] In General

To qualify for the exclusion, the taxpayer must have used the property as a principal residence for at least two years of the five-year period ending on the date of the sale or exchange. n15.7 The use requirements may be satisfied by establishing use for 24 full months or 730 days. The requirements of ownership and use may be satisfied during non-concurrent periods, provided that both ownership and use requirements are met on the date of the sale or exchange. n15.8

"Use" requires occupancy of the residence. Short temporary absences as for vacation or other seasonal absence (even if the residence is rented) are counted as periods of use. n15.9 Regulations do not specify a maximum period that can qualify as short or temporary and that can still qualify as "use" under *IRC Section 121*. The determination will depend on all facts and circumstances, and be made on a case-by-case basis. n15.10

A divided Tax Court has held that the property sold must include the dwelling that the taxpayer actually used as a principal residence. In the case, the taxpayers demolished their old home (which they had used as a principal residence for more than two years) and constructed a new house on the property. They never occupied the new house, however, but instead sold it. The Tax Court held that the taxpayers were not entitled to exclude any gain from the sale under *IRC Section 121* because they never met the "use" requirement with respect to the new house. The court rejected the taxpayers' argument that they were entitled to the exclusion because the new residence was built on the same land where the old residence was located, and that the term "property" as used in *IRC Section 121* included not only the dwelling but also the land on which the dwelling was located. n15.10.1

NOTE:

The dissent in the *Gates* case, joined by five judges, points out the perhaps untenable distinction between remodeling a house (in which case the *IRC Section 121* exclusion would be allowed for a post-remodel sale of the home) and demolishing and rebuilding a new house (the situation for which the majority denied the exclusion). The dissent would allow the *IRC Section 121* exclusion in both cases. Expect an

appeal of the Tax Court's decision. n15.10.2

NOTE:

There are exceptions allowing the "use" requirement to be satisfied notwithstanding long-term absences from the home. One allows absence for outside health care, n15.11 the other allows members of the uniformed services US Foreign Service to elect to suspend the 5-year period during which the 2-year use and ownership requirements must be met during periods of qualified official extended duty. n15.12 Except for these circumstances, non-occupancy for a long-term period cannot be counted as "use." n15.13

Whether property is used by the taxpayer as a residence depends upon all the facts and circumstances. A residence may be a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation. n15.14

[b] Principal Residence When Taxpayer Has Multiple Residences

In the case of a taxpayer using more than one property as a residence, whether a property is used by the taxpayer as his or her principal residence depends upon all the facts and circumstances. If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. n15.14.1 The regulation refers to the time spent in a residence *during a single tax year*. In one case, a district court ruled that a residence was not the taxpayers' principal residence because they had spent more time in it than in one of their other residences only in one year of the five-year period. n15.14.2 The court also noted that for the entirety of the five-year period the taxpayers had spent more time in their other homes combined than they did in the house in question. In addition to the taxpayer's use of the property, however, relevant factors in determining a taxpayer's principal residence, include, but are not limited to the following: n15.15

- the taxpayer's place of employment;
- the principal place of abode of the taxpayer's family members;
- the address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- the taxpayer's mailing address for bills and correspondence;
- the location of the taxpayer's banks; and
- the location of religious organizations and recreational clubs with which the taxpayer is affiliated.

A taxpayer may meet the principal residence use requirement for more than one residence.

In one case, the taxpayers purchased a second home, where the wife lived full-time, while the husband returned only on weekends and non-workdays. The Tax Court agreed with the taxpayers that the second home was their principal residence, even though they kept license and voter registrations, and received mail, at their old residence. They wanted to maintain a consistent appearance regarding the husband's profession and business activities, which were closer to the old residence. In addition, although they dropped nearly all social and organizational attachments at the old residence, they didn't join new ones near the second home because the husband traveled with business and the wife spent much time caring for a daughter. n15.15.1

Example:

T owns two residences, one in Virginia and one in Maine. During Year 1 and Year 2, T lives in the Virginia residence. During Year 3 and Year 4, she lives in the Maine residence. During Year 5, she lives in the Virginia residence. T's principal residence during Years 1, 2, and 5 is the Virginia residence. T's principal residence during Years 3 and 4 is the Maine residence. T would be eligible for the *IRC Section 121* exclusion of gain from the sale or exchange of either residence (but not both) during Year 5. n15.16

[c] Use Determination During Periods of Outside Care

A taxpayer is treated as using his or her residence for purposes of the use requirement during any period in which he or she is incapable of self-care and resides in a licensed nursing home or similar facility, provided the following requirements are met: n15.17

- the taxpayer is physically or mentally incapable of self-care;
- the taxpayer owns and uses the property as a principal residence for at least one year of the five-year period ending on the date of the sale or exchange; and
- the taxpayer owns the property while living in the licensed nursing home or other facility.

Note that this relief provision would not apply to an incapacitated taxpayer who is residing with a relative. n15.18

[d] Property Used in Part as a Residence

The *IRC Section 121* exclusion does not apply to the gain allocable to any portion of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement if the non-residential portion is separate from the dwelling unit. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for non-residential purposes, only the gain allocable to the residential portion is excludable under *IRC Section 121*. n15.19 Allocation of basis and the amount realized between the business and residential portions of the property must be made in the same manner as any depreciation adjustments. n15.20 No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, *IRC Section 121* does not apply to any gain allocable to the non-residential portion of the property. n15.21 If the depreciation for periods after May 6, 1997, attributable to the non-residential portion of the property exceeds the gain allocable to the non-residential portion of the property, the excess will not reduce the *IRC Section 121* exclusion applicable to gain allocable to the residential portion of the property. n15.22

[4] Requirements When Joint Return Is Filed

The \$250,000 exclusion is available when a husband and wife file a joint return if either spouse meets the statutory ownership and use requirements with respect to the property. n16 Each spouse is entitled to the full \$250,000 exclusion with respect to property as to which he or she separately satisfied the use and ownership requirements. n16.1 If either spouse filing a joint return fails to meet the ownership and use requirements, the maximum exclusion to be claimed by the couple is the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property. n16.2

Example (1):

Married taxpayers H and W each sell a residence that each had separately owned and used as a principal residence before their marriage. Each spouse meets the ownership and use tests for his or her respective residence. Neither spouse meets the use requirement for the other spouse's residence. H and W file a joint return for the year of the sales. The gain realized from the sale of H's residence is \$200,000. The gain realized from the sale of W's residence is \$300,000. Because the ownership and use requirements are met for each residence by each respective spouse, H and W are each eligible to exclude up to \$250,000 of gain from the sale of their individual residences. However, W may not use H's unused exclusion to exclude gain in excess of her limitation amount. Therefore, H and W must recognize \$50,000 of the gain realized on the sale of W's residence. n16.3

A \$500,000 exclusion is available, however, if the following requirements are met: n17

- a husband and wife file a joint return;
- either spouse meets the ownership requirements during the applicable two-year period;
- both spouses meet the use requirements with respect to the property during the applicable two-year period; and
- neither spouse is ineligible for the exclusion by virtue of a sale or exchange of a principal residence within the preceding two years.

Example (2):

H, a single taxpayer who owns his principal residence and is otherwise eligible for an exclusion under *IRC Section 121*, marries W, who has recently used the exclusion, H is allowed a maximum exclusion of \$250,000, whether on a separate return or on a joint return with W. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either spouse, the taxpayers may exclude \$500,000 on their joint return. n18

Where a husband and wife filing a joint return do not satisfy the two-year ownership test, the two-year use test and the prohibition on any other sale or exchange of a residence within the last two years, the limit on the amount of excludable gain is computed separately for each spouse. Each spouse is treated as owning the property during the period that either spouse owned the property. n19

Example:

H and W marry in June. H and W each owned separate residences before marrying each other, and each satisfied the statutory ownership and use tests of *IRC Section 121*. Both residences are sold in July. H and W may each exclude up to \$250,000 of gain from the sale of their residences. Assume instead that only H sells his residence, and that he recognizes a gain of \$300,000 on the sale. On their joint return, H and W may exclude only \$250,000 of H's gain under *IRC Section 121*. n19.1

[5] Availability of Partial Exclusion

[a] In General

A partial exclusion may be available for taxpayers who have owned or used a principal residence for less than two of the five years preceding the sale or exchange or who have excluded gain from another sale or exchange during the last two years. n20 A partial exclusion is available only if the sale or exchange is by reason of a change in place of employment, n21 health, n22 or, to the extent provided in regulations, unforeseen circumstances. n23 The partial

exclusion is computed by multiplying the maximum dollar limitation of \$250,000 (\$500,000 for qualifying joint filers) by a fraction. The numerator of the fraction is the shortest of the following:

- the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange;
- the period of time that the taxpayer used the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale or exchange; or
- the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under *IRC Section 121* and the date of the current sale or exchange.

The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator). n23.1

Example (1):

A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in the place of her employment. A has not excluded gain under *IRC Section 121* on a prior sale or exchange of property within the last 2 years. A is eligible to exclude up to \$125,000 of the gain from the sale of her house ($12/24 \times \$250,000$). n23.2

Example (2):

H owns a house that he has used as his principal residence since Year 1. On January 15, Year 3, H and W marry and W begins to use H's house as her principal residence. On January 15, Year 4, H sells the house due to a change in W's place of employment. Neither H nor W has excluded gain under *IRC Section 121* on a prior sale or exchange of property within the last 2 years.

Because H and W have not each used the house as their principal residence for at least 2 years during the 5-year period preceding its sale, the maximum dollar limitation amount that may be claimed by H and W will not be \$500,000, but the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. n23.3

H is eligible to exclude up to \$250,000 of gain because he meets the requirements of *IRC Section 121*. W is not eligible to exclude the maximum dollar limitation amount. Instead, because the sale of the house is due to a change in place of employment, W is eligible to claim a reduced maximum exclusion of up to \$125,000 of the gain ($365/730 \times \$250,000$). Therefore, H and W are eligible to exclude up to \$375,000 of gain ($\$250,000 + \$125,000$) from the sale of the house. n23.4

NOTE:

When the proration provision comes into play, it reduces the amount of the exclusion available. It is not applied to reduce the amount of recognized gain that is eligible for the exclusion. For example, assume T owns a home for one year and is then transferred by her employer to another city. T sells the home at a \$40,000 gain. The proration provision reduces the exclusion for which T is eligible to \$125,000 [$\$250,000 \times 1/2$]. Because the amount of T's gain is less than the reduced exclusion amount, however, T may exclude the full \$40,000 from gross income. n23.4.1

[b] Circumstances Qualifying for Partial Exclusion

[i] In General

The reduced maximum exclusion is available only if the sale or exchange is by reason of a change in place of employment, health, to the extent provided by regulations, or unforeseen circumstances. n23.5 Extensive regulations provide safe harbors for each of the three types of available circumstances. If one of the safe harbors applies, a sale or exchange is deemed to be by reason of a change in place of employment, health, or unforeseen circumstances. If a safe harbor does not apply, the taxpayer may nevertheless be eligible to claim a reduced maximum exclusion if the taxpayer establishes, based on the facts and circumstances, that his or her primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances. n23.6 Factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which: n23.7

- the sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;
- the suitability of the property as the taxpayer's principal residence materially changes;
- the taxpayer's financial ability to maintain the property is materially impaired;
- the taxpayer uses the property as his or her residence during the period of the taxpayer owns the property;
- the circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and
- the circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

[ii] Change of Employment

A sale or exchange is by reason of a change in place of employment if the taxpayer's primary reason for the sale or exchange is a change in the location of the employment of a qualified individual. n23.8 "Employment" is defined as the commencement of employment with a new employer, the continuation of employment with the same employer, or the commencement or continuation of self-employment. n23.9 A qualified individual can be the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer. n23.10

A safe harbor provides that a sale or exchange is deemed to be by reason of a change in place of employment if the new place of employment of a qualified individual is at least fifty miles farther from the residence sold or exchanged than was the former place of employment. If the individual was unemployed, the distance between the new place of employment and the residence sold or exchanged must be at least fifty miles. The safe harbor applies only if the change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence. n23.11 If a sale or exchange does not satisfy this safe harbor, a taxpayer may still qualify for the reduced maximum exclusion by reason of a change in place of employment if the facts and circumstances indicate that a change in place of employment is the primary reason for the sale or exchange. n23.12

[iii] Health

The general rule is that a sale or exchange is by reason of health if the taxpayer's primary reason for the sale or exchange is (1) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the

individual is not a sale or exchange by reason of health. n23.13 There is a "physician's recommendation" safe harbor, under which a sale or exchange is deemed to be by reason of health if a physician n23.14 recommends a change of residence for reasons of health. n23.15 For purposes of the reduced maximum exclusion by reason of health, a "qualified individual" includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, n23.15.1 a person whose principal place of abode is in the same household as the taxpayer, and certain family members of these individuals. This definition is broader than the definition that applies to the exclusions by reason of change in place of employment and unforeseen circumstances because it encompasses taxpayers who sell or exchange their residence in order to care for sick family members. n23.16 One ruling found a sale of a personal residence made in order to accommodate the taxpayer's mother-in-law, who had become partially paralyzed, to be made by reason of health. n23.16.1

[iv] Unforeseen Circumstances

A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. A sale or exchange by reason of unforeseen circumstances (other than a sale or exchange within a safe harbor) does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is simply a preference for a different residence or an improvement in financial circumstances. n23.17 There are several "specific event" safe harbors under which the a sale or exchange is deemed to be by reason of unforeseen circumstances if one of the safe harbor events occurs during the taxpayer's ownership and use of the property as the taxpayer's principal residence. The safe harbor events include the involuntary conversion of the residence, a natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence, n23.18 and, in the case of a qualified individual: n23.19

- death;
- the cessation of employment as a result of which the individual is eligible for unemployment compensation;
- a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household;
- divorce or legal separation under a decree of divorce or separate maintenance; and
- multiple births resulting from the same pregnancy.

The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability or in a ruling directed to a specific taxpayer. n23.20 In one ruling, the IRS ruled that unexpected criminal activities in the neighborhood and personal assaults on the taxpayer sufficed as unforeseen circumstances. n23.20.1 The IRS has also ruled that threats to the life of a narcotics investigator after his participation in an arrest of a drug dealer sufficed as an unforeseen circumstance. n23.20.2 A violent crime against the taxpayer just outside of the residence also sufficed. n23.20.2.1 In another, the taxpayers had purchased a home in a retirement community. Shortly thereafter, their daughter lost her job and divorced her husband, and she and the taxpayers' granddaughter therefore needed to live with the taxpayers. They could not do so, however, because of age restrictions in the retirement community. The IRS ruled that the sale of the home in order to purchase a new home to house the daughter and granddaughter was a sale primarily due to unforeseen circumstances. n23.20.3 A pregnancy n23.20.3.1 or the birth of a single child has also been ruled to be an unforeseen circumstance, n23.20.4 as has the adoption of a child. n23.20.5 Although reasonably anticipated street noise (and presumably other local noise) does not ordinarily qualify as an unforeseen circumstance, n23.20.6 one ruling did allow a taxpayer who conducted a reasonable investigation of a residence and neighborhood to use the unforeseen circumstance provision when airport noise caused him to later sell the home. He had lived the same distance from the airport before purchasing the property, but in a different direction (in

which airport noise was not a problem). His contention that he did not anticipate airport noise before purchasing the home was found to be credible and reasonable. n23.20.7 In another ruling, the taxpayer, a member of the military, received an unexpected assignment that required him to live in government quarters. The IRS ruled that this was an unforeseen circumstance that allowed him to take advantage of a reduced exclusion under *IRC Section 121(c)*. n23.20.8

A taxpayer who does not qualify for a safe harbor may demonstrate that the primary reason for the sale or exchange is unforeseen circumstances, under a facts and circumstances test. n23.21 For purposes of the reduced maximum exclusion by reason of unforeseen circumstances, a "qualified individual" includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, and a person whose principal place of abode is in the same household as the taxpayer. n23.22

Note:

In its final regulations, IRS and Treasury refused to adopt suggestions of commentators that marriage, bankruptcy of the taxpayer's employer not resulting in the loss of the taxpayer's employment, and the adoption of a family member should be additional unforeseen circumstances safe harbors. These events may still qualify a taxpayer for the reduced maximum exclusion under the facts and circumstances test if, as a result of one of those events, the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances. n23.23

[v] Effective Date of Final Regulations

The final regulations relating to the reduced maximum exclusion n23.24 apply to sales and exchanges on or after August 13, 2004. n23.25 For sales or exchanges before August 13, 2004, and on or after May 7, 1997, taxpayers may elect to apply the rules retroactively and will be afforded audit protection. n23.26

[c] Recognition of Gain that Is Allocated to Periods of Nonqualified Use

Gain from the sale or exchange of a principal residence that is allocated to periods of nonqualified use is not excluded from gross income under *IRC Section 121*. n23.27 The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction. The numerator is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer; the denominator is the period the taxpayer owned the property. n23.28 Both these versions are mis-numbered, and duplicate an existing *IRC Section 121(b)(4)*, which deals with sales of a principal residence by surviving spouse [see § 9.02[6][a], below, for a discussion of that provision]. Presumably, a future technical corrections bill will eliminate the duplicate renumbering.

A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. n23.29 For purposes of determining periods of nonqualified use, the following periods are not taken into account: n23.30

- Any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period);
- Any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty with the U.S. uniformed services, Foreign Service, or as an employee of the intelligence community; n23.31 curiously, periods of time serving for the Peace Corps cannot be omitted in determining periods of qualified use; n23.31.1 or
- Any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

If any gain is attributable to post-May 6, 1997 depreciation, the exclusion does not apply to that amount of gain, and that gain is not taken into account in determining the amount of gain allocated to nonqualified use. n23.32

Example (1):

Tom buys a property on January 1, 2008, for \$400,000, and uses it as rental property for two years, claiming \$20,000 of depreciation deductions. On January 1, 2010, Tom converts the property to his principal residence. On January 1, 2012, Tom moves out, and sells the property for \$700,000 on January 1, 2013. The \$20,000 gain attributable to the depreciation deductions is included in gross income. Of the remaining \$300,000 gain, 40% of the gain (2 years divided by 5 years), or \$120,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of \$180,000 is less than the maximum gain of \$250,000 that may be excluded, gain of \$180,000 is excluded from Tom's gross income. n23.33

Example (2):

Mary buys a principal residence on January 1, 2008, for \$400,000. She moves into the home and begins using it as her principal residence on that date. She moves out on January 1, 2018, and on December 1, 2020 (more than two years after she last used the property as her principal residence) sells the property for \$600,000. The entire \$200,000 gain is excluded from Mary's gross income. n23.34

[6] Application of Exclusion Under Special Circumstances

[a] Property of Deceased Spouse

A surviving spouse who has not remarried at the time of sale is entitled to a \$500,000 exclusion, provided that the sale occurs within two years of the date of death of the deceased spouse, and the statutory ownership and use requirements were met immediately before the date of the deceased spouse's death. n23.34.1

For purposes of satisfying the ownership and use requirements of *IRC Section 121*, a taxpayer is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death. n23.35 This rule applies, however, only if the taxpayer's spouse is deceased on the date of the sale or exchange of the property; and the taxpayer has not remarried at the time of the sale or exchange of the property. n23.36

Example:

H has owned and used a house as his principal residence for more than five years. H and W marry on July 1 of Year 1 and from that date they use H's house as their principal residence. H dies on August 15, of Year 2, and W inherits the property. W sells the property on March 1 of Year 3, at which time she has not remarried. Although W has owned and used the house for less than 2 years, W will be considered to have satisfied the ownership and use requirements of *IRC Section 121* because W's period of ownership and use includes the period that H owned and used the property before death. n23.37 W is entitled to a \$500,000 exclusion on the sale. n23.38

Note:

IRC Section 121 and regulations thereunder do not clarify the computation of basis and gain for

surviving spouses, or explain any interaction between *IRC Section 121* and *IRC Section 1014*, which provides a step-up in basis for inherited property.

[b] Property Owned by Spouse or Former Spouse

For property transferred to a spouse or to a former spouse incident to a divorce, the period that the transferee owns the property includes the period the transferor owned the property. ⁿ²⁴ In addition, an individual is treated as using property as a principal residence during any period that the taxpayer has an ownership interest in the property while that individual's spouse or former spouse is granted use of the property under a divorce or separation instrument. ⁿ²⁵ This rule applies only if the spouse or former spouse uses the property as his or her principal residence. ^{n25.1}

Note:

At least one commentator has suggested the possibility that these rules can result in a \$750,000 exclusion. If the spouse who is granted the use of the home under the divorce instrument remarries, and continues to use the home as a principal residence, a \$500,000 exclusion may be available if a joint return is filed with the new spouse in the year of sale. At the same time, however, the former spouse who lost use of the home in the divorce instrument, but who still retains an ownership interest in the home, can qualify for a \$250,000 exclusion on the sale. The IRS has not ruled on this circumstance, however. ^{n25.2}

[c] Tenant-Stockholders in Cooperative Housing Corporations

IRC Section 121 applies to tenant-stockholders in cooperative housing corporations. In that case, the holding requirements are applied to the holding of the stock, and the use requirements are applied to the house or apartment that the taxpayer's stock ownership (and proprietary lease) entitle it to occupy. ⁿ²⁶

[d] Involuntary Conversions

For purposes of *IRC Section 121*, an involuntary conversion or destruction is treated as a sale of the property. ⁿ²⁷ The IRS takes the position that a complete destruction, e.g., in whole, of the residence is required, and that a partial destruction will not be treated as a sale or exchange of the residence. ^{n27.1} In applying *IRC Section 1033*, the amount realized from the sale or exchange is treated as being the amount determined without regard to *IRC Section 121*, reduced by the amount of gain not included in gross income by reason of *IRC Section 121*. ⁿ²⁸ If the taxpayer takes a carryover basis under *IRC Section 1033(b)* in property acquired after the involuntary conversion, the holding and use periods of the converted property are taken into account with respect to the acquired property. ⁿ²⁹ It should be noted that an involuntary conversion is an unforeseen circumstance that qualifies as a safe harbor under which a taxpayer may qualify for a partial exclusion under *IRC Section 121*. ^{n29.1}

Example:

A fire destroys T's house, which has an adjusted basis of \$80,000. T had owned and used this property as her principal residence for 20 years prior to its destruction. T's insurance company pays her \$400,000 as a result of the fire. T realizes a gain of \$320,000 (\$400,000 - \$80,000). Six months later, T purchases a new house for \$100,000.

Because the destruction of the house is treated as a sale for purposes of *IRC Section 121*, T may exclude \$250,000 of the realized gain from her gross income. For purposes of *IRC Section 1033*, the amount realized is then treated as being \$150,000 (\$400,000 - \$250,000) and the gain realized is \$70,000 (\$150,000 amount realized - \$80,000 basis). T elects under *IRC Section 1033* to recognize only \$50,000

of the gain (\$150,000 amount realized - \$100,000 cost of new house). The remaining \$20,000 of gain is deferred and T's basis in the new house is \$80,000 (\$100,000 cost - \$20,000 gain not recognized).

T will be treated as owning and using the new house as her principal residence during the 20-year period that she owned and used the destroyed house. n29.2

[e] Sales of Partial and Remainder Interests

A taxpayer may exclude under *IRC Section 121* gain from the sale or exchange of partial interests (other than interests remaining after the sale or exchange of a remainder interest) in the taxpayer's principal residence if the interest sold or exchanged includes an interest in the dwelling unit. n29.3

Only one maximum limitation amount of \$250,000 (\$500,000 for qualifying joint returns), however, applies to the combined sales or exchanges of partial interests. For purposes of determining the maximum limitation amount n29.4 the sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount. Each spouse is treated as excluding one-half of the gain from a sale or exchange to which limits for joint returns apply. n29.5

For purposes of restricting the *IRC Section 121* exclusion to only one sale or exchange every two years, n29.6 each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying that two-year restriction to that sale or exchange and the sale or exchange of any other principal residence. n29.7

A similar, but separate rule, applies to a sale of a remainder interest. Unless the sale or exchange is with a related party, n30 a taxpayer selling a remainder interest in a principal residence may elect to have the exclusion apply. However, the exclusion does not apply to any other interest in that residence that is sold or exchanged separately. n31

A taxpayer makes the election simply by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the remainder interest in the taxpayer's gross income. A taxpayer may make or revoke the election at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred. n31.1

[f] Principal Residences Acquired in Rollovers Under Former IRC Section 1034

In the case of a principal residence acquired in a reinvestment pursuant to which any gain was not recognized on the sale or exchange of another residence under former *IRC Section 1034*, the period that the taxpayer owned and used the replacement residence includes the period the taxpayer owned and used the prior residence (and also the period of ownership and use of any other prior residences taken into account under *IRC Section 1223(6)*) in determining the holding period of the replacement residence. n32

[g] Expatriates

The exclusion is not available for certain expatriates. n33

Note:

It is unclear how this provision will be interpreted after June 18, 2008. Under legislation enacted in 2008, *IRC Section 877* does not apply to any individual whose expatriation date is on or after June 18, 2008.

n33.0.1 To carry out the intent of the provision, it seems that *IRC Section 121(e)* will need to be amended to refer to *IRC Section 877A*, the new expatriate taxation provision, as well.

[h] Bankruptcy Trustees

The bankruptcy estate of an individual in a chapter 7 or 11 bankruptcy case under title 11 of the United States Code succeeds to and takes into account the individual's *IRC Section 121* exclusion if the individual satisfies the requirements of *IRC Section 121*. n33.1 The final regulations are in accord with prior cases that held that a Chapter 7 or Chapter 11 bankruptcy trustee may use the *IRC Section 121* exclusion in selling the debtor's principal residence, n34 Furthermore, after a long series of defeats, the IRS finally acquiesced in the court holdings. n35 Therefore, for periods prior to the effective date of the regulations, it will not challenge a position that a bankruptcy estate may use the *IRC Section 121* exclusion if the debtor would otherwise satisfy the statutory requirements. n35.1

Note:

The regulations and cases cited above depart from cases interpreting the pre-1998 version of *IRC Section 121*. Those cases held that bankruptcy trustees could not make an election to exclude gain under the pre-1998 version of *IRC Section 121*. n36

[i] Grantor Trusts

If a grantor trust owns title to the trustor's personal residence, the trustor is treated as the owner of the trust and the residence under statutory grantor trust provisions. n37 The trustor is also treated as the owner of the residence for purposes of meeting requirements under *IRC Section 121*. Therefore, a sale by the trustee-grantor of the residence is eligible for the exclusion under *IRC Section 121* if statutory conditions are otherwise met. n37.1

[j] Application of Exclusion to Sales or Exchanges of Vacant Land

A sale or exchange of vacant land is treated as a sale or exchange of the taxpayer's principal residence only if all of the following requirements are met: n37.2

- the vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;
- the taxpayer owned and used the vacant land as part of the taxpayer's principal residence;
- the taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of *IRC Section 121* within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and
- the requirements of *IRC Section 121* have otherwise been met with respect to the vacant land.

For purposes of the statutory maximum limitation amount n37.2.1 sales or exchanges of the dwelling unit and vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of \$250,000 (\$500,000 for qualifying joint returns) applies to the combined sales or exchanges of the vacant land and dwelling unit. n37.2.2 In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount n37.2.3 is excluded first, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which the limitations apply. n37.2.4

Sales or exchanges of the dwelling unit and adjacent vacant land in separate transactions are disregarded in applying *IRC Section 121(b)(3)* (restricting the exclusion to only 1 sale or exchange every 2 years) to each other, but are taken

into account as a sale or exchange of a principal residence on the date of each transaction in applying the limit to that transaction and the sale or exchange of any other principal residence. n37.2.5

If the sale or exchange of the dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. A taxpayer meeting the statutory requirements, however, may later claim the exclusion under *IRC Section 121* with regard to the sale or exchange of the vacant land by filing an amended return, if the statute of limitations for doing so n37.2.6 has not run. n37.2.7

Example:

C owns a house and 10 acres that she has used as her principal residence for 5 years. In May of Year 1, C sells 8 acres of the land and realizes a gain of \$110,000. C does not sell the dwelling unit before the due date for filing her Year 1 return, so she is not eligible to exclude the \$110,000 of gain. In March of Year 3, C sells the house and remaining 2 acres, realizing a gain of \$180,000 from the sale of the house. C may exclude the \$180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence. C may file an amended return for Year 1 to claim an exclusion for \$70,000 (\$250,000 - \$180,000 gain previously excluded) of the \$110,000 gain from the sale of the 8 acres. n37.2.8

[k] Deemed Sale Election Made Under Uncodified 1997 Legislation

Section 311(e) of the Tax Reform Act of 1997 allows a noncorporate taxpayer holding a capital asset on January 1, 2001 to elect to treat that asset as having been both sold and reacquired on that date for an amount equal to its fair market value. The availability of the election was intended to allow the asset to have a holding period beginning after 2000, which would make the asset eligible for the 18-percent capital gains rates if a 5-year holding period requirement was satisfied. n37.2.9 The purpose of the deemed sale election was obsoleted by the reduction in capital gains rates to 15 percent (5 percent for low-income taxpayers), effective for tax years beginning on or after May 6, 2003. n37.2.10

In hindsight, some taxpayers who made the deemed sale election would have been better off not doing so. Section 311(e)(2)(A) of the Tax Reform Act of 1997 provides that any gain resulting from the election must be treated as received or accrued on the date the asset is treated as sold, and that the gain must be recognized notwithstanding any other provision of the Code.

The IRS has ruled that a deemed sale election under Section 311(e) of the Tax Reform Act of 1997 for a principal residence prevents the taxpayer from excluding the gain on the deemed sale under *IRC Section 121*. n37.2.11 The ruling addresses the application of the above provision in the context of an individual's election to treat his principal residence as both sold and reacquired on January 1, 2001. The fact pattern in the ruling is that the taxpayer makes a Section 311(e) election on his federal income tax return for the year including January 1, 2001. On January 1, 2001, the taxpayer's residence had a fair market value that was \$250,000 in excess of the taxpayer's basis. If the taxpayer had actually sold the home on that date for its fair market value, *IRC Section 121* would have allowed the taxpayer to exclude from gross income the full \$250,000 of gain realized on the sale.

Because the taxpayer made the election, however, the IRS ruled that the taxpayer could not exclude from gross income any of the gain on the deemed sale under *IRC Section 121*. It noted that the Section 311(e) election conferred tax benefits (a holding period beginning after December 31, 2000 and a step-up in basis), but in exchange imposed a tax cost--the current recognition of gain resulting from any existing appreciation in the asset. The IRS ruled that the statutory requirement that gain be recognized "notwithstanding any other provision" of the Code necessarily precluded

application of the exclusion otherwise available under *IRC Section 121*. Otherwise, the intended consequences of the mandated recognition (taxation of the gain) would be prevented. n37.2.12

[l] Members of Uniformed Services and Foreign Service, Employees of the Intelligence Community, and Peace Corps Workers

Under the general rule of *IRC Section 121*, gain from the sale of a principal residence may be excluded from gross income only if the taxpayer owned and used the property as a principal residence for at least two years during the 5-year period before the date of the sale or exchange. n37.2.13 Qualifying taxpayers may elect to suspend the 5-year period during which the 2-year use and ownership requirement must be met. The 5-year period may be suspended during any year that the individual or that individual's spouse is serving on qualified official extended duty as a member of the uniformed services or of the Foreign Service of the United States. n37.2.14 The election is limited to one property at a time, and an election does not suspend the running of the 5-year period for any period during which the running of the 5-year period with respect to any other property of the taxpayer is suspended by an election under *IRC Section 121(d)(9)*. n37.2.15 A taxpayer makes an election by filing a return for the taxable year of the sale or exchange of the residence that does not include the resulting gain in the taxpayer's gross income. n37.2.16 An election may be revoked at any time. n37.2.17 The maximum period of suspension is 10 years. n37.2.18

"Qualified official extended duty" is a period of active duty pursuant to a call or order to that duty for at least 90 days or an indefinite period. The duty must be served at a duty station at least 50 miles from the residence or while residing under Government orders in Government quarters. n37.2.19

Specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty, in the same manner as members of the uniformed services or the Foreign Service of the United States. n37.2.20 The five-year period may not be extended more than 10 years. n37.2.21

The term "employee of the intelligence community" means an employee of the Office of the Director of National Intelligence, the Central Intelligence Agency, the National Security Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence Agency, or the National Reconnaissance Office. The term also includes employment with: (1) any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs; (2) any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard; (3) the Bureau of Intelligence and Research of the Department of State; and (4) the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information. n37.2.22

Peace Corps employees and volunteers and their spouses may also elect to suspend the running of the five-year test period during any period in which they or their spouses are serving outside the U.S. on qualified official extended duty as a Peace Corps employee or as an enrolled volunteer or volunteer leader. n27.2.23 The five-year period may not be extended by more than 10 years. n27.2.23.1 In addition, the election is limited to one property at a time, and an election may be made only if an election is not in effect with respect to any other property. An election may be revoked at any time. n27.2.23.2

[m] Principal Residences Acquired in Like-Kind Exchanges

The exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years. n37.2.24 If a taxpayer acquires property in a like-kind exchange in which any gain is not recognized n37.2.25 the exclusion from gain does not apply to any sale or exchange of the residence by the taxpayer for five years beginning with the date of the acquisition. The exclusion is also not available during that period for a sale or exchange of the residence by any person whose basis in the residence is determined, in whole or in part, by reference to the basis of the residence in the hands of

the taxpayer. n37.2.26 This could occur, for example, when a person receives property as a gift n37.2.27 or incident to a divorce. n37.2.28

[n] Disposition of Principal Residence in Like-Kind Exchange

The IRS has issued a pro-taxpayer revenue procedure that provides guidance when both *IRC Section 121* and *IRC Section 1031* apply to a single exchange of property. n37.2.29 *Revenue Procedure 2005-14* indicates that, in certain cases, a homeowner may benefit from both the home-sale exclusion and the like-kind deferral. The revenue procedure sets forth an ordering rule for applying *IRC Sections 121* and *1031*, an application of *IRC Section 1031* to depreciation recapture amounts that are not excluded under *IRC Section 121*, the manner in which boot is taken into account in applying *IRC Section 1031*, and a method for computing the basis of replacement property received in an exchange. n37.2.30 *Revenue Procedure 2005-14* is discussed in detail in Chapter 8.

[o] Property Acquired From Decedents Dying After 2009

Effective for estates of decedents dying after 2009, n37.3 the exclusion for the sale of a principal residence is extended to estates and individuals who acquire a residence from the decedent. n37.4 If the decedent's estate or an individual heir sells the decedent's principal residence, \$250,000 of gain can be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. n37.5 The exclusion for the gain on the sale of a principal residence also applies to property sold by a trust that was a qualified revocable trust under *IRC Section 645* immediately prior to the decedent's death. n37.6 The decedent's period of occupancy of the property as a principal residence can be added to an heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence, regardless of whether the residence was owned by the trust during the decedent's occupancy. n37.7

[7] Election Not to Have Exclusion Apply

The exclusion does not have to be elected (except for sales of remainder interests), n38 and automatically applies unless the taxpayer makes an election not to have the exclusion apply. n39 Such an election might be prudent where the taxpayer expects to have two eligible sales within a two-year period, and expects that the gain on the first sale will be less than the \$250,000/\$500,000 ceiling and also smaller than the gain on the second sale. Under these circumstances, it would make sense for the taxpayer to waive the application of the exclusion to the first sale so that it can apply to the second sale.

An election not to have *IRC Section 121* apply to a sale or exchange (or an election to revoke an election to have *IRC Section 121* not apply) may be made at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred. n39.1

[8] Return Filing Requirements

The return that is generally required in the case of a real estate transaction n39.2 need not be filed with respect to sales or exchanges of residences for \$250,000 or less (or \$500,000 or less if the seller is married) if the real estate reporting person has written assurance of the following: n40

- the property is the principal residence of the seller;
- there is no federally subsidized mortgage assistance with respect to the mortgage on the residence;
- the full amount of gain is excludable under *IRC Section 121*; and

- when the \$500,000 base amount applies, the seller is married.

Revenue Procedure 2007-12 sets for the acceptable form of the written assurances (certification) that a real estate reporting person must obtain from the seller of a principal residence to except the sale or exchange of the residence from the information reporting requirements for real estate transactions under *IRC Section 6045(e)(5)*. n40.1 The Secretary is authorized to increase the above dollar amounts by regulation. n40.2

Planning Tip:

It should be noted that, for purposes of the above exception to the reporting requirements, the \$250,000 amount (or \$500,000 amount if the seller is married) refers to the *selling price* of the property, not the amount of gain from the sale. n41

[9] Effective Date and Transition Rules

[a] Effective Date of *IRC Section 121*

The exclusion of gain under *IRC Section 121* described above is generally effective for sales and exchanges after May 6, 1997. However, a taxpayer may elect to have the 1997 amendments to *IRC Section 121* not apply to any sale or exchange taking place before August 5, 1997, or to any sale or exchange taking place after August 4, 1997, pursuant to a binding contract in effect on August 5, 1997. A taxpayer may also elect not to have the 1997 amendments apply to a sale or exchange taking place after August 4, 1997, if, without regard to the amendments, gain would not be recognized under former *IRC Section 1034*, as in effect before August 5, 1997, on the sale or exchange by reason of the acquisition of a new residence on or before that date, or with respect to the acquisition of which by the taxpayer a binding contract was in effect on that date. n42

[b] Effective Date of Regulations

Final and temporary regulations under *IRC Sale 121* are effective for sales and exchanges occurring on or after December 24, 2002. n42.1 A taxpayer who would otherwise qualify under those regulations to exclude gain from a sale or exchange before the effective date of the regulations, but on or after May 7, 1997, may elect to apply the provisions of the final regulations for any years for which the period of limitation under *IRC Section 6511* has not expired. A taxpayer may make the election by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. A taxpayer who has filed a return for the taxable year of the sale or exchange may elect to apply the provisions of the final regulations for any years for which the period of limitation under *IRC Section 6511* has not expired by filing an amended return. n42.2

The IRS will not challenge a taxpayer's position that a sale or exchange before the effective date of the regulations but on or after May 7, 1997, qualifies for the *IRC Section 121* exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of *IRC Section 121*. Compliance with the provisions of the proposed regulations that preceded final regulations generally will be considered a reasonable, good faith effort. n42.3

[10] Alternative to Sale--Conversion to Business Use

An alternative to selling a personal residence is to convert it to business or investment real estate. The tax benefits available to the investor, together with potential rental income and appreciation, may make conversion economically advantageous. Consideration should be given to the tax effects of *IRC Section 1231*, discussed in Chapter 6. Under *IRC Section 1231*, property that has been converted to investment or income-producing property may receive capital gains treatment if sold at a profit, or ordinary loss treatment if sold below basis. n43

When converting property from personal use to business or investment use, a taxpayer generally obtains a new tax basis

for the converted property. The new basis, which is used to determine allowable depreciation as well as the amount of any loss sustained, is the lesser of: (1) the fair market value of the property at the time of conversion; or (2) the original cost, adjusted upward for capital improvements and downward for any allowable deductions (e.g., depreciation up to the date of conversion).ⁿ⁴⁴ The taxpayer will have the burden of establishing the fair market value of the property at the time of conversion.ⁿ⁴⁵

A personal residence is converted, for these purposes, only if it achieves the status of income-producing property.ⁿ⁴⁶ Property offered for rent, as evidenced by the owner's affirmative actions, will be considered as having been converted to income-producing property for purposes of deducting business expenses and depreciation, but a taxpayer will be entitled to deduct a loss on the sale of a former personal residence only if the property has actually been rented for more than a *de minimis* period of time.ⁿ⁴⁷ The key issue is the intent of the taxpayer in light of all the facts and circumstances.ⁿ⁴⁸

It should be noted that, once the property is converted to investment status, the relief provisions discussed earlier in this chapter may no longer be available to the taxpayer when the property is sold.ⁿ⁴⁹

FOOTNOTES:

(n1)Footnote 9. *IRC § 121(a), (b)(1), (2).*

(n2)Footnote 9.1. *Treas Reg § 1.121-2(a)(2), (4), Ex 1.*

(n3)Footnote 9.2. *IRC § 121(b)(3)(A); Treas Reg § 1.121-2(b).*

(n4)Footnote 9.3. *See IRC § 121(a).*

(n5)Footnote 9.4. *See IRC § 121(b)(3)(A).*

(n6)Footnote 10. *IRC § 121(b)(3)(B).*

(n7)Footnote 11. *IRC § 121(a).*

(n8)Footnote 12. *See IRC § 1250(b)(3).*

(n9)Footnote 13. *IRC § 121(d)(6); Treas Reg § 1.121-1(d)(1).*

(n10)Footnote 14. *Treas Reg § 1.121-1(d)(1).*

(n11)Footnote 14.1. Chief Counsel Memorandum 200630015. The ruling involved 18-year ACRS property and the amount of depreciation that had been claimed in excess of straight-line depreciation had to be recaptured.

(n12)Footnote 15. *IRC § 121(a).*

(n13)Footnote 15.1. *Treas Reg § 1.121-1(c)(1);* see [3], below, for discussion of the use requirement.

(n14)Footnote 15.2. *Treas Reg § 1.121-1(c)(3)(i);* see *IRC §§ 671-679*; the regulation comports with prior holdings regarding ownerships by trusts [see *Rev Rul 85-45, 1985-1 CB 183*] (sale of trust property used by beneficiary as a primary residence qualifies for exclusion under former *IRC § 121*); *Rev Rul 66-159, 1966-1 CB 162* (grantor of grantor trust that owned and sold a residence could roll over gain under former *IRC § 1034* into replacement residence); *Ltr Rul 200104005* (exclusion under *IRC § 121* available to a portion of a residence that was attributable to the taxpayer's 5 or 5 power in a trust which held the residence).

(n15)Footnote 15.3. *See IRC § 121(a).*

- (n16)Footnote 15.4. *Treas Reg § 1.121-1(c)(3)(ii)*.
- (n17)Footnote 15.5. *Ltr Rul 200029045* (taxpayers owned their principal residence through a limited partnership).
- (n18)Footnote 15.6. *Ltr Rul 200119014* , revoking *Ltr Rul 200004022* .
- (n19)Footnote 15.6.1. *Farah v Commr, TC Memo 2007-369* .
- (n20)Footnote 15.7. *IRC § 121(a)*.
- (n21)Footnote 15.8. *Treas Reg § 1.121-1(c)(1)*; see [2], above, for discussion of the ownership requirement.
- (n22)Footnote 15.9. *Treas Reg § 1.121-1(c)(2)(i)*.
- (n23)Footnote 15.10. See *Treas Reg §§ 1.121-1(b)(1), 1.121-1(c)(2)(i)*.
- (n24)Footnote 15.10.1. *Gates v Commr, 135 TC No 1 (2010)* .
- (n25)Footnote 15.10.2. *Gates v Commr, 135 TC No 1 (2010)* .
- (n26)Footnote 15.11. *IRC § 121(d)(7)*; see § 9.02[3][c], below, for a detailed discussion.
- (n27)Footnote 15.12. *IRC § 121(d)(9)*; see § 9.02[6][l], below, for a discussion.
- (n28)Footnote 15.13. See *Treas Reg § 1.121-1(c)(2)(i)*.
- (n29)Footnote 15.14. *Treas Reg § 1.121-1(b)(1)*.
- (n30)Footnote 15.14.1. *Treas Reg § 1.121-1(b)(2)*.
- (n31)Footnote 15.14.2. *Guinan v US, 2003-1 USTC P 50,475 (DC Az 2003)*.
- (n32)Footnote 15.15. *Treas Reg § 1.121-1(b)(2)*; *Guinan v US, 2003-1 USTC P 50,475 (DC Az 2003)* (factors evaluated).
- (n33)Footnote 15.15.1. *Farah v Commr, TC Memo 2007-369* .
- (n34)Footnote 15.16. *Treas Reg § 1.121-1(b)(4)*, Ex 2.
- (n35)Footnote 15.17. *IRC § 121(d)(7)*.
- (n36)Footnote 15.18. See *IRC § 121(d)(7)*.
- (n37)Footnote 15.19. *Treas Reg § 1.121-1(e)(1)*.
- (n38)Footnote 15.20. *Treas Reg § 1.121-1(e)(3)*.
- (n39)Footnote 15.21. *Treas Reg § 1.121-1(e)(1)*.
- (n40)Footnote 15.22. *Treas Reg § 1.121-1(e)(4)*, Ex 5.
- (n41)Footnote 16. *IRC § 121(d)(1)*.
- (n42)Footnote 16.1. *IRC § 121(a)*; *Treas Reg § 1.121-2(a)(1), (a)(4)*, Ex 3.

(n43)Footnote 16.2. *Treas Reg § 1.121-2(a)(3)(ii)*.

(n44)Footnote 16.3. *Treas Reg § 1.121-2(a)(4)*, Ex 3.

(n45)Footnote 17. *IRC § 121(b)(2)(A)*; *Treas Reg § 1.121-2(a)(3)(i)*.

(n46)Footnote 18. *IRC § 121(b)(2)(A)*; *Treas Reg § 1.121-2(a)(4)*, Ex 2.

(n47)Footnote 19. *IRC § 121(b)(2)(B)*.

(n48)Footnote 19.1. See *IRC § 121(b)(2)(B)*.

(n49)Footnote 20. *IRC § 121(c)(1)*.

(n50)Footnote 21. See [b][ii], below.

(n51)Footnote 22. See [b][iii], below.

(n52)Footnote 23. *IRC § 121(c)(2)(B)*; see [b][iv], below, for a discussion of unforeseen circumstances.

(n53)Footnote 23.1. *Treas Reg § 1.121-3(g)(1)*.

(n54)Footnote 23.2. *Treas Reg § 1.121-3(g)(2)*, Ex 1.

(n55)Footnote 23.3. See *Treas Reg § 1.121-2(a)(3)(ii)*.

(n56)Footnote 23.4. *Treas Reg § 1.121-3(g)(2)*, Ex 2.

(n57)Footnote 23.4.1. See *IRC § 121(c)(1)*.

(n58)Footnote 23.5. *IRC § 121(c)(2)(B)*.

(n59)Footnote 23.6. *Treas Reg § 1.121-3(b)*.

(n60)Footnote 23.7. *Treas Reg § 1.121-3(b)*.

(n61)Footnote 23.8. *Treas Reg § 1.121-3(c)(1)*.

(n62)Footnote 23.9. *Treas Reg § 1.121-3(c)(3)*.

(n63)Footnote 23.10. *Treas Reg § 1.121-3(c)(1)*, (f).

(n64)Footnote 23.11. *Treas Reg § 1.121-3(c)(2)*.

(n65)Footnote 23.12. *Treas Reg § 1.121-3(b)*; see [i], above.

(n66)Footnote 23.13. *Treas Reg § 1.121-3(d)(1)*.

(n67)Footnote 23.14. See *IRC § 213(d)(4)* for a definition.

(n68)Footnote 23.15. *Treas Reg § 1.121-3(d)(2)*.

(n69)Footnote 23.15.1. *Ltr Rul 200604013* (sale due to declining health of one of four joint tenants qualified for partial exclusion).

(n70)Footnote 23.16. *Temp Treas Reg § 1.121-3(d)(1), (f)(5)*.

(n71)Footnote 23.16.1. *Ltr Rul 200626024* .

(n72)Footnote 23.17. *Treas Reg § 1.121-3(e)(1)*.

(n73)Footnote 23.18. The existence of a casualty is determined without regard to deductibility as a casualty loss under *IRC § 165(h)* [*Reg § 1.121-3(e)(2)(ii)*].

(n74)Footnote 23.19. *Treas Reg § 1.121-3(e)(2)*.

(n75)Footnote 23.20. *Treas Reg § 1.121-3(e)(3)*; see, for example, *Notice 2002-60, 2002-2 CB 482* , explaining how taxpayers affected by the 9/11 terrorist attacks could qualify for partial exclusion of gain. Also see *Ltr Rul 200504012* (IRS ruled that a police officer met the unforeseen circumstance safe harbor when he had to sell a townhouse before meeting the statutory requirements of *IRC § 121*. As a result of a promotion and special assignment shortly after purchasing the townhouse, he was required to care for a dog and maintain a kennel at his residence. The homeowners association did not permit its residents to maintain a kennel. The IRS concluded that the taxpayer's primary reason for the sale of the residence was an unforeseen circumstance).

(n76)Footnote 23.20.1. *Ltr Rul 200601009* .

(n77)Footnote 23.20.2. *Ltr Rul 200615011* .

(n78)Footnote 23.20.2.1. *Ltr Rul 200630004* .

(n79)Footnote 23.20.3. *Ltr Rul 200601023* .

(n80)Footnote 23.20.3.1. *Ltr Rul 200745011* ; *Ltr Rul 200652041* .

(n81)Footnote 23.20.4. *Ltr Rul 200601022* .

(n82)Footnote 23.20.5. *Ltr Rul 200613009* (sale of home was necessary because state law required an additional bedroom for the child in order for the adoption to occur).

(n83)Footnote 23.20.6. *Treas Reg § 1.121-3(e)(4)*, Example 5.

(n84)Footnote 23.20.7. *Ltr Rul 200702032* .

(n85)Footnote 23.20.8. *Ltr Rul 200947024*. The residence had been rented to tenants over the years during periods when the taxpayer had military assignments elsewhere. The exclusion was not available exclusion for any gain from the sale of property related to depreciation adjustments claimed by the taxpayer during periods of rental.

(n86)Footnote 23.21. *Treas Reg § 1.121-3(b), (e)(1)*; see [i], above, for a discussion.

(n87)Footnote 23.22. *Treas Reg § 1.121-3(e)(2), (f)*.

(n88)Footnote 23.23. See *Treas Reg § 1.121-3(e)(1)*.

(n89)Footnote 23.24. *Treas Reg § 1.121-3(b)-(f)*.

(n90)Footnote 23.25. *Treas Reg § 1.121-3(h)*.

(n91)Footnote 23.26. *Treas Reg § 1.121-4(j), (k)*.

(n92)Footnote 23.27. *IRC § 121(b)(4)(A)*, effective for sales and exchanges after December 31, 2008 [Pub Law 110-289, § 3092(b)]. A prior version of *IRC § 121(b)(4)* was enacted by Pub Law 110-142, and was effective for sales and exchanges after Dec 31, 2007. The only difference between that provision and the provision enacted by Pub Law 110-289 was that the period of non-qualified use in the prior version did not include any period before Jan 1, 2008; the provision enacted by Pub Law 110-289 states that the period of non-qualified use in the prior version did not include any period before Jan 1, 2009. The provision is intended to eliminate the exclusion for second homes during any period those homes were used as rental properties.

(n93)Footnote 23.28. *IRC § 121(b)(4)(B)*.

(n94)Footnote 23.29. *IRC § 121(b)(4)(C)(i)*.

(n95)Footnote 23.30. *IRC § 121(b)(4)(C)(ii)*.

(n96)Footnote 23.31. See *IRC § 121(d)(9)(A)(i), (ii), (iii), 121(d)(9)(C)*.

(n97)Footnote 23.31.1. *IRC § 121(b)(4)(C)(ii), (d)(12)*.

(n98)Footnote 23.32. *IRC § 121(b)(4)(D)*.

(n99)Footnote 23.33. See *IRC § 121(b)(4)*.

(n100)Footnote 23.34. See *IRC § 121(b)(4)*.

(n101)Footnote 23.34.1. *IRC § 121(b)(4)*. The 2-year period cannot be extended by reason of a depressed real estate market [INFO 2008-0035 (July 23, 2008)].

(n102)Footnote 23.35. *IRC § 121(d)(2); Treas Reg § 1.121-4(a)*.

(n103)Footnote 23.36. *Treas Reg § 1.121-4(a)(1)*.

(n104)Footnote 23.37. *Treas Reg § 1.121-4(a)(1), Ex.*

(n105)Footnote 23.38. See *IRC § 121(b)(4)*.

(n106)Footnote 24. *IRC § 121(d)(3)(A); Treas Reg § 1.121-4(b)(1)*.

(n107)Footnote 25. *IRC § 121(d)(3)(B); Treas Reg § 1.121-4(b)(2)*.

(n108)Footnote 25.1. *Treas Reg § 1.121-4(b)(2)*.

(n109)Footnote 25.2. See *IRC § 121(d)(3)(B); Treas Reg § 1.121-4(b)(2); see 38 The Tax Advisor 449 (Aug 2007)*.

(n110)Footnote 26. *IRC § 121(d)(4); Treas Reg § 1.121-4(c)*.

(n111)Footnote 27. *IRC § 121(d)(5)(A); Treas Reg § 1.121-4(d)(1)*.

(n112)Footnote 27.1. CCA 2007-34021 (Aug 24, 2007).

(n113)Footnote 28. *IRC § 121(d)(5)(B); Treas Reg § 1.121-4(d)(2)*.

(n114)Footnote 29. *IRC § 121(d)(5)(C); Treas Reg § 1.121-4(d)(3)*.

(n115)Footnote 29.1. *Treas Reg § 1.121-3(e)(2)(i); see IRC § 121(c)(2)(B); see § 9.02[5][b][iv] for a discussion.*

(n116)Footnote 29.2. *Treas Reg § 1.121-4(d)(4)*.

(n117)Footnote 29.3. *Treas Reg § 1.121-4(e)(1)(i)*.

(n118)Footnote 29.4. See *IRC § 121(b)(1), (2)*.

(n119)Footnote 29.5. *Treas Reg § 1.121-4(e)(1)(ii)(A)*; see *IRC § 121(b)(2)(A)*, *Treas Reg § 1.121-2(a)(3)(i)*.

(n120)Footnote 29.6. See *IRC § 121(a)*.

(n121)Footnote 29.7. *Treas Reg § 1.121-4(e)(1)(ii)(B)*.

(n122)Footnote 30. See *IRC §§ 267(b), 707(b)*.

(n123)Footnote 31. *IRC § 121(d)(8)*; *Treas Reg § 1.121-4(e)(2)*.

(n124)Footnote 31.1. *Treas Reg § 1.121-4(e)(2)(iii)*.

(n125)Footnote 32. *IRC § 121(g)*; *Treas Reg § 1.121-4(h)*.

(n126)Footnote 33. *IRC § 121(e)*; *Treas Reg § 1.121-4(f)*; see *IRC § 877*.

(n127)Footnote 33.0.1. *IRC § 877(h)*.

(n128)Footnote 33.1. *Treas Reg § 1.1398-3*, effective for sales or exchanges on or after December 24, 2002; see *IRC § 1398(f)(1), (g)(6)*.

(n129)Footnote 34. *In re Curran*, 99-2 USTC P 50,742 (US Bkcy Ct ND Ala 1999); *In re Slye*, 99-2 USTC P 50,739 (US Bkcy Ct Md 1999); *In re Williams*, 99-2 USTC P 50,738 (US Bkcy Ct Md 1999); *In re Munster*, 226 BR 632 (ED Mo 1998) ; *In re Luciano Popa*, 98-1 USTC P 50,276 (US Bkcy Ct ND Ill 1998); *In re Kerr (Debtor)*, 99-1 USTC P 50,310 (WD Wa 1999); *In re Bradley*, 1998 WL 400737, 222 BR 313 (MD Tenn 1998) ; *In re St Francis (Debtor)*, 232 BR 518 (ND Ga 1999) ; *In re Godwin*, 230 BR 341 (SD Ohio 1999) ; 99-1 USTC P 50,287; but see *In re Winch*, 226 BR 591 (SD Ohio 1998) (holding that trustee cannot use the exclusion).

(n130)Footnote 35. See *In re Bradley*, 222 BR 313 (MD Tenn 1998) , AOD CC-1999-009 (Aug 30, 1999).

(n131)Footnote 35.1. *TD 9030* .

(n132)Footnote 36. See *In re Mehr*, 153 BR 430, 93-1 USTC P 50,091 (Bankr DNJ 1993); *In re Barden*, 97-1 USTC P 50,243 (EDNY 1996), *affd* 97-1 USTC P 50,244 (2d Cir 1997); see § 9.03[2], for a discussion of prior *IRC § 121*.

(n133)Footnote 37. See *IRC §§ 671, 676(a)*.

(n134)Footnote 37.1. *Treas Reg § 1.121-1(c)(3)(i)*. The regulations comport with prior rulings. See Rev Rul 85-45, 1985-1 CB 183 (gain realized from the sale of trust property used by trust beneficiary as a principal residence qualified for one-time exclusion of gain under former *IRC Section 121*); see Rev Rul 66-159, 1966-1 CB 162 (gain from the sale of a residence in a grantor trust qualified for rollover of gain into replacement residence under former *IRC Section 1034*); *Ltr Rul 199912026* ; *Ltr Rul 200104005* (exclusion under *IRC § 121* available to a portion of a residence that was attributable to the taxpayer's 5 or 5 power in a trust which held the residence).

(n135)Footnote 37.2. *Treas Reg § 1.121-1(b)(3)(i)*.

(n136)Footnote 37.2.1. See *IRC § 121(b)(1), (2)*.

(n137)Footnote 37.2.2. *Treas Reg § 1.121-1(b)(3)(ii)(A)*.

(n138)Footnote 37.2.3. See *IRC § 121(b)(1), (2)*.

(n139)Footnote 37.2.4. *Treas Reg § 1.121-1(b)(3)(ii)(A)*.

(n140)Footnote 37.2.5. *Treas Reg § 1.121-1(b)(3)(ii)(B)*.

(n141)Footnote 37.2.6. *IRC § 6511*.

(n142)Footnote 37.2.7. *Treas Reg § 1.121-1(b)(3)(ii)(C)*.

(n143)Footnote 37.2.8. *Treas Reg § 1.121-1(b)(4)*, Ex 3.

(n144)Footnote 37.2.9. See *IRC § 1(h)(2), (9)*, before repeal by Pub L No 108-27.

(n145)Footnote 37.2.10. *IRC § 1(h)(1)(B), (C)*.

(n146)Footnote 37.2.11. *Rev Rul 2001-57, 2001-2 CB 448*.

(n147)Footnote 37.2.12. *Rev Rul 2001-57, 2001-2 CB 448*.

(n148)Footnote 37.2.13. *IRC § 121(a), (c)(1)(B), (d)(7)*.

(n149)Footnote 37.2.14. *IRC § 121(d)(9)(A)*.

(n150)Footnote 37.2.15. *IRC § 121(d)(9)(D)(i); Treas Reg § 1.121-5(a)*.

(n151)Footnote 37.2.16. *Treas Reg § 1.121-5(b)*, effective for sales and exchanges on or after May 7, 1997 [*Reg § 1.121-5(e)*]. Because of the retroactive effective date of this provision, elections for closed years could be made by filing an amended return before Nov 11, 2004 [*Reg § 1.121-5(c)*].

(n152)Footnote 37.2.17. *IRC § 121(d)(9)(D)(ii)*.

(n153)Footnote 37.2.18. *IRC § 121(d)(9)(B)*.

(n154)Footnote 37.2.19. *Treas Reg § 1.1034*.

(n155)Footnote 37.2.20. *IRC § 121(d)(9)(A)(iii)*, effective for sales and exchanges after Dec 20, 2006.

(n156)Footnote 37.2.21. *IRC § 121(d)(9)(B)*.

(n157)Footnote 37.2.22. *IRC § 121(d)(9)(C)(iv)*. For sales and exchanges before June 19, 2008, the duty station had to be located outside the United States. This requirement is eliminated for sales and exchanges after June 18 2008 [former *IRC § 121(d)(9)(C)(vi)*, repealed by Pub Law No. 110-246, § 113].

(n158)Footnote 27.2.23. *IRC § 121(d)(12)(A)*, effective for tax years beginning after 12/31/07 [Pub Law No. 110-246, § 110(b)].

(n159)Footnote 27.2.23.1. *IRC § 121(d)(12)(B)*; see *IRC § 121(d)(9)(B)*.

(n160)Footnote 27.2.23.2. *IRC § 121(d)(12)(B)*; see *IRC § 121(d)(9)(D)*.

(n161)Footnote 37.2.24. *IRC § 121(d)(10)*, effective for sales or exchanges of principal residences after Oct 22, 2004.

(n162)Footnote 37.2.25. See *IRC § 1031*.

(n163)Footnote 37.2.26. *IRC § 121(d)(10)*.

(n164)Footnote 37.2.27. See *IRC § 1015(a)*.

(n165)Footnote 37.2.28. See *IRC § 1041(b)*.

(n166)Footnote 37.2.29. *Rev Proc 2005-14, 2005-1 CB 528* , effective Jan 27, 2005, but taxpayers may elect to apply it in any open tax years (see *IRC § 6511*).

(n167)Footnote 37.2.30. *Rev Proc 2005-14* , § 4, *2005-1 CB 528* .

(n168)Footnote 37.3. Pub L No 107-16, § 542(f).

(n169)Footnote 37.4. *IRC § 121(d)(11)(A), (B)*.

(n170)Footnote 37.5. *IRC § 121(b)(1)*.

(n171)Footnote 37.6. *IRC § 121(d)(11)(C)*.

(n172)Footnote 37.7. *IRC § 121(d)(11)*.

(n173)Footnote 38. See *IRC § 121(d)(8)*; see § 9.02[6][e], above.

(n174)Footnote 39. *IRC § 121(a), (f)*.

(n175)Footnote 39.1. *Treas Reg § 1.121-4(g)*.

(n176)Footnote 39.2. *IRC § 6045(e)(1)*.

(n177)Footnote 40. *IRC § 6045(e)(5)(A)*.

(n178)Footnote 40.1. *Rev Proc 2007-12, 2007-4 IRB 357* .

(n179)Footnote 40.2. See *IRC § 6045(e)(5)(A)*.

(n180)Footnote 41. See *IRC § 6045(e)(5)(A)*.

(n181)Footnote 42. Pub L No 105-34, § 312(d)[e].

(n182)Footnote 42.1. *Treas Reg §§ 1.121-1(f), 1.121-2(c), 1.121-3(l), 1.121-4(l), 1.1398-3(d)*; *Temp Treas Reg § 1.121-3(l)*.

(n183)Footnote 42.2. *Treas Reg § 1.121-4(j)*.

(n184)Footnote 42.3. *Treas Reg § 1.121-4(k)*.

(n185)Footnote 43. *Treas Reg § 1.165-9(b)*.

(n186)Footnote 44. *Treas Reg § 1.165-9(b)*; *Higgins v Commr, TC Memo 1995-139* ; see *Bundren v Commr, TC Memo 2001-2* (parties stipulated basis of property); *Howard v Commr, 69-2 USTC P 9534 (ND Ill 1969)*.

(n187)Footnote 45. *Wood v Commr, 197 F2d 859 (5th Cir 1952)* .

(n188)Footnote 46. *Ireland v Commr*, 10 TCM 430 (1951) .

(n189)Footnote 47. *Grammar v Commr*, 12 TC 34 (1949) ; *McAuley v Commr*, TC Memo 1976-276 ; *Richardson v Commr*, TC Memo 1978-322 (note that the property in this case was rented, but only for 8 days--not a sufficiently substantial time).

(n190)Footnote 48. See § 9.11[6], *infra*.

(n191)Footnote 49. See *IRC* § 121(a).

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Federal Taxes Affecting Real Estate

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.03

§ 9.03 Prior Law Relief Provisions for Principal Residences

[1] Rollover of Gain From Sale of Principal Residence Under Former IRC Section 1034

Former IRC Section 1034, relating to the rollover and nonrecognition of gain from the sale of principal residences, has been repealed, effective generally for sales and exchanges after May 6, 1997. n50 As is noted above, taxpayers may elect to have former IRC Section 1034 apply to any sale or exchange occurring before August 5, 1997. n51 In addition, taxpayers may elect to have former IRC Section 1034 apply to any sale or exchange occurring after August 4, 1997, if either of the following circumstances is present: n52 (1) the sale or exchange is pursuant to a contract that was binding on August 5, 1997; or (2) if, without regard to the 1997 federal amendments, gain would not be recognized under former IRC Section 1034, as in effect before August 5, 1997, on the sale or exchange by reason of the acquisition of a new residence on or before that date, or with respect to the acquisition of which by the taxpayer a binding contract was in effect on that date.

Accordingly, the discussion in this subsection dealing with the provisions of *IRC Section 1034* before its repeal by 1997 federal legislation, is of interest primarily for taxpayers who may wish to take advantage of the transition rules and for those who have an issue relating to former IRC Section 1034 raised on audit.

Former IRC Section 1034 offers relief by providing that the gain realized on the sale or exchange of the "principal residence" of the taxpayer is deferred when the proceeds are invested in another "principal residence" that the taxpayer buys or builds within specified time limits. In contrast to *IRC Section 121*, which provides a complete exclusion from gain income for residence sales meeting its criteria, former IRC Section 1034 provided only a deferral of tax.

There are three general requirements that must be met for a transaction to qualify under former IRC Section 1034. These concern:

- (1) the definition of a taxpayer's principal residence;
- (2) the timing of the purchase or construction and the use of the new principal residence by the taxpayer;
and
- (3) the extent to which the proceeds from disposition of an old principal residence are reinvested in a

new principal residence. n53

An exchange of a residence for other property is treated as a sale of the residence. Conversely, the acquisition of a residence in exchange for other property is treated as a purchase of that new residence. n54

[a] "Principal Residence" Requirement

The first requirement is that the "principal residence" of a taxpayer must have been sold or exchanged and another "principal residence" purchased, constructed or reconstructed within the specified time frame. There is no clear definition of this term, and what constitutes the principal residence of a taxpayer depends primarily on the facts and circumstances in each case. n55 The IRS will not issue advance rulings on the issue of whether a property qualifies as a principal residence for purposes of former IRC Section 1034. n56 Obviously, the term presupposes a use requirement, although it is not necessary that the property be occupied as a residence at the time of sale. Property cannot constitute a principal residence if the taxpayer never has resided there. n57 In addition, the taxpayer must have title to the property claimed to be a principal residence. n58 A partner in a partnership that held title to property used by the taxpayer as a residence was not able to use the benefits of former IRC Section 1034 when the partnership sold the property because the partnership, and not the taxpayer, held title. n59

A taxpayer can have only one "principal residence" at a time, and this could present a serious problem to a taxpayer who maintains more than one home. In one case, the Tax Court considered the following factors:

- (1) length of time spent in each residence;
- (2) business location;
- (3) where state income tax returns were filed; and
- (4) where the taxpayer was registered to vote. n60

A potential problem in obtaining deferral of gain occurs when the taxpayer stops using the principal residence as a residence, i.e., when he or she vacates the home or converts the residence into income-producing property.

[i] Manifestations of Principal Residence Intent

Taxpayer intent, as evidenced by objective facts, is an important factor in determining whether a residential property no longer being used by the taxpayer as a residence continues to be the taxpayer's principal residence. n61 If the taxpayer indicates an intent never to return, that home will no longer be considered the taxpayer's principal residence. n62 However, temporary rental will not violate the nonrecognition provisions *per se*, especially when care and maintenance of the property, instead of rental income, are the important concerns of the taxpayer. Similarly, the fact that depreciation and maintenance deductions are claimed on the temporarily-rented house is not determinative when care and maintenance are the important reasons for the rental. n63

A Ninth Circuit case allows a taxpayer to claim deductions for depreciation, insurance and miscellaneous expenses in excess of rental income even though the house is held for sale, and ultimate gain on sale qualifies for former IRC Section 1034 deferral. The Tax Court decision reversed by the Ninth Circuit had limited the taxpayer's deductions to the amount of rental income generated by the property. The Ninth Circuit rejected the Service's argument that a residence that qualifies for nonrecognition treatment cannot also be held for the production of income. The opinion stated: "If the IRS wants such a rule, it should ask Congress to enact it." n64 The Service may, however, continue to argue that a principal residence cannot qualify for former IRC Section 1034 deferral and also be considered as held for the

production of income. Immediate efforts to sell a principal residence after a taxpayer moves out is the best evidence that the taxpayer intends to sell the property and not hold it for rental income. When these efforts occur, courts will consider external factors, such as a lack of a ready marketⁿ⁶⁵ or refusal of a co-owner to cooperate in the sale,ⁿ⁶⁶ as evidence that the residence remains the taxpayer's principal residence even after the taxpayer has moved out with no intent to return. The IRS frequently takes positions that are seemingly inconsistent, challenging principal residence characterization where a residential property is sold at a profit, but contending that a property was a principal residence when the property is sold at a loss.ⁿ⁶⁷

Nevertheless, cases typically hold that a taxpayer who leaves a residence, rents a home elsewhere for a period of time, and eventually sells the old residence and purchases a new one is ordinarily not entitled to roll over gain under former IRC Section 1034. The rationale is usually that the taxpayer's ceasing to use the residence as his or her actual residence reflects an intent not to use the residence as a principal residence.ⁿ⁶⁸

For example, a spouse who relinquishes a former marital residence in a divorce to the other spouse cannot roll over gain from the later sale of the residence under former IRC Section 1034 because that house is no longer the departing spouse's principal residence. This result occurs even if the departing spouse retains a financial interest in the residence and even if the parties agree at the time of the departure and divorce to later sell the residence and split the proceeds.ⁿ⁶⁹

[iii] Adjacent Land--Partial Residence Use

Property may be used partially for a principal residence and partially for other purposes. A question arises when a house that is the principal residence of a taxpayer is situated on a large tract of land--that is, how much of the surrounding land is includable in the nonrecognition provisions?

Taxpayers who own and intend to sell land adjacent to their principal residence will find that in some circumstances the sale of the adjacent land would be eligible for rollover treatment under former IRC Section 1034, whereas in others it would not. While the principal residence can consist of a dwelling house and adjacent land, the adjacent land alone cannot be considered a residence.ⁿ⁷⁰ However, land and a dwelling need not always be sold together. In *Bogley v Commissioner*,ⁿ⁷¹ the taxpayer first sold his residence and three acres of land surrounding it. When he later sold the remaining ten acres of the original 13-acre tract, and the court held that the ten acres had not lost their status as part of the residence. The abandonment theory, however, could probably have been successfully argued by the Commissioner if the remaining land had been sold long after the sale of the residence.

Case law in this area has been based on the actual use of the property and the intent of the taxpayer, rather than on the amount of land surrounding the house. In *Estate of Campbell v Commissioner*,ⁿ⁷² the court ruled that a house itself and the five acres surrounding it constituted the residence, but not the 37 acres used for farming. In *Beckwith v Commissioner*,ⁿ⁷³ the court would not include as part of the replacement personal residence the 28 acres of marshland and wooded area adjoining a residence. In another case, the jury held that a house and the full 65-acre tract surrounding it constituted a principal residence.ⁿ⁷⁴ In *Lokan v Commissioner*,ⁿ⁷⁵ the court held that only one and one-half of the seven and one-half acres constituted the replacement principal residence of the taxpayer.

However, it should be noted that courts take a fairly liberal view of residential purposes and property use under former IRC Section 1034. Therefore, if there is a home on the old property or on the replacement property, a large amount of the adjoining property--up to 65 acres in one case--may be considered part of the principal residence eligible for rollover treatment.ⁿ⁷⁶

Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, stock held by a tenant/stockholder in a cooperative housing corporation,ⁿ⁷⁷ or a condominium apartment.ⁿ⁷⁸ However, a transferable membership in a life-care facility did not qualify as a new residence for purposes of former IRC Section 1034.ⁿ⁷⁹

[b] Timing Requirements

The second requirement concerns timing. The purchase and use of a new principal residence must be accomplished within two years before or after disposition of an old principal residence. n80 This provides, in effect, a four-year replacement period. It is important to define the actual date of the sale of the old residence when the taxpayer is nearing this two-year limit. In one case, n81 the taxpayer was denied deferral of gain because the two-year time period was determined by reference to the date on which the benefits and burdens of ownership were shifted to the purchaser, which took place on the date the sales agreement was executed, not the date on which legal title was transferred.

The timing requirements are strictly construed, and cannot be waived even if there are extraordinary circumstances. Courts routinely refuse to waive the statutory replacement period requirement, even if the taxpayer makes good faith efforts to timely find a replacement residence and the failure to comply is due to physical, financial, or some other hardship outside of the taxpayer's control. n82 Accordingly, it was common to include a "time-is-of-the-essence" provision in the contract for the acquisition of the replacement residence. Similarly, if the replacement home is being constructed rather than purchased, and construction of the new home is incomplete at the end of the replacement period, no rollover under former IRC Section 1034 is allowed. Residential use within the statutory replacement period is an essential prerequisite to construction cost inclusion. n82.1

[i] Multiple Replacements

Former IRC Section 1034(k) extended the reinvestment period up to four years for taxpayers who had a new tax home (as defined in *IRC Section 911(d)(3)*) outside the United States (with certain exceptions) after the sale of their old residence. This longer period is appropriate because the Service generally refuses to extend the reinvestment period even when there are extenuating circumstances. n83 Members of the armed services also have four years in which to replace their residences. This can be extended to eight years if they are stationed overseas, or one year after returning to the United States--whichever period is shorter. n84

If a taxpayer, during the two-year replacement period, purchases more than one residence that is used at some time within that replacement period as a principal residence, only the last residence so used within the replacement period is treated as a new residence under former IRC Section 1034. n85 The tax deferral under former IRC Section 1034 is not available if a taxpayer has deferred gain from the sale of another principal residence within two years before the date of the later sale. n86 This restriction does not apply, however, for certain sales required by employment-related relocations. n87

[ii] Actual Use as Residence

The requirement about timing has two facets:

- (1) The new residence must be purchased or constructed within the applicable replacement period.
- (2) The taxpayer must actually use the new residence as his principal residence during some time within the same period. "Use" requires physical occupancy, i.e., a taxpayer must live in the new residence. n88

In *Welch v Commissioner*, n89 it was held that failure to move into the new residence within the required period will render the original sale a taxable transaction, regardless of the circumstances causing the delay.

[iii] Related Party Sales

A 1983 letter ruling stated there was no prohibition under former IRC Section 1034 against a sale between related parties. n90 Consequently, nonrecognition of gain was allowed, even though the old residence was sold to the taxpayer's

wholly-owned corporation that would use the former residence for business purposes. Under *IRC Section 1239*, any gain recognized on the sale of property to a related party must be treated as ordinary income if the property is depreciable by the transferee. However, the ruling concluded that *IRC Section 1239* did not apply to the transaction at hand because no gain was recognized under former *IRC Section 1034*.

[c] Reinvestment of Proceeds

The third requirement for deferral of gain under former *IRC Section 1034* is the reinvestment requirement. Under former *IRC Section 1034*, gain on the sale of a principal residence would be deferred completely only if the cost of a new residence was at least equal to the "adjusted sales price" of the old residence. Gain is recognized to the extent that the "adjusted sales price" of the old residence exceeds the cost of the new residence. n91 This requirement could be satisfied through a purchase or construction of a new residence or the partial or total construction or reconstruction of an existing residence. The mere improvement of a residence that does not amount to a reconstruction cannot qualify as a new residence. n92 In one private letter ruling, the Service ruled that the building of an addition onto existing residential rental property owned by the taxpayer qualified as a new residence because it was new construction, rather than a mere improvement. The addition added 1,500 square feet to the existing building, which was about one-third the size of the entire completed building (existing structure plus the addition). The Service may have been influenced by the fact that the taxpayer was to reside only in the addition, and that the existing structure before the improvements would continue to be leased to unrelated tenants. n93

The term "adjusted sales price" means the "amount realized" on the sale of the former residence, reduced by the aggregate of the expenses for work performed on the former residence to assist in its sale. n94 These costs are commonly referred to as "fixing-up" costs and are discussed in *Section 9.03[1][d]*, below.

The "amount realized" is the selling price of an old residence, reduced by sales commissions and other selling expenses. Selling price includes:

- (1) cash or other property received;
- (2) notes or purchase money mortgages of the buyer; and
- (3) any indebtedness to which the old residence was subject, if the purchaser assumes the indebtedness or takes the property subject to the indebtedness.

Any amount received by the seller from his or her employer, pursuant to a guarantee-against-loss agreement, is compensation and is not included in the computation of the "amount realized." n95 However, if the employer purchases the employer's principal residence, or arranges for its purchase, the transaction is treated in the manner of a sale to a third party. n96

The excess of the "amount realized" on the sale over the "adjusted basis" of the residence is, of course, the gain realized. n97 The adjusted basis of a residence is its original cost, plus any capital improvements, less such items as casualty losses deducted, depreciation for partial business use, or gain deferred under former *IRC Section 1034* on the prior sale of a residence. n98

[i] Cost Defined

The cost of a new residence includes: n99

- (1) the purchase price of the new residence and any reconstruction costs and capital improvements that

are incurred within the replacement period; n100

(2) construction costs; and

(3) other fees and expenses which a taxpayer incurs in its acquisition.

If a new residence is being constructed, only those costs attributable to the construction of a structure that is put into use as a residence within two years of the date the old residence is sold may be taken into account. n100.1 If the construction is not completed within the 2-year period, and the new home put into use as a residence by the taxpayers within that time, construction costs cannot be taken into account, even if the taxpayers reside in a temporary dwelling on the same replacement parcel during the construction of a permanent residence. n100.2

The cost also includes all liabilities to which the property is subject, whether or not a taxpayer assumes the debt. For example, in some cases, the cost of a cooperative apartment may include a taxpayer's proportionate share of any unpaid mortgage on the building owned by the cooperative corporation. n101

The tax basis of a new residence is determined by aggregating the costs described above, and subtracting the amount of deferred gain on the disposition of the old residence. n102

[ii] Partial Use as Residence

When part of the property sold was used by the taxpayer as his principal place of residence and part was used for other purposes, as in the case of a multifamily rental dwelling or when a taxpayer maintains an office on part of the property, an allocation of the gain must be made to determine the part of the gain attributable to the residential portion. The part of the gain allocable to the residential portion, and the part allocable to any business use portion that does not meet the business-use requirements of *IRC Section 280A* in the year of sale can qualify for deferral. n103 Similarly, if only part of the new property is used only partially for residential purposes, only that part of the cost that is allocable to the residential portion qualifies as reinvested proceeds. n104

[iii] Identity of Owner

In general, the new residence must be owned by the same taxpayer who sold the old residence. n105 If the new residence is purchased by someone other than the taxpayer--for whatever reason--nonrecognition under former *IRC Section 1034* is not available. n106 This result ensues even if title to the new residence is taken in the name of another only for purposes of convenience to the taxpayer, as when a parent takes title to replacement property only in order to obtain a loan for the child to purchase a replacement property. n107

There is a special provision for a husband and wife, however, whereby a taxpayer and his or her spouse can file a consent to have themselves treated as a single taxpayer. n108 Such treatment is available only if the old and new residences are each used by the taxpayer and his/her spouse as their principal residences.

Frequently, a divorcing taxpayer sells a home owned jointly with the soon-to-be-ex-spouse and within the replacement period purchases a new home, either alone or jointly with a new spouse. In either case, the gain from the sale of the old principal residence may be rolled over, provided statutory requirements are met. For a taxpayer buying a new home alone, the entire gain may be rolled over against the entire cost of the new principal residence. It is the position of the IRS that if a home is purchased jointly with a new spouse, however, the gain may be rolled over under prior law only if the taxpayer's share of the cost of the new residence exceeds the taxpayer's share of the adjusted sales price of the old residence. n109 This position was rejected, and the cited regulation invalidated by the Fourth Circuit. n110

Example:

In 1995, W sells a home that she owned jointly with her ex-husband. The total adjusted sales price is \$400,000, and the total basis in the home was \$200,000. W's half portion of the adjusted sales price is \$200,000, and her half basis in the home is \$100,000. W files a separate return for 1995. In 1996, W and her new husband purchase a home jointly for \$250,000. According to *Treasury Regulation Section 1.1034-1(f)*, W cannot roll over her gain from the sale of the old residence to the entire cost of the new one because she has only a one-half interest in the new residence. Her share of the cost of the new residence (\$125,000) is therefore less than her share of the adjusted sales price of the old residence (\$200,000). However, if W lives in the Fourth Circuit (Maryland, Virginia, West Virginia, North Carolina and South Carolina), she could rollover the gain; n111 and even the IRS would agree that if W did not own the new home jointly with her new spouse, but was the sole owner, she could roll over the gain from the sale of the old residence.

Revenue Ruling 74-250 n112 explains the application of former IRC Section 1034 in divorce situations. The ruling provides that if each divorcing spouse is entitled under state law to receive one-half of the proceeds of the sale of the old residence, each is eligible for rollover treatment on his or her one-half share of the gain resulting from the sale of a principal residence pursuant to a divorce if the statutory requirements of former IRC Section 1034 are otherwise met. This is accomplished by allocating one-half of the adjusted sale price from the sale of the residence to each spouse. A determination is then made separately for each as to whether enough of the adjusted sale price is reinvested in a new principal residence within the required time period. If the cost of each new residence exceeds each spouse's respective share of the adjusted sale price, then each will be entitled to roll over the gain from the sale of the old residence. Divorcing spouses should be aware that although each is entitled to compute gain on the sale of the jointly held residence by taking into account only one-half of the basis and net proceeds from the sale of the property, if the parties file a joint return for the year of sale, the joint and several liability provisions of the Code will provide that either spouse may be held responsible for the tax on the entire gain if for some reason rollover treatment under former IRC Section 1034 is not available, or if one or both of the former spouses decides not to reinvest in a new principal residence. n113

Note that the way for the spouses to avoid potential joint and several liability for tax on the entire gain from the sale of a principal residence is to file separate returns for the year in which the principal residence is sold, although this may result in a higher aggregate tax burden for the year of the sale because of the higher tax rates applicable to married persons filing separate tax returns. Merely specifying in the divorce decree that the spouses agree to split the sale proceeds and that each spouse is responsible for reinvesting his or her share of the proceeds within the required time period does not nullify joint and several liability arising from the filing of a joint return for the year of sale. n114 Further, the gain on the sale of the former residence must be allocated in accordance with the spouses' ownership interests in the property, even if the divorce decree provides that the proceeds will be shared in a different ratio. n115

The same rule applies for two unmarried people who marry and replace their separate homes with a single, jointly-owned home. Each spouse must separately satisfy the requirements for postponing gain, and each spouse's share of the cost of the new home must be equal to or greater than the adjusted sales price of his or her old home. Similarly, if only one of the spouses has gain to defer, that gain may be rolled over only with respect to that spouse's share of the cost of the new jointly-owned home. n116

[d] Treatment of "Fixing-Up" Expenses

"Fixing-up" expenses are noncapital expenditures incurred on the sale of the residence to assist in its sale, such as painting. As previously stated, these expenses are deducted from the amount realized to determine "adjusted sales price." To qualify as "fixing-up" expenses, the expenditures must meet the following conditions:

- (1) They must be for work performed within a 90-day period before the execution of the contract for sale of the old residence.

(2) They must be paid within 30 days after the date of the sale.

(3) They must not be capital in nature (capital expenditures would, of course, be included in the adjusted basis of the old residence without regard to the 90-day or 30-day periods).

(4) They must not be otherwise allowable as deductions. n117

[e] Example of Gain Determinations

The following example illustrates the computation of gain to be deferred and basis of a new residence.

Example:

A taxpayer purchases his old residence for \$14,000 on June 5, 1950. He makes permanent improvements costing \$6,000. He sells the residence for \$50,000 on May 2, 1994. Selling expenses and commissions amount to \$3,000. During the 90-day period before execution of the contract of sale, the taxpayer spends \$2,000 to paint and "dress up" the house to make it more saleable. On January 15, 1996, he purchases a new residence for \$44,000, inclusive of all fees incident to purchase. The taxpayer occupies the new residence on April 1, 1996, which is within two years from the date of sale.

Selling price of old home		\$50,000
Less: Selling expenses		3,000_____

		—
Amount realized		47,000
Cost of old home	\$14,000	
Add: Cost of capital improvements	6,000_____	

Tax basis of old home		20,000_____

		—
Gain realized on sale		\$27,000_____

Amount realized	\$47,000	
Less: "Fixing-up" expenses	2,000_____	

Adjusted sales price		\$45,000
Cost of new home		44,000_____

		—
Gain recognized and subject to tax		\$1,000_____

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Total cost of new home		\$44,000
Gain realized on sale of old home	\$27,000	
Less: Recognized gain	1,000	
Deferred portion of gain realized		26,000
Tax basis of new home		\$18,000

[f] Reporting Requirements

The taxpayer is required to report the sale or exchange of his residence on Form 1040, Schedule D, for the year of disposition, whether or not there is a deferral of the gain. If the taxpayer does not intend to purchase a new residence within the specified time period, the total gain subject to capital gains treatment (discussed in Chapter 6) must be included in the taxpayer's taxable income in the year of the sale (assuming that the sale is not made on the installment basis). If the taxpayer later changes his mind and purchases a residence within the replacement period, he will be entitled to a refund of the tax paid. The refund is obtained by filing an amended return. When a new residence is purchased before a taxpayer has filed his return, he must attach a statement to his return showing the necessary computations of the gain and the basis of the new residence. Form 2119, Sale or Exchange of Personal Residence, shows the required details and computations.

If a taxpayer intends to purchase a new residence but has not done so by the time the return is due for the year of disposition of the old residence, and the replacement period has not expired, the gain on Schedule D should be shown as "none." A statement should be attached to the return showing the computation of the gain and indicating that a new residence has not yet been purchased, but that the taxpayer intends to do so. When a purchase is later made, the taxpayer must then forward to the district director the information and computations necessary to establish the deferral of the gain. If the adjusted sales price exceeds the cost of the new residence, thereby causing some of the gain to be taxed currently, the taxpayer must file an amended return, showing the amount of taxable gain, and remit the tax due. Interest must be paid on any tax deficiency. n118 The statute of limitations for the year of the sale with respect to the assessment of tax on the gain on the sale does not expire until three years after the taxpayer furnishes the district director with a written statement concerning his or her reinvestment, decision not to reinvest, or failure to reinvest within the statutory time limits. n119

[g] Election for Involuntary Conversions

When there has been an involuntary conversion of the taxpayer's principal residence, he has the option of electing to come under the provisions of the "sale of residence" rules of former IRC Section 1034 or under the involuntary conversion provisions of *IRC Section 1033* (discussed in Chapter 8). n120 This election is made in a statement attached to the taxpayer's income tax return for the year of disposition of the old residence.

[h] Using Both Unlimited Rollover and Over 55 Exclusion

It was possible under prior law to use both the unlimited rollover of gain discussed in this section and the over age 55 exclusion discussed in the immediately following section.

[2] Exclusion for Persons Age 55 or Over Under Prior *IRC Section 121***Planning Note:**

IRC Section 121, as currently in effect, allows all taxpayers to exclude up to \$250,000 on the sale of a principal residence. That provision is discussed in detail in *Section 9.02*, above. The discussion in this subsection deals with the provisions of former *IRC Section 121*, as in effect before its substantial modification by the 1997 amendments. n121

The provisions discussed below are repealed, effective generally for sales and exchanges after May 6, 1997. n122 Taxpayers may elect to have former *IRC Section 121* apply, however, to any sale or exchange occurring before August 5, 1997. n123 In addition, taxpayers may elect to have former *IRC Section 121* apply to any sale or exchange occurring after August 4, 1997, if either of the following circumstances is present: n124 (1) the sale or exchange is pursuant to a contract that was binding on August 5 1997; or (2) if, without regard to the 1997 federal amendments, gain would not be recognized under former *IRC Section 1034*, as in effect before August 5, 1997, on the sale or exchange by reason of the acquisition of a new residence on or before that date, or with respect to the acquisition of which by the taxpayer a binding contract was in effect on that date.

Former *IRC Section 121* n125 provided a once-in-a-lifetime election for taxpayers age 55 or over, whereby up to \$125,000 (\$62,500 in the case of married individuals who file separate returns) of gain on the sale or exchange of a principal residence is forever tax free. n126

Two general requirements must be satisfied before a taxpayer could elect the relief provided by this section:

- (1) the age of the taxpayer; and
- (2) the ownership and use of the property.

[a] Principal Residence and Ownership Issues

The property must be owned and used by a taxpayer as his principal residence for at least three out of the five years preceding the date of sale. The ownership requirement means that the taxpayer must have title or must have assumed the benefits and burdens of ownership of the property claimed to be a principal residence. n127 In one case, the taxpayer was a partner in a partnership that held title to property used by the taxpayer as a residence. The Tax Court held that the benefits of *IRC Section 121* were not available with respect to the partner's allocable share of gain from the partnership when the partnership sold the property because the partnership, and not the taxpayer, held title. n128 The holding period of a condemned or otherwise involuntarily converted principal residence will tack on to the holding period of the replacement residence, but no other holding period tack-on is permitted. n129

The use requirement means that the taxpayer must have used the residence as his or her principal residence for the requisite three-year period. Short temporary absences are not disqualifying, even though a residence may be rented during the periods of absence. n130

The U.S. Court of Federal Claims has held that physical occupancy is not necessarily required to satisfy the "use" requirement. The court held that a "facts and circumstances" analysis should be undertaken to determine whether the home was used as a principal residence for the requisite period. The court held that, depending on the situation, an individual who did not physically occupy a home for the required time could have extenuating circumstances which prevented physical occupancy, but which would not deny the characterization of use of the property as a principal residence. If an absence from the residence is explained under a "facts and circumstances" test, a court might or might

not find that the party used the property as a principal residence for the requisite period. n131 The Tax Court has also applied a "facts and circumstances" analysis in determining whether the taxpayer has met the use requirement. n131.1

When the property is held by a husband and wife as joint tenants, as tenants by the entirety or as community property, the age, ownership and use requirements are satisfied when either the husband or wife meets all three requirements, as long as the spouses file a joint return. n132 Similar treatment applies to a surviving taxpayer whose deceased spouse had met the age, ownership and use requirements as long as the surviving spouse has not remarried by the time of the sale and provided that the deceased spouse had not previously made an election under former *IRC Section 121(a)*. n133 An unmarried individual qualifies when he holds the residence in joint tenancy or as a tenant in common. n134 Since a grantor is treated for tax purposes as the owner of property held by a revocable trust, a sale of the grantor's principal residence by the trust qualifies for the Section 121 election. n135 A bankruptcy trustee, however, could not make an election to exclude gain under former *IRC Section 121*. n136 A special rule was provided for taxpayers who become physically or mentally incapable of self-care. n137

[b] Age Requirement

This relief provision is available only for taxpayers who have attained the age of 55 before the date of the sale or exchange of their "principal residence." n138

[c] Elective Treatment

The relief provision must be specifically elected before the expiration of the statute of limitations on refunds for the taxpayer's return for the year of disposition, generally three years from the due date of the return for that year. n139 It is not necessary, therefore, that the election be made on the return in the year of disposition. In addition, an election once made can be revoked at any time before the expiration of the statute of limitations on refunds for the year of disposition. n140 If an election is made for a sale that generates less than the maximum excludable gain--for example, \$75,000--then the tax benefit of the remaining exclusions is permanently lost. n141

A taxpayer who makes this election is forever barred from making a similar election for any later sale or exchange of a principal residence. n142 This rule has broad implications for married taxpayers who make this election during marriage and later divorce--not even remarriage will reinstate the ability to make the election. The divorced spouse *and* the new spouse are barred from ever making another election. n143

Cases have held that a bankruptcy trustee could not make an election to exclude gain under former *IRC Section 121*. n144

[d] Miscellaneous Issues

A number of Treasury rulings make planning for the sale of a home important. For example, assume a man and a woman who each own their own home decide to sell their individual homes, get married, and then buy a new home together. They may each claim the \$125,000 exclusion (if all other requirements are met) on their joint return. The critical time for selling their separate homes was before they married. n145

Moreover, the Service ruled for the taxpayer in the following situation: An individual sold his principal residence in January 1984. At the time of the sale he qualified for and took the \$125,000 exclusion. In June, he married and the couple filed a joint return for 1984. The spouse did not join in this election, however, because they were not married at the time the sale was made. The husband died in 1986, and the wife qualified for the election when selling their joint residence. The Service held that, for purposes of the election, marital status is determined as of the date of the sale or exchange. n146

[e] Interrelation of Former Unlimited Rollover and Age 55-or-Over Provisions

A taxpayer who attains the age of 55 before the sale of his personal residence can obtain the dual benefits of the rollover relief provisions discussed in *Section 9.03[1]*, above, as well as the "55-or-over exclusion." n147 Thus, any gain that would otherwise be recognizable after electing the once-in-a-lifetime exclusion may be subject to the general deferral provision of former IRC Section 1034.

Example:

Sales price of old residence	\$210,000
Tax basis of old residence	50,000
Gain realized	\$160,000
Sales price of old residence	\$210,000
Gain excluded under former IRC Section 121 election	125,000
Amount realized for purposes of applying former IRC Section 1034	\$85,000
Purchase price of new residence	75,000
Net gain taxable	\$10,000
Gain realized on sale	\$160,000
Less gain excluded under former IRC Section 121 election	\$125,000
Adjusted gain realized on sale	\$35,000
Less gain recognized	10,000
Deferred portion of gain realized	\$25,000
Purchase price of new residence	\$75,000
Less deferred portion of gain realized	25,000
Tax basis of new residence	\$50,000

In an unusual ruling, the taxpayer sold his personal residence to a charity in a bargain sale in exchange for a private annuity for life. As it was a bargain sale, the taxpayer was required to allocate basis between the charitable gift portion and the exchange portion. He was allowed to elect former *IRC Section 121* and defer gain via former IRC Section 1034 so that no tax was due on the exchange. Also, he was allowed a charitable deduction for the contribution element. n148

FOOTNOTES:

(n1)Footnote 50. Pub L No 105-34, § 312(d)[e](1).

(n2)Footnote 51. Pub L No 105-34, § 312(d)[e](2).

(n3)Footnote 52. Pub L No 105-34, § 312(d)[e](4).

(n4)Footnote 53. See *IRC § 1034(a)*, before repeal by Pub L No 105-34.

(n5)Footnote 54. *IRC § 1034(c)(1)*, before repeal by Pub L No 105-34.

(n6)Footnote 55. *Treas Reg § 1.1034-1(c)(3)(i); Beall v Commr, TC Memo 1998-52, affd 2000-2 USTC P 50,577 (9th Cir 2000).*

(n7)Footnote 56. *Rev Proc 99-3, 1999-1 IRB 103, § 3.01(6).*

(n8)Footnote 57. *Goldberg v Commr, TC Memo 1997-74, affd 246 F3d 674 (9th Cir 2000); Vidaurre v Commr, TC Memo 1997-164 (construction of home was not completed before property was sold).*

(n9)Footnote 58. *Kirst v Commr, TC Memo 1997-353 (oral agreement to transmute property as new residence without transfer of record title insufficient); Boesel v Commr, 65 TC 378 (1975); Marcello v Commr, 380 F2d 499 (5th Cir 1967).*

(n10)Footnote 59. *Gibbons v Commr, TC Memo 1997-101, affd 98-2 USTC P 50,547 (4th Cir 1998).*

(n11)Footnote 60. *Thomas v Commr, 92 TC 206 (1989).*

(n12)Footnote 61. *Trisko v Commr, 29 TC 515 (1957), acq 1959-1 CB 5; Rev Rul 59-72, 1959-1 CB 203.*

(n13)Footnote 62. *Houlette v Commr, 48 TC 350 (1967).* But see *Clapham v Commr, 63 TC 505 (1975), acq 1979-2 CB 1*, where principal residence status was not lost when the taxpayer vacated his former residence without any intention to return and rented it prior to sale.

(n14)Footnote 63. *Barry v Commr, TC Memo 1971-179.*

(n15)Footnote 64. *Bolaris v Commr, 776 F2d 1428, 1432 (9th Cir 1985), affg, revg, and remanding 81 TC 840 (1983).*

(n16)Footnote 65. *Clapham v Commr, 63 TC 505 (1975), acq 1979-2 CB 1*, where principal residence status was not lost when the taxpayer vacated his former residence without any intention to return and rented it prior to sale.

(n17)Footnote 66. *Green v Commr, TC Memo 1992-439.*

(n18)Footnote 67. *Murphy v Commr, TC Memo 1993-292.*

(n19)Footnote 68. *Biltmore Homes, Inc v Commr, 288 F2d 336 (4th Cir 1961); Stolk v Commr, 40 TC 345 (1963), affd per curiam 326 F2d 760 (2d Cir 1964); Houlette v Commr, 48 TC 350 (1967).*

(n20)Footnote 69. *Perry v Commr, 91 F3d 82 (9th Cir 1996).*

(n21)Footnote 70. *O'Barr v Commr, 44 TC 501 (1965); Rev Rul 56-420, 1956-2 CB 519.*

(n22)Footnote 71. *263 F2d 746 (4th Cir 1959), revg 30 TC 452; Rev Rul 76-541, 1976-2 CB 246; Ltr Rul 8817015.*

(n23)Footnote 72. *TC Memo 1964-83.*

(n24)Footnote 73. *TC Memo 1964-254.*

(n25)Footnote 74. *Bennett v US, 295 F2d 503 (D Ga 1961).*

(n26)Footnote 75. *TC Memo 1979-380.*

(n27)Footnote 76. *Bennett v US, 61-2 USTC P 9697 (ND Ga 1961) (65 acres); Schlicher v Commr, TC Memo 1997-37 (43 acres); Richards v Commr, TC Memo 1993-422 (28.6 acres of the replacement property); Estate of*

Campbell v Commr, TC Memo 1964-83 (5.1 acres).

(n28)Footnote 77. See former IRC § 1034(f).

(n29)Footnote 78. *Rev Rul 64-31, 1964-1 CB 300* .

(n30)Footnote 79. *Ltr Rul 8837022* .

(n31)Footnote 80. *IRC § 1034, before repeal by Pub L No 105-34; Stilz v Commr, TC Memo 1999-245* .

(n32)Footnote 81. *Awalt v Commr, TC Memo 1987-42* .

(n33)Footnote 82. *Begelfer v Commr, TC Memo 1995-455* ; *Skorniak v Commr, TC Memo 1996-178* ; *Waters v Commr, TC Memo 1995-535* .

(n34)Footnote 82.1. *Parker v Commr, TC Memo 1999-347, affd 13 Fed Appx 611 (9th Cir 2001)* ; see *Perry v Commr, 91 F3d 82 (9th Cir 1996)* , *affg TC Memo 1994-247* ; *US v Sheahan, 323 F2d 383 (5th Cir 1963)* ; *Elam v Commr, 58 TC 238 (1972)* , *affd per curiam 477 F2d 1333 (6th Cir 1973)* .

(n35)Footnote 83. *Rev Rul 75-438, 1975-2 CB 334* .

(n36)Footnote 84. Former IRC § 1034(h).

(n37)Footnote 85. Former IRC § 1034(c)(4); *Asher v Commr, TC Memo 1998-219* ; *Bergersen v Commr, TC Memo 1995-424* .

(n38)Footnote 86. Former IRC § 1034(d)(1), *before repeal by Pub L No 105-34*.

(n39)Footnote 87. Former IRC § 1034(d)(2); *Conhardt v Commr, TC Memo 1986-399* .

(n40)Footnote 88. *Bayley v Commr, 35 TC 288 (1960)* , *acq 1961-2 CB 4* ; *Ltr Rul 8018015* .

(n41)Footnote 89. *TC Memo 1979-9, affd in an unpublished opinion 615 F2d 1365 (8th Cir 1979)* .

(n42)Footnote 90. *Ltr Rul 8350084* . See also *Ltr Ruls 8946021, 9625035*.

(n43)Footnote 91. See former IRC § 1034; *Johnson v Commr, TC Memo 1999-312* .

(n44)Footnote 92. *Treas Reg § 1.1034-1(b)(9)*.

(n45)Footnote 93. *Ltr Rul 9626020* .

(n46)Footnote 94. Former IRC § 1034(b).

(n47)Footnote 95. *Lull v Commr, 434 F2d 615 (9th Cir 1970)* , *affg 51 TC 841* .

(n48)Footnote 96. *Ltr Rul 8134089* ; *Rev Rul 72-339, 1972-2 CB 31* .

(n49)Footnote 97. *IRC § 1001(a); Treas Reg § 1.1034-1(b)(5)*.

(n50)Footnote 98. *IRC §§ 1011(a), 1016(a); Treas Reg § 1.1034-1(e)*.

(n51)Footnote 99. *Treas Reg § 1.1034-1(b)(7)*.

(n52)Footnote 100. *Mitchell v Commr, TC Memo 1997-493* ; see *Ltr Rul 8548027* , in which the costs of

reconstruction of a vacation home to convert it to a principal residence were allowed as a cost of the new residence.

(n53)Footnote 100.1. Former IRC § 1034(c)(2).

(n54)Footnote 100.2. *Swartout v Commr, TC Memo 2001-16* .

(n55)Footnote 101. *Rev Rul 60-76, 1960-1 CB 296* .

(n56)Footnote 102. Former IRC § 1034(e).

(n57)Footnote 103. *Treas Reg § 1.1034-1(c)(3)(ii); Rev Rul 82-26, 1982-1 CB 114* .

(n58)Footnote 104. See *Richards v Commr, TC Memo 1993-422* .

(n59)Footnote 105. *IRC § 1034(a)*.

(n60)Footnote 106. *Yakira v Commr, TC Memo 1998-415* ; *De Ocampo v Commr, TC Memo 1997-161* ; *Marcello v Commr, 380 F2d 499 (5th Cir 1967)* , *affg on this issue TC Memo 1964-299* ; *May v Commr, TC Memo 1974-54* .

(n61)Footnote 107. *Id.*

(n62)Footnote 108. Former IRC § 1034(g). Former IRC Section 1034(g) also permits a surviving spouse to defer gain from the sale of the old residence when one spouse has died after the sale of the old residence but before the purchase of the new residence.

(n63)Footnote 109. *Treas Reg § 1.1034-1(f)*.

(n64)Footnote 110. *Snowa v Commr, 97-2 USTC P 50,614 (4th Cir 1997), revg TC Memo 1995-336* .

(n65)Footnote 111. *Id.*

(n66)Footnote 112. *1974-1 CB 202* .

(n67)Footnote 113. *Murphy v Commr, 103 TC 111 (1994)* , *acq 1996-2 CB 1* . *IRC § 6013(d)(3)*.

(n68)Footnote 114. *Ltr Rul 8911015* ; see *Urbauer v Commr, TC Memo 1997-227* (IRS not bound by divorce decree allocating responsibility for paying tax on sale of principal residence to one spouse).

(n69)Footnote 115. *Id.*

(n70)Footnote 116. *Rev Rul 75-238, 1975-1 CB 257* .

(n71)Footnote 117. Former IRC § 1034(b)(2).

(n72)Footnote 118. *Rev Rul 53-122, 1953-2 CB 226* .

(n73)Footnote 119. *Treas Reg § 1.1034-(i)*.

(n74)Footnote 120. Former IRC § 1034(i). See *Ltr Rul 9334007* (ruling that voluntary sale of land underlying principal residence destroyed by tornado eligible for involuntary conversion treatment under *IRC § 1033* where construction of a similar home on the site was economically infeasible).

(n75)Footnote 121. *IRC § 121, before amendment by Pub L No 105-34*.

(n76)Footnote 122. *Pub L No 105-34, § 312(d)[e](1)*.

(n77)Footnote 123. Pub L No 105-34, § 312(d)[e](2).

(n78)Footnote 124. Pub L No 105-34, § 312(d)[e](4).

(n79)Footnote 125. *IRC § 121, before amendment by Pub L No 105-34.*

(n80)Footnote 126. *IRC § 121, before amendment by Pub L No 105-34.*

(n81)Footnote 127. *Blanton v Commr, TC Memo 1998-211* (court analyzed whether burdens and benefits of ownership were transferred to taxpayers before passage of legal title).

(n82)Footnote 128. *Gibbons v Commr, TC Memo 1997-101, affd 98-2 USTC P 50,547 (4th Cir 1998).*

(n83)Footnote 129. Former *Treas Reg § 1.121-5(d)*, before removal by *TD 9030*.

(n84)Footnote 130. Former *Treas Reg § 1.121-1(c)*, before amendment by *TD 9030*.

(n85)Footnote 131. *Gummer v US, 98-1 USTC P 50,401* (US Ct of Fed Cls 1998).

(n86)Footnote 131.1. *Taylor v Commr, TC Memo 2001-17* (New Jersey home qualified as the taxpayer's principal residence even though he had stopped filing New Jersey tax returns and had gradually been spending more time in Florida and established residence there).

(n87)Footnote 132. Former *Treas Reg § 1.121-5(a)*, before removal by *TD 9030*

(n88)Footnote 133. Former *Treas Reg § 1.121-5(b)*, before removal by *TD 9030*.

(n89)Footnote 134. *Rev Rul 67-234, 1967-2 CB 78*; *Rev Rul 67-235, 1967-2 CB 79*.

(n90)Footnote 135. *Rev Rul 85-45, 1985-1 CB 183*; *Ltr Rul 8549046*. See also *Rev Rul 82-1, 1982-1 CB 26* (ruling that a decedent's estate could elect to exclude gain under former *IRC § 121*, where all but minor ministerial actions relating to the transfer of the decedent's principal residence had been completed prior to the decedent's death).

(n91)Footnote 136. *In re Barden, 97-1 USTC § 50,243* (EDNY 1996), *affd 97-1 USTC P 50,244 (2d Cir 1997)*; *In re Mehr, 93-1 USTC 50,091, 153 BR 430* (Bankr DNJ 1993); but see *In re Luciano Popa, 98-1 USTC P 50,276* (US Bkcy Ct ND Ill 1998) (holding that bankruptcy trustee may use the post-1997 *IRC Section 121* exclusion in selling the debtor's principal residence, and indicating that the *Barden* and *Mehr* cases were wrongly decided).

(n92)Footnote 137. *IRC § 121(d)(9)*, before amendment by Pub L No 105-34.

(n93)Footnote 138. *IRC § 121(a)(1)*, before amendment by Pub L No 105-34.

(n94)Footnote 139. Former *Treas Reg § 1.121-4(a)*, before amendment by *TD 9030*; see *Ltr Rul 200124011* (IRS allowed taxpayer to make election in 2001 for 1996 return because no return had been filed or tax paid for 1996).

(n95)Footnote 140. *IRC § 121(c)*, before amendment by Pub L No 105-34; Former *Treas Reg § 1.121-4(a)*, before amendment by *TD 9030*.

(n96)Footnote 141. See Former *Treas Reg § 1.121-2(b)*, before amendment by *TD 9030*.

(n97)Footnote 142. *IRC § 121(b)(2)*, before amendment by Pub L No 105-34; *Koppen v Commr, TC Memo 1995-316*; *Robarts v Commr, 103 TC 72*, *affd without published opin 56 F3d 1390, 95-2 USTC P 50,351 (11th Cir 1995)*.

(n98)Footnote 143. Former *Treas Reg* § 1.121-2(b)(2), Ex 1, *before amendment by TD 9030* .

(n99)Footnote 144. *In re Mehr*, 93-1 USTC 50,091, 153 BR 430 (Bankr DNJ 1993); *In re Barden*, 97-1 USTC P 50,243, *affd* 97-1 USTC P 50,244 (2d Cir 1997); but see *In re Luciano Popa*, 98-1 USTC P 50,276 (US Bkcy Ct ND Ill 1998) (holding that bankruptcy trustee may use the post-1997 IRC Section 121 exclusion in selling the debtor's principal residence, and indicating that the *Barden* and *Mehr* cases were wrongly decided); see § 9.02[5][h] for a discussion.

(n100)Footnote 145. *GCM* 39722 (Apr 1, 1988) .

(n101)Footnote 146. *Rev Rul* 87-104, 1987-2 CB 45 .

(n102)Footnote 147. *IRC* § 121(d)(7), *before amendment by Pub L* No 105-34; *Ltr Rul* 8442011 .

(n103)Footnote 148. *Ltr Rul* 8615025 .

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Federal Taxes Affecting Real Estate

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.04

§ 9.04 Relief Provisions for Interest

[1] Qualified Residence Interest

[a] In General

Although in general there are significant limitations on the deductibility of many types of interest expense, qualified-residence interest is deductible. It is defined as any interest paid or accrued n149 during the taxable year on "acquisition indebtedness" or "home equity indebtedness" for any qualified residence of the taxpayer. n150

Acquisition indebtedness includes any indebtedness incurred in the acquisition, construction, or substantial improvement of any qualified residence of the taxpayer, and secured by such residence. The term also includes any debt, secured by such residence, resulting from the refinancing of such debt. n151 Refinancing debt, however, only qualifies to the extent it does not exceed the amount of acquisition indebtedness refinanced. The aggregate amount treated as acquisition indebtedness for any period may not be greater than \$1 million (\$500,000 for a married individual filing separately). n152 Taxpayers may compute the average balance of outstanding home acquisition loans in order to determine whether their loans exceed the \$1 million limit. For a residence owned only part of the year, to calculate the average daily balance, taxpayers must add the daily balance for each day a loan is outstanding and divide the sum by the number of days the residence is a qualified residence during the year (not in excess of the number of days the taxpayers own the residence). n152.1

Under a lenient interpretation of the definition of "acquisition indebtedness" relating to the \$1 million acquisition indebtedness limitation, the IRS Chief Counsel has ruled that the \$1 million limitation set forth in the statute n152.2 is a component element of the definition of acquisition indebtedness, and not a separate limit to deductibility. Therefore, indebtedness that otherwise qualifies as acquisition indebtedness fails to qualify to the extent it exceeds \$1 million. Therefore, a taxpayer who borrows in excess of \$1 million to acquire, construct, or substantially improve a qualified residence may be able to treat up to \$100,000 of the excess above \$1 million as home equity indebtedness, because that amount by definition does not constitute acquisition indebtedness. n152.3 The conclusion of the Chief Counsel Memorandum criticizes and disagrees with the result in two cases addressing the same issue. n152.4 The other possible interpretation of the definition of "acquisition indebtedness"--the one accepted by the court decisions--is that acquisition indebtedness means all indebtedness, *regardless of amount*, incurred to acquire, construct, or substantially improve a qualified residence. n152.5 Under that interpretation, the \$1 million limitation n152.6 is not an element of the definition of acquisition indebtedness, but is a separate limitation on deductibility. If that interpretation were correct, then a

taxpayer who borrowed in excess of \$1 million to acquire, construct, or substantially improve a qualified residence could not treat the excess above \$1 million as home equity indebtedness, because that amount, even though in excess of \$1 million, would still be considered acquisition indebtedness. n152.7 The Chief Counsel ruling also holds that the \$1million limitation n152.8 is part of the definition of "acquisition indebtedness" for AMT purposes. n152.9

Example:

T buys a principal residence for \$1,500,000, paying \$200,000 in cash and borrowing the remaining \$1,300,000 through a loan that is secured by the residence. Up to \$100,000 of T's indebtedness in excess of \$1 million can qualify as home equity indebtedness. n152.10 Therefore, interest on up to \$1.1 million of the debt is deductible (\$1 million of acquisition indebtedness and \$100,000 of home equity indebtedness). n152.11

Generally, an "acquisition indebtedness" must be an obligation of the taxpayer and not of another. n153 Regulations, however, do allow a deduction for interest on a mortgage on which the taxpayer is not personally liable, where the mortgage is nonrecourse or where the taxpayer purchases property subject to a mortgage. n154

In addition, cases sometimes address the issue of whether taxpayers may deduct mortgage interest payments made by them on residences in which legal title is held by a sibling or other family member, or a third party. For mortgage interest to be deductible by a particular taxpayer, the mortgage must ordinarily be the obligation of the taxpayer claiming the deduction, not the obligation of another. n154.1 However, even though property may not be in a taxpayer's name, a deduction may be allowed if the taxpayer is the legal or equitable owner of the property, and is at least indirectly liable on the mortgage. n154.2 Voluntary mortgage payments made by a family member or other third party who has no obligation on the mortgage and who does not have a legal or equitable interest in the residence cannot support a mortgage interest deduction, even if the person making the payment lives in the home. n154.3 Usually, the family member has acted in an accommodation capacity in order to acquire a loan for which the taxpayer could not qualify. Almost always, courts deny the deduction. n155 The Tax Court has also disallowed an interest deduction for amounts a taxpayer paid under a real property lease-option agreement. The court found that the agreement under which payments were made was an option, and not a purchase or sale of the underlying property. Although the taxpayer paid real property taxes and the amount of his lease payments was tied to the owner's mortgage payments, he did not have an equity ownership interest in the property that would support an interest deduction. n155.1

In one case, however, the Tax Court allowed the deduction even though the taxpayers did not have legal title to the house and were not personally liable on the mortgage. The taxpayers deducted mortgage interest payments on a mortgage that the husband's brother had signed for them. The court found that, in effect, the mortgage payments made by the taxpayers to the lending institution were payments of principal and interest to the husband's brother. As such, the payments constituted payments on an indebtedness of the taxpayers. The court found that the taxpayers' agreement with the husband's brother to pay the mortgage, coupled with their continued occupancy of the property and their performance of all obligations under the mortgage, were sufficient to render the taxpayers' obligation to pay off the mortgage an enforceable debt to the husband's brother for the amount of the mortgage at the interest rate specified in the mortgage. The Tax Court found that the taxpayers held equitable and beneficial ownership of the property because they had made every required mortgage payment, had paid all property maintenance expenses, and had been the sole occupants of the property since the date of purchase. In addition, the court noted that real property taxes and insurance on the property were paid from an escrow account funded with a portion of the taxpayers' mortgage payments. n156 The *Uslu* case was followed in another case in which a relative of the taxpayers obtained a mortgage for them because their prior bankruptcy prevented them from obtaining a loan in their own names. The taxpayers made the down payment on the property, paid all mortgage payments and property taxes, and also paid for improvements on the property. The court, citing *Uslu*, stated that the taxpayers had the burdens and benefits of ownership and thus allowed them to deduct mortgage interest and property taxes paid on the property. n156.1

Taxpayers may deduct more than their proportionate share of mortgage interest arising from property in which they

have an interest as a tenant in common where they pay the mortgage in order to avoid personal liability or to preserve their interest in the property. This could occur if a co-tenant makes mortgage payments in order to avoid foreclosure of property. n156.2 Taxpayers may not deduct more than their share of mortgage interest, however, where they are entitled to reimbursement for payments in excess of their proportionate share under State law, and they in fact receive contribution from co-tenants. Thus, taxpayers may deduct mortgage interest payments beyond their proportionate share only to the extent they actually make the payments and do not receive reimbursement from fellow co-tenants. n156.3

Home equity indebtedness means any indebtedness secured by a qualified residence that does not exceed the fair market value of the residence, less the amount of acquisition indebtedness on the property; provided that the aggregate amount treated as home equity indebtedness for any period may not exceed \$100,000 (\$50,000 for married individuals filing separately). n157 Interest on qualifying home equity indebtedness is deductible even if the proceeds are used for personal expenditures.

NOTE:

As noted above, the IRS now takes the lenient position that a taxpayer who borrows in excess of \$1 million to acquire, construct, or substantially improve a qualified residence may be able to treat up to \$100,000 of the excess above \$1 million as home equity indebtedness, because any borrowed amount in excess of \$1 million does not constitute acquisition indebtedness. n157.1

A qualified residence includes the principal residence of the taxpayer and one other residence (i.e., a vacation home). A principal residence is one that qualifies for gain exclusion under *IRC Section 121*. n158 The second residence must be one designated by the taxpayer and used for personal purposes for a number of days exceeding the greater of 14 days or 10 percent of the number of days during the year for which the home is rented at fair market value. n159 Qualifying use of a second residence may include use by a family member of the taxpayer, even if the taxpayer does not reside in the residence. n160 If the second home is neither rented nor used as a residence at any time during the tax year, a special rule provides that the residence still may be treated as a taxpayer's second residence for the tax year, regardless of the lack of personal use. n161 The taxpayer is able to switch his second residence designation from year to year among otherwise qualifying residences. Note also that a principal or a second residence can include a boat or mobile home provided that basic sanitation and eating and sleeping facilities are present. n162

The Service has ruled that when a taxpayer's principal residence is destroyed by a natural disaster and the underlying land is later sold or the dwelling reconstructed within a reasonable period of time, the property continues to qualify as a "qualified residence" during the period between the destruction of the dwelling and its sale or re-occupancy. Therefore, interest paid on the mortgage debt on the property during that period is deductible. n163

Interest paid on indebtedness incurred to acquire an interest in a residence incident to a divorce may also be deductible as qualified residence interest, without regard to the treatment of the transaction under *IRC Section 1041*. n164

Example:

As part of a property settlement agreement in a divorce, H receives W's interest in a family home and various other assets. In exchange, H must pay W \$100,000 over 10 years, with interest at 10 percent. H executes a promissory note to W containing the payment provisions. To secure the note, H also conveys to W a mortgage deed on the home. Subject to the home equity indebtedness statutory limit, n165 H may deduct interest paid to W as qualified personal residence interest to the extent the indebtedness is allocable to the home. n166

[b] Mortgage Insurance Premiums as Qualified Residence Interest

A temporary provision allows certain mortgage insurance premiums to be treated as qualified residence interest. n166.1

The provision applies only with respect to mortgage insurance contracts issued after 2006 and before 2015.

Subject to the above effective date limits, premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest. The premiums are therefore deductible. n166.2 The amount allowable as a deduction is phased out ratably by 10 percent for each \$1,000 by which the taxpayer's adjusted gross income exceeds \$100,000 (\$500 and \$50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds \$110,000 (\$55,000 in the case of married individual filing a separate return). n166.3

For purposes of the provision, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on December 20, 2006). n166.4 Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. n166.4.1

The manner of allocating prepaid mortgage insurance premiums is set forth in temporary regulations. n166.4.2 With respect to mortgage insurance provided by the Federal Housing Administration or private mortgage insurance (but not mortgage insurance provided by the Department of Veterans Affairs or the Rural Housing Service), n166.4.3 an individual taxpayer may allocate prepaid premiums over the shorter of (1) the stated term of the mortgage, or (2) a period of 84 months. n166.4.4 This allocation requirement applies whether the qualified mortgage insurance premiums are paid in cash or are financed, without regard to source. n166.4.5

No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Administration). n166.5

Mortgage servicers must report the amount of all mortgage insurance premiums, including prepaid mortgage insurance premiums, received in the calendar year from any individual if that amount is \$600 or more for any calendar year. n166.6 The reporting requirement applies, whether premiums are paid, by cash or financing, without regard to source. The reporting requirement applies, however, only to premiums for mortgage insurance provided by the Federal Housing Administration, Department of Veterans Affairs, or the Rural Housing Service (or their successor organizations), or to private mortgage insurance. n166.7 Whether a person receives \$600 or more of mortgage insurance premiums is determined on a mortgage-by-mortgage basis. A recipient need not aggregate mortgage insurance premiums received on all of the mortgages of an individual to determine whether the \$600 threshold is met. Therefore, a recipient need not report mortgage insurance premiums of less than \$600 received on a mortgage, even though it receives a total of \$600 or more of mortgage insurance premiums on all of the mortgages for an individual for a calendar year. n166.8

[2] Points

Generally speaking, points paid on a loan are deducted ratably over the term of the loan because they constitute prepaid interest. n167 However, a major exception exists in the case of points paid on a home mortgage loan for the purchase or improvement of, or secured by, a principal residence. Such points are deductible in the year paid to the extent that, under Treasury Regulations, the payment of points is an established practice in the geographic area involved and the amount of the payment does not exceed that generally charged in the area for a home loan. n168 This rule is narrower than the rule allowing a deduction for qualified residence interest--it applies only to points paid with respect to debt secured by the taxpayer's principal residence, not to points paid with respect to debt secured by a second residence.

If the five criteria listed below are met, the Service will treat as deductible in the year paid points paid by a cash-basis taxpayer with respect to a home mortgage:

- (1) They are designated as points (for example, as "loan origination fees", "loan discounts", "discount points" or "points") on the "RESPA" closing statement.
- (2) They are calculated as a percentage of the principal amount.
- (3) They are paid to acquire the taxpayer's principal residence, and the loan is secured by that residence. n169
- (4) They are paid directly by the taxpayer and are not derived from loan proceeds.
- (5) They conform to an established business practice of charging points for loans for the acquisition of personal residences in the area in which the residence is located, and the amount of points does not exceed the amount generally charged in that area. n170

Many individuals pay points in connection with the refinancing of their personal residence. These points must generally be amortized over the life of the refinanced mortgage. n171 However, in certain circumstances, a current deduction is allowed for points paid in connection with refinancing the mortgage on a principal residence. n172 In *Huntsman v Commissioner*, the taxpayer's original mortgage was a three-year loan with a balloon payment. The year after the taxpayers took out their original loan they obtained a home-improvement loan secured by a second mortgage. In the following year the taxpayers obtained permanent financing and used the proceeds from that loan to pay off the two earlier loans. The court found the points on the permanent financing to be fully deductible because of the time period involved. The permanent mortgage was deemed obtained in connection with the purchase of the home within the meaning of *IRC Section 461(g)(2)*. n173 The IRS will not follow *Huntsman* outside the Eighth Circuit. n174

Revenue Procedure 87-15 n175 allows the taxpayer, as a matter of administrative convenience, to allocate the deduction for points that are not currently deductible ratably (i.e., on a straight-line basis) over the indebtedness period. *Revenue Procedure 94-27* further clarifies the current deductibility of points paid in connection with the acquisition of a principal residence. n176

[3] AMT Provisions Relating to Deduction of Home Mortgage Interest

[a] In General

The regular tax provisions that apply with respect to the deduction of home mortgage interest generally apply for AMT purposes as well, subject to several differences. n176.1 For regular tax purposes, a deduction is allowed for "qualified residence interest." n176.2 For AMT purposes, the deduction allowed is for "qualified housing interest." n176.3 There is a relatively minor difference in the type of home that can support a mortgage interest deduction for AMT purposes. As for regular tax purposes, a taxpayer's principal residence will support an interest deduction. n176.4

For a second residence to qualify for an AMT qualified housing deduction, however, it must be a qualified residence, as for regular tax purposes, but it also must be a "qualified dwelling." n176.5 A "qualified dwelling" is a house, apartment, condominium or mobile home not used on a transient basis, including appurtenant structures and property. n176.6 A cooperative apartment that qualifies for a regular tax deduction would also qualify for an AMT interest deduction. n176.7

As a practical matter, a home that meets the regular tax requirements for deductibility of interest almost always meets the AMT requirements. The primary exceptions are mobile homes used on a transient basis, boats, and house trailers. These can qualify as a second residence for regular tax purposes if they have sleeping, cooking and toilet facilities. They cannot, however, qualify as a second residence for AMT purposes. n176.8

[b] Rules for Loans to Acquire, Construct, or Improve Property

For AMT purposes, interest on a housing loan is deductible only if the proceeds are used to acquire, construct, or substantially improve the residence that secures the loan. n176.9 This is the same rule as for regular tax purposes. n176.10 Therefore, except for mobile homes used on a transient basis, boats, and house trailers, n176.11 acquisition indebtedness that qualifies for a regular tax interest deduction will also generate an interest deduction for AMT purposes. n176.12

For home equity indebtedness, however, a restriction applies for AMT that does not come into play for regular tax purposes. For AMT purposes, interest on a home equity loan is not deductible unless the loan proceeds are used to acquire, construct, or substantially improve a principal residence or a dwelling that is a qualified residence of the taxpayer. The residence for which the expenditure is made need not be the residence that secures the loan, but it must be a principal residence or a dwelling unit that is qualified residence. Thus, if the proceeds of a home equity loan (up to \$100,000) n176.12.1 on a taxpayer's principal residence are used to make a down payment for a qualifying second home, the interest would be deductible for both AMT and regular purposes. n176.13 For regular tax purposes, in contrast, a home equity loan may be used for other purposes (such as purchasing a car), and an interest deduction may still be taken on up to \$100,000 of debt. n176.14 For this reason, home equity loans frequently increase AMT income.

[c] Refinancing Rules

The AMT rules on refinancing of mortgage debt are generally the same as for regular tax purposes--generally, the refinanced amount cannot exceed the debt outstanding immediately before the refinancing. The debt being refinanced must also be indebtedness that otherwise qualifies for the AMT interest deduction. n176.15

The same rule applies with respect to home mortgages that have been refinanced more than once. Interest paid on a home mortgage that has been refinanced more than one time is deductible as qualified housing interest for purposes of the AMT only to the extent that the interest on the mortgage that was refinanced is qualified housing interest and the amount of the mortgage indebtedness is not increased. A home equity loan is not deductible for AMT purposes unless it is used to acquire, construct, or substantially improve a principal residence or a qualified residence. n176.16

Example:

In Year 1, A borrows \$100,000 to purchase a principal residence (the Year 1 mortgage). In Year 10, the outstanding principal balance on the Year 1 mortgage is \$90,000, and A refinances the \$90,000 balance of the Year 1 mortgage (the Year 10 mortgage). In Year 15, the outstanding principal balance on the Year 10 mortgage is \$80,000. A refinances the \$80,000 balance of the Year 10 mortgage and borrows an additional \$30,000. Thus, the total amount of A's mortgage in Year 15 is \$110,000 (the Year 15 mortgage). A does not use the \$30,000 to acquire, construct, or substantially improve any property that is a principal residence or a qualified residence. At no time does A's indebtedness to acquire a principal residence or a qualified residence exceed \$1,000,000. A is not a married individual filing a separate return.

When A refinances the Year 1 mortgage in Year 10, the refinanced amount equals the amount of the outstanding principal. Thus, the interest paid or accrued on the Year 10 mortgage is deductible as qualified housing interest for purposes of the AMT because the interest on the Year 1 mortgage is qualified housing interest and the amount of the loan is not increased.

Similarly, when A refinances the Year 10 mortgage in Year 15, the interest on the Year 15 mortgage

is qualified housing interest to the extent of the outstanding principal balance of the Year 10 mortgage at the time of the refinancing. This is because the interest on the Year 10 mortgage is qualified housing interest. However, as part of the Year 15 refinancing, A borrows an additional \$30,000, which is not used to acquire, construct, or substantially improve any property that is a principal residence or a qualified residence. Accordingly, for AMT purposes, A may deduct only the interest paid or incurred on \$80,000 and not the interest attributable to the additional \$30,000 of the \$110,000 of the Year 15 mortgage.

n176.17

[d] Grandfather Provisions for Pre-July 1, 1982 Debt

For AMT purposes, more generous provisions apply for debt incurred before July 1, 1982. Interest on this debt is deductible for two residences--the taxpayer's principal residence, and a qualified dwelling used by the taxpayer or any member of the taxpayer's family. Unlike later-incurred debt, there is no requirement that the debt be incurred to acquire, construct, or substantially improve the residence in order to be deductible. n176.18

FOOTNOTES:

(n1)Footnote 149. See *Nelson v Commr, TC Memo 1993-419* (taxpayers who assumed their transferor's prior purchase contract on property and were thereby obligated to pay mortgage interest were entitled to deductions for those payments despite having only beneficial interest in the property).

(n2)Footnote 150. *IRC § 163(h)(3)(A)(i), (ii)*.

(n3)Footnote 151. *IRC § 163(h)(3)(B)(i)*.

(n4)Footnote 152. *IRC § 163(h)(3)(B)(ii)*. See also *IRS Notice 88-74* for guidance as to the meaning of acquisition indebtedness under various circumstances.

(n5)Footnote 152.1. See *FSA 200137033*.

(n6)Footnote 152.2. See *IRC § 163(h)(3)(B)(ii)*.

(n7)Footnote 152.3. *CCA 200940030*.

(n8)Footnote 152.4. *CCA 200940030*; criticizing *Pau v Commr, TC Memo 1997-43*, and *Catalano v Commr, TC Memo 2000-82*, *rev'd on other grounds 279 F3d 682 (9th Cir 2002)*.

(n9)Footnote 152.5. See *IRC § 163(h)(3)(B)(i)*.

(n10)Footnote 152.6. *IRC § 163(h)(3)(B)(ii)*.

(n11)Footnote 152.7. See *IRC §§ 163(h)(3)(B), (C)*; see *Pau v Commr, TC Memo 1997-43*, and *Catalano v Commr, TC Memo 2000-82*, *rev'd on other grounds 279 F.3d 682 (9th Cir 2002)*.

(n12)Footnote 152.8. See *IRC § 163(h)(3)(B)(ii)*.

(n13)Footnote 152.9. *CCA 200940030*; see *IRC § 56(e)*.

(n14)Footnote 152.10. See *IRC § 163(h)(3)(C)*.

(n15)Footnote 152.11. *IRC §§ 163(h)(3)(B), (C)*; *CCA 200940030*.

(n16)Footnote 153. *Golder v Commr, 604 F2d 34 (9th Cir 1979)*; *Smith v Commr, 84 TC 889 (1985)*, *aff'd without pub opin 805 F2d 1073 (DC Cir 1986)*; *Hynes v Commr, 74 TC 1266 (1980)*; *Blanche v Commr, TC Memo 2001-63*

(interest deduction denied because taxpayers were not legal or equitable owners of property).

(n17)Footnote 154. *Treas Reg § 1.163-1(b)*.

(n18)Footnote 154.1. *Golder v Commr*, 604 F2nd 34 (9th Cir 1979) , *affg TC Memo 1976-150* ; *Jones v Commr*, *TC Memo 2006-176* .

(n19)Footnote 154.2. *Treas Reg § 1.163-1(b)*; *Jones v Commr*, *TC Memo 2006-176* .

(n20)Footnote 154.3. *Daya et al v Commr*, *TC Memo 2000-360* .

(n21)Footnote 155. *Loria v Commr*, *TC Memo 1995-420* ; *Song v Commr*, 1995-446.

(n22)Footnote 155.1. *Jones v Commr*, *TC Memo 2006-176* .

(n23)Footnote 156. *Uslu v Commr*, *TC Memo 1997-551* .

(n24)Footnote 156.1. *Trans v Commr*, *TC Memo 1999-233* .

(n25)Footnote 156.2. See *Daya et al v Commr*, *TC Memo 2000-360* ; *Powell v Commr*, *TC Memo 1967-32* ; *Conroy v Commr*, *TC Memo 1958-6* .

(n26)Footnote 156.3. See *Daya et al v Commr*, *TC Memo 2000-360* ; *James v Commr*, *TC Memo 1995-562* ; *Powell v Commr*, *TC Memo 1967-32* ; *Conroy v Commr*, *TC Memo 1958-6* .

(n27)Footnote 157. *IRC § 163(h)(3)(C)*.

(n28)Footnote 157.1. CCA 200940030 ; *criticizing Pau v Commr*, *TC Memo 1997-43* , and *Catalano v Commr*, *TC Memo 2000-82* , *revd on other grounds 279 F3d 682 (9th Cir 2002)* .

(n29)Footnote 158. *IRC § 163(h)(4)(A)(i)(I)*.

(n30)Footnote 159. *IRC §§ 163(h)(4)(A)(i)(II), 280A(d)(1)*.

(n31)Footnote 160. *IRC § 280A(d)(2)(A)*; *Estate of Dickerson et al v Commr*, *TC Memo 1997-165* .

(n32)Footnote 161. *IRC § 163(h)(4)(A)(iii)*.

(n33)Footnote 162. *Temp Treas Reg § 1.163-10T(p)(3)(ii)*; but see *Garrison v Commr*, *TC Memo 1994-200* , *affd in unpub opin 95-2 USTC P 50,555* (a qualified residence does not include an unimproved lot on which the taxpayer camped every year).

(n34)Footnote 163. *Rev Rul 96-32, 1996-1 CB 177* .

(n35)Footnote 164. *Seymour v Commr*, 109 TC 279 (1997) ; *Notice 88-74, 1988-2 CB 385* .

(n36)Footnote 165. See *IRC § 163(h)(3)(C)(ii)*.

(n37)Footnote 166. *Seymour v Commr*, 109 TC 279 (1997) .

(n38)Footnote 166.1. *IRC § 163(h)(3)(E)(i)*.

(n39)Footnote 166.2. *IRC § 163(h)(3)(i)*.

(n40)Footnote 166.3. *IRC § 163(h)(3)(ii)*.

(n41)Footnote 166.4. *IRC § 163(h)(4)(E)*.

(n42)Footnote 166.4.1. *IRC § 163(h)(4)(F)*.

(n43)Footnote 166.4.2. The temporary regulations apply to prepaid qualified mortgage insurance premiums paid or accrued on or after Jan 1, 2008, and on or before Dec 31, 2010, for mortgage insurance provided by the Federal Housing Administration or private mortgage insurers issued on or after Jan 1, 2007 [*Temp Treas Reg § 1.163-11T(d)*].

(n44)Footnote 166.4.3. *Temp Treas Reg § 1.163-11T(b)*.

(n45)Footnote 166.4.4. *Temp Treas Reg § 1.163-11T(a)(1)*. Instructions for calculating the portion of prepaid qualified mortgage insurance premiums that are deductible in a particular taxable year are in IRS Publication 936, *Home Mortgage Interest Deduction*.

(n46)Footnote 166.4.5. *Temp Treas Reg § 1.163-11T(b)*.

(n47)Footnote 166.5. *IRC § 163(h)(4)(F)*. *Temp Treas Reg § 1.163-11T(a)(2)*.

(n48)Footnote 166.6. *Temp Treas Reg § 1.6050H-3T(a)*. See Form 1098, *Mortgage Interest Statement*). See *IRC § 6050H(h)* (authority to prescribe reporting requirements). The reporting requirement applies to premiums received on or after Jan 1, 2008 [*Temp Treas Reg § 1.6050H-3T(e)*].

(n49)Footnote 166.7. *Temp Treas Reg § 1.6050H-3T(b)*.

(n50)Footnote 166.8. *Temp Treas Reg § 1.6050H-3T(c)*.

(n51)Footnote 167. *IRC § 461(g)*.

(n52)Footnote 168. *IRC § 461(g)(2)*.

(n53)Footnote 169. *Russell v Commr, TC Memo 1994-96, affd in unpub opin 96-1 USTC P 50,096* (deduction for points paid to acquire a principal residence allowed, even though taxpayer rented out several rooms in the house to others).

(n54)Footnote 170. *Rev Proc 94-27, 1994-1 CB 613*.

(n55)Footnote 171. *Rev Rul 87-22, 1987-1 CB 146* (points paid with respect to a refinancing that are allocable to the portion of the new loan proceeds used to improve the principal residence are currently deductible).

(n56)Footnote 172. *Huntsman v Commr, 905 F2d 1182 (8th Cir 1990), revg 91 TC 917 (1988)*.

(n57)Footnote 173. But see *Cao v Commr, TC Memo 1994-60* (deduction for points paid in refinancing of home mortgage denied where taxpayers failed to show points were related to compensation for use of lender's money rather than to services performed by the lender).

(n58)Footnote 174. *AOD/CC 1991-02 (1991)*.

(n59)Footnote 175. *1987-1 CB 624*.

(n60)Footnote 176. *1994-1 CB 613*.

(n61)Footnote 176.1. *IRC §§ 56(b)(1)(C), (e), 163(h)(2)(D)*.

(n62)Footnote 176.2. *IRC § 163(h)(2)(D)*.

(n63)Footnote 176.3. *IRC § 56(b)(1)(C), (e).*

(n64)Footnote 176.4. *IRC §§ 56(e)(1)(A), 163(h)(4)(A)(i)(I).*

(n65)Footnote 176.5. *IRC §§ 56(e)(1)(B), 163(h)(4);* for indebtedness incurred before July 1, 1982, the second residence must be a qualified dwelling used by the taxpayer or a member of the taxpayer's family (*IRC § 56(e)(3)*).

(n66)Footnote 176.6. *IRC § 56(e)(2); see IRC § 7701(a)(19)(C)(v).*

(n67)Footnote 176.7. *IRC §§ 56(e), 163(h)(4)(B).*

(n68)Footnote 176.8. *IRC § 56(e)(1)(B)(2); see Temp Treas Reg § 1.163-10T(p)(3)(ii).*

(n69)Footnote 176.9. *IRC § 56(e)(1).*

(n70)Footnote 176.10. *IRC § 163(h)(3)(B)(i).*

(n71)Footnote 176.11. *IRC § 56(e)(1)(B), (2); see Temp Treas Reg § 1.163-10T(p)(3)(ii);* see [a], above, for a discussion.

(n72)Footnote 176.12. *IRC §§ 56(b)(1)(C)(i), (e)(1), 163(h)(3),* effective for indebtedness incurred after Oct 13, 1987.

(n73)Footnote 176.12.1. *See IRC § 163(h)(3)(C)(ii).*

(n74)Footnote 176.13. *IRC §§ 56(b)(1)(C)(i), (e)(1), 163(h)(3)(C)(i).*

(n75)Footnote 176.14. *IRC § 163(h)(3)(C),* effective for indebtedness incurred on or after Oct 13, 1987.

(n76)Footnote 176.15. *IRC §§ 56(e)(1) (flush language), 163(h)(3)(B)(i) (flush language).*

(n77)Footnote 176.16. *IRC §§ 56(e)(1) (flush language), 163(h)(3)(B)(i) (flush language); Rev Rul 2005-11, 2005-1 CB 816 .*

(n78)Footnote 176.17. *Rev Rul 2005-11, 2005-1 CB 816 ; IRC §§ 56(e)(1) (flush language), 163(h)(3)(B)(i) (flush language).*

(n79)Footnote 176.18. *IRC § 56(e)(3).*

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Federal Taxes Affecting Real Estate

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.05

§ 9.05 Tax-Free Distributions From Retirement Plans for First-Time Homebuyers

[1] In General

Qualified taxpayers may receive distributions from their individual retirement accounts without penalty if the proceeds are used to purchase a "first home." n177 As is explained below, this provision is not actually limited to a taxpayer's "first" home. The 10-percent additional tax on early distributions from qualified plans does not apply to a distribution to an individual from an individual retirement plan if the distribution is a qualified first-time homebuyer distribution. n178 Note that only the 10 percent additional tax is waived; the distribution from the IRA (other than from a Roth IRA) is subject to the regular income tax rules applicable to distributions from an IRA. A "qualified first-time homebuyer distribution" is any payment or distribution to the extent it is used by the individual within 120 days of receipt to pay qualified acquisition costs with respect to a principal residence n179 of a first-time homebuyer. The first-time homebuyer may be the individual from whose plan the distribution is received, that individual's spouse, or any child, grandchild or ancestor of that individual or that individual's spouse. n180 If the purchase or construction of the residence is delayed or cancelled, the distribution may be rolled over to an IRA within 120 days after the date the distribution is received. n181

The lifetime dollar limitation for payments received by an individual that can be treated as qualified first-time homebuyer distributions is \$10,000. n182 If a residence is owned by several related or unrelated co-owners, each co-owner who is eligible under these rules should be able to receive a \$10,000 qualified first-time home buyer distribution to apply to his or her share of the qualified acquisition costs of the "first home." There are no income level restrictions on the ability of taxpayers to take advantage of this provision.

"Qualified acquisition costs" include costs of acquiring, constructing, or reconstructing a residence, including usual or reasonable settlement, financing, or other closing costs. n183

[2] First-Time Homebuyer Defined

A "first-time homebuyer" is any individual if: n184

- (1) that individual (and the individual's spouse) n185 has had no present ownership interest in a principal residence during the two-year period ending on the date the principal residence in question is acquired; and

(2) any rollover period under former IRC Section 1034, as in effect before its repeal, has not been suspended with respect to the individual on the day before the date the distribution is applied to the acquisition of that residence by virtue of service in the armed forces or residency outside the United States. n186

FOOTNOTES:

(n1)Footnote 177. *IRC § 72(t)(2)(F), (t)(8)*, effective for payments and distributions in tax years beginning after December 31, 1997.

(n2)Footnote 178. *IRC § 72(t)(2)(F)*.

(n3)Footnote 179. See *IRC § 121* for definition of principal residence.

(n4)Footnote 180. *IRC § 72(t)(8)(A)*.

(n5)Footnote 181. *IRC § 72(t)(8)(E)*; see *IRC § 408(d)(3)(A)(i)*.

(n6)Footnote 182. *IRC § 72(t)(8)(B)*.

(n7)Footnote 183. *IRC § 72(t)(8)(C)*.

(n8)Footnote 184. *IRC § 72(t)(8)(D)(i)*.

(n9)Footnote 185. The legislative history of this provision states that the taxpayer's spouse must meet this requirement as of the date of the contract to purchase the residence or the date construction or reconstruction of the residence begins.

(n10)Footnote 186. *IRC § 280A*. See *IRC § 1034(h), (k)*, *before repeal by Pub L No 105-34*.

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.06

§ 9.06 First-Time Homebuyer Credit

A first-time homebuyer is allowed a refundable tax credit equal to the lesser of a specified dollar limit or 10 percent of the purchase price of a principal residence located in the United States. The credit is available only for a principal residence purchased on or after April 9, 2008 and before December 1, 2009. n186.1 For qualifying residences purchased before January 1, 2009, the dollar limit for the credit is \$7,500 (\$3,750 for a married individual filing separately). For qualifying residences purchased after December 31, 2008, the dollar limit is \$8,000 (\$4,000 for a married individual filing separately). n186.2 The credit is discussed in detail in Chapter 5, at § 5.09.

FOOTNOTES:

(n1)Footnote 186.1. *IRC § 36(h)*.

(n2)Footnote 186.2. *IRC § 36(a), (b)*.

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.07

§ 9.07 Exclusion for Payments Under Home Affordable Modification Program

In response to the contraction in the economy in 2008 and 2009, President Obama announced in February 2009 the Homeowner Affordability and Stability Plan (the Plan), which helps at-risk homeowners modify their mortgages to avoid foreclosure. Part of the Plan is the Home Affordable Modification Program (HAMP). n186.2.1 HAMP, a component of the Plan, is intended to assist homeowners who have defaulted, or are at risk of default, on their mortgages. Under HAMP, homeowners that make timely payments on their modified loans are eligible to have incentive payments made on their behalf to lenders/investors. Each month that a homeowner makes a mortgage payment on time, the homeowner accrues an amount toward a Pay-for-Performance Success Payment. A payment of the accrued amounts is made annually, to reduce the principal balance on the homeowner's mortgage loan. Homeowners can receive principal reductions of up to \$1,000 per year for up to five years, subject to a *de minimis* threshold. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation have a substantial role in administering HAMP. The IRS has ruled that any payments received by a homeowner under the HAMP program are excludable from gross income under the general welfare exclusion. n186.3

FOOTNOTES:

(n1)Footnote 186.2.1. Information about the program for borrowers may be found at:
<http://www.makinghomeaffordable.gov>.

(n2)Footnote 186.3. *Rev Rul 2009-19, 2009-28 IRB 111* .

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1-9 Federal Taxes Affecting Real Estate §§ 9.08-9.19

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.20

§ 9.20 Disallowance of Personal, Living, and Family Expenses

Unless expressly provided otherwise in the Internal Revenue Code, no deduction is allowed for personal, living, or family expenses. n187 Therefore, the typical costs of maintaining a household that is owned and occupied by the taxpayer as a personal residence are not deductible. This would include costs of insurance, rent, water, utilities, and repairs and maintenance. n188 The cost of a first telephone line to any residence of a taxpayer is also non-deductible. n189

Otherwise personal expenses connected with a personal residence that may be deducted include real property taxes, n190 allowable mortgage interest or interest on a home equity indebtedness, n191 and casualty losses. n192

FOOTNOTES:

(n1)Footnote 187. *IRC § 262(a)*.

(n2)Footnote 188. *Treas Reg § 1.262-1(b)(2), (3)*.

(n3)Footnote 189. *IRC § 262(b)*.

(n4)Footnote 190. *IRC § 164(a)*.

(n5)Footnote 191. *IRC § 163(h)(3)*.

(n6)Footnote 192. *IRC § 165(c)(3)*.

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.21

§ 9.21 Deductions Under IRC Section 280A

[1] Home Office Deductions Restricted

IRC Section 280A was adopted in part to prevent taxpayers from deducting expenses connected with their home even if they used the home in part for business or income-producing purposes. Under its general rule, a taxpayer cannot claim otherwise allowable business deductions with respect to the use of a dwelling unit that is used by the taxpayer during the taxable year as a residence. n193

IRC Section 280A provides several exceptions, under which otherwise deductible business expenses connected with a trade or business in a home may be taken. An expense is deductible if it is allocable to a portion of the dwelling unit n194 that is exclusively used on a regular basis n195 as one of the following: n196

- the principal place for any trade or business of the taxpayer; n197
- a place of business used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of the taxpayer's trade or business; n198 or
- in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business. n199

In the case of an employee, the use must be for the convenience of his or her employer in order for deductions to be allowed. n200

Separate exceptions from the general disallowance rule under *IRC Section 280A(a)* apply to allow deductions for the following:

- certain storage use; n201
- use in providing day care services; n202 and
- certain rental use. n203

A separate gross income limitation may restrict to deductions under *IRC Section 280A*. Any deductions allowed cannot exceed the excess of the gross income derived from the trade or business use for the taxable year, over the sum of certain deductions allocable to that income (such as interest and taxes). n204

NOTE:

In approaching any potential business/rental deduction originating in the taxpayer's home, or any rental of property owned by the taxpayer, the preliminary inquiry must be to determine whether *IRC Section 280A* even applies. This involves checking whether the taxpayer falls within the definitional provisions of the statute. The first step is determining whether a "dwelling unit" is involved, n205 and whether the taxpayer uses it during the taxable year as a "residence." n206 "Dwelling unit" and the type and amount of use that constitutes personal use as a residence are specifically defined by statute. n207 If *IRC Section 280A* does not apply, the practitioner must still determine whether there is a profit motive and whether *IRC Section 183* may deny any otherwise allowable deduction.

If the taxpayer falls within the parameters of *IRC Section 280A*, the practitioner must determine whether the taxpayer meets one of the exceptions for business use, n208 storage use, n209 rental use, n210 or day care use n211 of the property. n212 If the taxpayer does not meet one of these exceptions, then deductions other than those that can be itemized without regard to business use of the property (i.e. qualified mortgage interest, real property taxes, and casualty losses) will be denied. n213

If the taxpayer does meet one of the exceptions, deductions must be properly allocated between business and personal use. n214 Rental expenses must be properly attributed to rental periods, as well. n215 Then, it must be determined whether deductions are limited by the gross income limitation. n216 All of the steps involved in approaching these deductions entail detailed definitions and special rules for specific circumstances.

[2] Deductions Allowed Without Regard to Business Use of Home

The general rule disallowing deductions under *IRC Section 280A* does not apply to non-business deductions that are otherwise allowable, such as real property taxes, n217 qualifying home mortgage interest or interest on a home equity loan, n218 or casualty losses. n219

NOTE:

Although not prohibiting their allowance as deductions, *IRC Section 280A* does require that the above deductions be allocated between business and personal use of the dwelling unit. n220 For rental expenses, the above deductions must be properly attributed to rental/non-rental use periods as well. n221 These allocations in turn will determine what portion of the above deductions may be taken as an itemized deduction on Schedule A, or as a business-related deduction on some other schedule, such as a Schedule C (from a home business), Schedule E (rental real estate) or some other schedule. See § 9.21[4], below for a discussion of allocation of expenses between personal and business use of a residence and § 9.30[2], below, for rules for determining the attribution of expenses attributable to rental property.

[3] Taxpayers Subject to *IRC Section 280A* Limitations

Only individuals, S corporations, partnerships (including LLCs treated as partnerships), trusts, and estates are subject to *IRC Section 280A*. n222 C corporations are not subject to *IRC Section 280A*. n223 C corporations that are partners in a partnership, however, would be indirectly affected by any *IRC Section 280A* limitations that applied to the partnership.

[4] Allocation of Expenses Between Personal and Business (or Rental) Use of Residence

[a] Allocation Requirement

A taxpayer subject to *IRC Section 280A* who uses part of a home for business and part for business or rental use must allocate the expenses that are allocable to the entire dwelling unit between personal and business uses. n224 The allocation may be done by any method that is reasonable under the circumstances. The most typical means is by square footage, according to the percentage of the total floor space that is used for business purposes compared to the total square footage of the dwelling unit. If rooms in a dwelling unit are of approximately equal size, allocation may be by the number of rooms used for business purposes compared to the total number of rooms. n225 For purposes of determining the percentage of space used exclusively for business, any space that can actually be used must be included in the computation of the total square footage of a residence. This can even include attic space. n226

NOTE:

Traditionally, the IRS has not been too picky about exact square footage. It is to a taxpayer's advantage to compute the deduction both on a number-of-rooms (if the rooms are roughly the same size) and square footage, and then take the larger deduction. n227

NOTE:

A separate allocation of expenses based on rental/non-rental use periods must be made with respect to a dwelling or a portion of it that is rented out. For a dwelling unit that is rented, expenses must be attributed between rental use of the unit and personal use periods if the taxpayer makes personal use of the dwelling unit for even a single day during the year. This attribution of expenses is required even if the taxpayer's use is not so extensive as to be use of the unit as a residence. n228

[b] Manner of Allocating Expenses

Any expense that is attributable only to a certain portion of the dwelling unit is allocated in full to that portion. Thus, a repair to a home office, costs of painting a home office, or installation of blinds in a home office (if a *IRC Section 179* deduction is claimed) are allocable in full to the business portion of the property and would be fully deductible. n229 The IRS refers to these kinds of expenses as "direct" expenses. n230

Expenses incurred with respect to parts of the home not used for business are referred to by the IRS as "unrelated" expenses. n231 These unrelated expenses are not deductible and cannot be allocated in part to a home office, based on business/personal use of the home. For example, a repair to kitchen fixtures or costs of painting a bedroom cannot be allocated in part to a home office, based on business/personal use of the home. n232 In addition, expenses that are not related to the use of the dwelling unit for business purposes also cannot be allocated in part to a home office and deducted. Thus, costs of lawn care or landscaping would ordinarily not be deductible. n233

NOTE:

Lawn care, snow shoveling and similar items arguably could be allocable to business use and therefore could be deductible if shown to be necessary to the proper maintenance of a home office. This might be the case if a taxpayer meets with patients, clients or customers in a home office, especially if the home office has a separate entrance. n234

The allocation of expenses to business use of a dwelling unit according to square footage or number of rooms generally comes into play for what the IRS calls "indirect" expenses. These are expenses incurred in keeping up and running the entire home, and therefore they benefit both business and personal use portions of a dwelling unit. Examples of indirect expenses that may be deductible to the extent properly allocated to the business use portion of the dwelling unit are the following: n235

- real estate taxes;

- deductible mortgage interest;
- rent;
- utilities and services; including internet expenses; n236
- insurance;
- depreciation;
- repairs that benefit the entire home, such as a furnace, roof, or gutter repair;
- expenses attributable to the purchase and operation of a security system; n237 and
- domestic cleaning services.

NOTE:

Usually, the business percentage for the above items will equate to the square footage or number of rooms used for business purposes. If a taxpayer can prove a higher use for the business purposes--as for special lighting, heat, or additional insurance that are specifically for business purposes--then a higher deduction may be possible. The problem is that billing information is unlikely to provide the information necessary to support a higher deduction. n238

NOTE:

Casualty losses can be a direct expense, indirect expense, or unrelated expense, depending on the part of the dwelling unit affected by the casualty. Storm damage to a roof, for example, would be an indirect expense, part of which could be allocated to the business use of the home and deducted. In contrast, a kitchen fire that did not damage any other part of the house would be an unrelated expense. n239

No part of the first telephone line to a home may be deducted as part of a home office expense, n240 but costs of additional phone lines, or additional telephone services used in a business above the cost of a basic connection, may be allocable in full to the business use of the home if used exclusively for business purposes. Long distance calls related to business use would also be deductible. n241

[c] Depreciation of Home Office

Depreciation deductions may be claimed under *IRC Section 280A* in connection with business use of a dwelling unit. Depreciation of tangible personal property used exclusively in business use of the home is a direct expense allocable entirely to business use, and may be deducted in full unless limited by the gross income limitation. Depreciation may also be claimed on the portion of the dwelling itself that is allocable to business use, based on the percentage of business use, and the amount of the adjusted basis allocable to the dwelling unit. n242 A 39-year recovery period must ordinarily be used. n243 Taxpayers may elect to expense qualifying property under *IRC Section 179*.

[5] Gross Income Limitation to Deductions Under *IRC Section 280A***[a] Deductions Restricted to Gross Income from Specified Uses**

Otherwise allowable deductions under *IRC Section 280A* that are attributable to business use, storage use, or use of the home for day care services n244 are subject to a gross income limitation. The same gross income limitation applies with respect to rental use of a dwelling unit if the unit is used by the taxpayer during the taxable year as a residence. n245

Under the gross income limitation, the total deductions attributable to any of the above uses cannot exceed the excess of the gross income derived from that use over the sum of the following deductions allocable to that income: n246

- the deductions allocable to that use that would be allowable without regard to that use, such as real property taxes and qualified mortgage interest; n247 and
- the deductions that are allocable to the trade or business activity (or rental activity) in which the use occurs, but which are not allocable to the use of the property itself. This would include such expenses as salaries, supplies, or in the case of rental property, advertising costs to obtain a tenant. n248

The general purpose of the gross income limitation is to prevent taxpayers from using deductions from the business use of a home to generate or increase a net loss from the business to which the deductions relate. This in turn prevents a loss resulting from home office deductions from offsetting income from other sources and activities. n249

[b] Determination of Gross Income

In determining a taxpayer's gross income for purposes of applying the gross income limitation, only gross income derived from the qualified business use of the dwelling unit (*i.e.* the uses under *IRC Section 280A(c)(1)*--as a principal place of business, a place to meet patients, clients or customers, or use of a separate structure in connection with a trade or business)--is taken into account. n250 If the office is used for multiple qualified business activities, however, income from all those different activities may be included. It is not necessary that all the gross income be reported on the same Schedule in order to be included. n251

Example:

S, a teacher at a school outside the home, also conducts a retail sales business out of a home office in his home. The home office is the principal place of business for the retail business. S may take into account only the gross income from the use of the office for the retail sales business in applying the gross income limitation. Even if S uses the office to correct student papers and prepare class presentations in the office, no portion of S's gross income from teaching may be taken into account in applying the gross income limitation. n252

Example:

Tom is engaged in the business of acquiring, constructing, improving, leasing, and managing commercial real property. He also derives income from installment sales of property that he leased in the business during prior years. He reports income from business operations on a Schedule C, but also reports income from leasing and selling property on Schedules B, D, and E. Income from all the different sources may be taken into account in applying the gross income limitation because they all constitute income from the taxpayer's business. n253

[c] Order in Which Deductions Are Allowed in Applying Gross Income Limitation

Deductions must be taken in a specified order in applying the gross income limitation. The ordering rule is intended to prevent deductions under *IRC Section 280A* that are related to a dwelling unit from creating a deductible business loss or being applied against other income that is not related to the dwelling unit. To this end, taxpayers are required to first offset income earned in the dwelling unit by expenses that would be deductible in any event, even if the dwelling unit were not used for the activity. Only after these deductions are exhausted may the taxpayer claim deductions related to the dwelling unit itself. As for the deductions related to the dwelling unit itself, deductions that do not reduce the basis of property must be taken before deductions that do reduce the basis of property. At any point, where the deductions exceed the gross income related to the dwelling unit, no further deductions are allowed. n254

In applying the gross income limitation under *IRC Section 280A(c)(5)*, deductions must be taken in the following order

and may be taken only to the extent described: n255

(1) Deductions allowable with respect to the dwelling unit without regard to any trade or business use. This would include real estate taxes, mortgage interest, and casualty losses. n256 See § 9.21[4], above, for a discussion of the allocation of expenses between business and personal use.

NOTE:

By requiring an allocable part of the above items to be deducted before all other business deductions, this ordering rule prevents taxpayers from deducting mortgage interest and taxes on a Schedule A, and deducting only other business expenses on a Schedule C, Schedule E, or Schedule F. n257

(2) If there is still income derived from the business use of the dwelling unit after taking the deductions in (1), then amounts otherwise allowable as deductions by reason of the business use of the property, but which are not allocable to the use of the unit itself. This would include typical trade or business expenses, such as compensation, supplies, a separate business phone, and depreciation on business equipment. n258

(3) If there is still income derived from the business use of the dwelling unit after taking the deductions in (1) and (2), amounts otherwise allowable by reason of business use of the dwelling unit, other than those which would result in an adjustment to the basis of property. This would include an allocable share of utilities, repairs, insurance and other similar costs relating to the dwelling unit.

(4) If there is still income derived from the business use of the dwelling unit after taking the deductions in (1)-(3), amounts otherwise allowable by reason of business use of the dwelling unit that result in an adjustment to the basis of property. This would include depreciation allocable to the business portion of the dwelling unit.

NOTE:

The proposed regulations provide only three "ordering" levels of deductions. The statute, which was amended after the proposed regulations were promulgated, clarifies that the deductions in paragraph (2) above, which are not allocable to the use of the dwelling unit, must be taken before the deductions that are allocable to use of the dwelling unit. n259

[d] Carryover of Disallowed Deductions

Any deduction that is disallowed under the gross income limitation may be carried forward to the following tax year and allowed as a deduction with respect to qualifying use of the residence in that year. Any deduction carried over to a later year is subject to the gross income limitation in the carryover year, even if the dwelling unit is not used as a residence during that year. n260

FOOTNOTES:

(n1)Footnote 193. *IRC § 280A(a)*.

(n2)Footnote 194. See § 9.22, below, for a discussion of what constitutes a "dwelling unit."

(n3)Footnote 195. See § 9.24, below, for a discussion of the exclusive and regular use requirements.

(n4)Footnote 196. *IRC § 280A(c)(1)*.

(n5)Footnote 197. See § 9.26, below, for a discussion of principal place of business requirement.

(n6)Footnote 198. See § 9.27, below, for a discussion of the home business use for meeting patients, clients or customers requirement.

(n7)Footnote 199. See § 9.28, below, for a discussion of the separate structure business use requirement.

(n8)Footnote 200. *IRC § 280A(c)(1)*. See § 9.29, below, for a discussion home office use by employees for the convenience of the employer.

(n9)Footnote 201. *IRC § 280A(c)(2)*. See § 9.24[3], below, for a discussion.

(n10)Footnote 202. *IRC § 280A(c)(4)*. See § 9.24[4], below, for a discussion.

(n11)Footnote 203. *IRC § 280A(c)(3)*. See § 9.30, below, for a discussion.

(n12)Footnote 204. *IRC § 280A(c)(5)*. See § 9.21[5], below, for a detailed discussion.

(n13)Footnote 205. See § 9.22, below, for a discussion.

(n14)Footnote 206. See § 9.23, below, for a discussion.

(n15)Footnote 207. *IRC § 280A(a), (d), (f)(1), (2)*.

(n16)Footnote 208. *IRC § 280A(c)(1)*.

(n17)Footnote 209. *IRC § 280A(c)(2)*.

(n18)Footnote 210. *IRC § 280A(c)(3)*.

(n19)Footnote 211. *IRC § 280A(c)(4)*.

(n20)Footnote 212. See §§ 9.24 through 9.29, below, for a discussion of these use requirements.

(n21)Footnote 213. *IRC § 280A(a)*; see *IRC §§ 163(h), 164, 165(c)(3)*.

(n22)Footnote 214. *Prop Treas Reg § 1.280A-2(i)(3)*. See § 9.21[4], below.

(n23)Footnote 215. *IRC § 280A(e)*. See § 9.30[2], below.

(n24)Footnote 216. *IRC § 280A(c)(5)*. See § 9.21[5], below.

(n25)Footnote 217. See *IRC 164(a)*.

(n26)Footnote 218. See *IRC § 163(h)(3)*.

(n27)Footnote 219. *IRC § 280A(b)*; *Prop Treas Reg § 1.280A-1(b)*; see *IRC § 165(c)(3)*.

(n28)Footnote 220. *Prop Treas Reg § 1.280A-2(i)(3)*.

(n29)Footnote 221. *IRC § 280A(e)*.

(n30)Footnote 222. *IRC § 280A(a)*; *Prop Treas Reg § 1.280A-1(a)*. The statute makes mention only of individuals and S corporations. Proposed regulations extend the provision to partnerships, trusts, and estates.

(n31)Footnote 223. *IRC § 280A(a)*.

(n32)Footnote 224. *Prop Treas Reg § 1.280A-2(i)(3)*.

(n33)Footnote 225. *Prop Treas Reg § 1.280A-2 (i)(3)*; *Swain v Commr, TC Memo 1996-22 (1996)*, *affd* 96-2 USTC ¶ 50,480 (4th Cir 1996) (taxpayer couldn't compute home office deductions based on cost of renting a room of comparable size). *Rev Rul 62-180, 1962-2 CB 52*.

(n34)Footnote 226. *Hefti v Commr, TC Memo 1988-22 (1988)*, *affd* without published opinion 894 F2d 1340 (8th Cir 1989), *cert denied* 495 US 933 (1990).

(n35)Footnote 227. See *Rev Rul 62-180, 1962-2 CB 52*.

(n36)Footnote 228. *IRC § 280A(e)*; see § 9.30[2], below, for a discussion.

(n37)Footnote 229. *Prop Treas Reg § 1.280A-2(i)(3)*.

(n38)Footnote 230. See IRS Publication 587, *Business Use of Your Home*.

(n39)Footnote 231. See IRS Publication 587, *Business Use of Your Home*.

(n40)Footnote 232. *Prop Treas Reg § 1.280A-2(i)(3)*. See *IRC § 262*.

(n41)Footnote 233. See *Prop Treas Reg § 1.280A-2(i)(3)*.

(n42)Footnote 234. See *Graves v Commr, TC Memo 1961-32 (1961)* (deduction allowed for cost lawn care and snow shoveling to attorney who saw clients in his home office). But see *Prop Treas Reg § 1.280A-2(i)(7)* (no part of lawn care expenses are allocable to business use of dwelling by consultant who sees clients in a home office).

(n43)Footnote 235. *Treas Reg § 1.262-1(b)(3)*; see IRS Publication 587, *Business Use of Your Home*.

(n44)Footnote 236. *Allen v Commr, TC Memo 2009-102 (2009)*; *Verma v Commr, TC Memo 2001-132 (2001)*.

(n45)Footnote 237. *Rev Rul 86-148, 1986-2 CB 43*.

(n46)Footnote 238. See *Prop Treas Reg § 1.280A-2 (i)(3)*.

(n47)Footnote 239. See IRS Publication 587, *Business Use of Your Home*.

(n48)Footnote 240. *IRC § 262(b)*.

(n49)Footnote 241. See IRS Publication 587, *Business Use of Your Home*.

(n50)Footnote 242. *Prop Treas Reg § 1.280A-2(i)(5)(iii), (7)*.

(n51)Footnote 243. *IRC § 168(c)*. But see CCA 200526002 (27.5-year recovery period allowed with respect to home office when the taxpayer's apartment was in an apartment building he owned, and the building qualified as residential property).

(n52)Footnote 244. See *IRC § 280A(c)(1), (2), (4)*.

(n53)Footnote 245. *IRC § 280A(c)(5)*. See § 9.23, below, for a discussion of what constitutes use as a residence, and § 9.30, below, for a discussion of rental use of a residence.

(n54)Footnote 246. *IRC § 280A(c)(5)*; *Prop Treas Reg § 1.280A-2(i)*.

(n55)Footnote 247. See *IRC* §§ 163(h)(3), 164(a)(1).

(n56)Footnote 248. *Prop Treas Reg* § 1.280A-2(i)(5)(iii).

(n57)Footnote 249. See *IRC* § 280A(c)(5); See *Tobin v Commr*, *TC Memo* 1999-328 (1999) ; *Jordan v Commr*, *TC Memo* 2000-206 (2000) ; *Visin v Commr*, *TC Memo* 2003-246 (2003), *affd in unpubl opinion* 2005-1 *USTC* P 50, 199 (9th Cir 2005).

(n58)Footnote 250. *Prop Treas Reg* § 1.280A-2(d)(5)(i)(2)(i).

(n59)Footnote 251. *Grinalds v Commr*, *TC Memo* 1993-66 (1993) .

(n60)Footnote 252. *Prop Treas Reg* § 1.280A-2(d)(5)(i)(2)(i).

(n61)Footnote 253. *Grinalds v Commr*, *TC Memo* 1993-66 (1993) .

(n62)Footnote 254. See *Prop Treas Reg* § 1.280A-2(i)(5).

(n63)Footnote 255. See *Prop Treas Reg* § 1.280A-2(i)(5).

(n64)Footnote 256. See *IRC* §§ 163(h)(3), 164(a)(1), 165(c)(3).

(n65)Footnote 257. See *Coffman v Commr*, *TC Memo* 2000-7 (2000) ; *Jordan v Commr*, *TC Memo* 2000-206 (2000) .

(n66)Footnote 258. See *IRC* § 280A(c)(5)(B)(ii).

(n67)Footnote 259. See *IRC* § 280A(c)(5)(B); *Prop Treas Reg* § 1.280A-2(i)(5). See IRS Publication 587, *Business Use of Your Home*.

(n68)Footnote 260. *IRC* § 280A(c)(5).

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Federal Taxes Affecting Real Estate

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.22

§ 9.22 "Dwelling Unit" Defined

[1] Broad Definition of "Dwelling Unit" Under *IRC Section 280A*

IRC Section 280A comes into play only if deductions are claimed with respect to the use of a dwelling unit that is also used by the taxpayer as a residence. n261 For this purpose, a *dwelling unit* is quite broadly defined to include a house, apartment, condominium, mobile home, boat, or similar property. n262 The ownership of shares in a cooperative housing association has been held to be a dwelling unit, n263 and so have motor homes. n264 The standard for being a dwelling unit is simply that basic living accommodations, such as a sleeping space, toilet and cooking facilities, must be present. n265 A dwelling unit also includes all structures and other property appurtenant to that dwelling unit. n266

The issue sometimes arises as to whether an area used for a trade or business is part of the taxpayer's "dwelling unit" so as to be subject to *IRC Section 280A*. In resolving this issue, courts look to whether the areas used as a business are physically or functionally separate from the area used as a personal residence by the taxpayer. Applying this test, the Tax Court in one case found that all three levels of a townhouse constituted a "dwelling unit," and concluded that an art gallery located on the first floor and basement was therefore subject to *IRC Section 280A*. Although the living quarters were "separate" in that they were on the second floor, no partitions or walls separated the residence area from the art gallery, there was no door on the steps between the gallery and the residence, and the taxpayer had to pass through the gallery to gain access to the residence. The court also mentioned that the building had a single real estate assessment and one sewage and water bill. n267 Other cases have made similar holdings. n268 Local commercial or other zoning is not relevant to whether a portion of a residence used as a business is part of the taxpayer's dwelling unit under *IRC Section 280A*. n269

[2] Hotel Exception

A "dwelling unit" does not include that portion of a unit that is used exclusively as a hotel, motel, inn, or similar establishment. n270 Thus, any portion of a dwelling unit that is used exclusively as a hotel, motel, inn, or similar business will not be considered part of the dwelling unit, and deductions related to it will not be subject to the disallowance under *IRC Section 280A(a)*. n271 Two requirements must be met for the hotel exception to apply. First, the property must be regularly available for occupancy by paying customers. Second, no person having an interest in the property can have used the unit or a portion of it as a residence during the taxable year. n272 The second requirement has been strictly construed to mean that *any* personal use of a unit during a taxable year precludes the hotel exception from applying. n273

NOTE:

The hotel exception can apply to a unit entered in a rental pool if the owner does not use it as a residence during the taxable year. n274 The hotel exception may also apply to a variety of situations not typically thought of as "hotels". For example, the proposed regulations state that the exception is available for a portion of a home used to furnish lodging to students who pay rent under a long-term basis. A room so used would not be considered part of the taxpayer's "dwelling unit", and so the restrictions of *IRC Section 280A(a)* would not come into play. n275 This interpretation seems to conflict with authority that allows deductions for bedrooms in a home that are rented to third parties, but treats the bedrooms as part of the taxpayer's dwelling unit and applies *IRC Section 280A* in determining the amount of deductions allowed. n276

[3] Single Structure with Multiple Dwelling Units

A single structure may contain multiple dwelling units. For example, each apartment in an apartment building is a separate unit. Similarly, if a basement of a house contains living accommodations, it may also qualify as a separate dwelling unit. If it does, the deductions related to it would not be subject to *IRC Section 280A* based on the taxpayer's use of another part of the structure. All structures and other property appurtenant to dwelling unit which do not themselves constitute dwelling units, however, are considered part of the larger dwelling unit. Thus, a garage appurtenant to a home owned and occupied by the taxpayer would be considered part of the taxpayer's dwelling unit if it were rented out, and would therefore be subject to *IRC Section 280A*. n277

PLANNING GUIDE:

The exact physical and functional separation necessary to allow a separate apartment in a taxpayer's home to be considered a separate dwelling unit from the taxpayer's living space is not entirely clear. Any kind of open stairwell to the taxpayer's living space, or structural arrangement requiring a tenant to enter the apartment via a common area shared by the taxpayer, would probably prevent the apartment from being a separate dwelling unit. At the least, a separate entryway for the apartment is probably necessary. n278 There are several tax advantages to having a separate apartment in a home treated as a separate dwelling unit rather than a part of the taxpayer's dwelling unit. The restrictions of *IRC Section 280A*--including the gross income limitation n279--will not apply to limit deductions related to the unit. Thus, subject to the passive activity limitations, all relevant expenses that are properly allocable to the unit may be deducted. Provided the taxpayer actively participates in the rental activity--which is highly likely in this type of rental--even deductible losses of up to \$25,000 per year may be available. n280

FOOTNOTES:

(n1)Footnote 261. *IRC § 280A(a)*.

(n2)Footnote 262. *IRC § 280A(f)(1)(A)*.

(n3)Footnote 263. *Holmes v United States*, 85 F3d 956 (2d Cir 1996) , revg 868 F Supp 42 (WDNY 1994) .

(n4)Footnote 264. *Haberkorn v Commr*, 75 TC 259 (1980) ; *Loughlin v US*, 82-2 USTC P 9543 (D Minn 1982).

(n5)Footnote 265. Prop Treas Reg § 1.280A-1(c)(1).

(n6)Footnote 266. *IRC § 280A(f)(1)(A)*.

(n7)Footnote 267. *Cunningham v Commr*, TC Memo 1996-141 (1996) , *affd per curiam without published opinion* 110 F3d 59 (4th Cir 1997) .

(n8)Footnote 268. *Burkhart v Commr*, TC Memo 1989-417 (1989) (basement where taxpayer conducted business was held part of upstairs dwelling unit because it was a physical and functional part of the building, and the costs of

maintaining it in terms of taxes, interest, utilities and insurance were integrated with the costs of maintaining the rest of the building); *Horton v Commr*, TC Memo 1997-572 (1997) (two-story building treated as one dwelling unit).

(n9)Footnote 269. *Horton v Commr*, TC Memo 1997-572 (1997) .

(n10)Footnote 270. IRC § 280A(f)(1)(B).

(n11)Footnote 271. *Anderson v Commr*, TC Memo 2006-33 (2006) .

(n12)Footnote 272. Prop Treas Reg § 1.280A-1(c)(2); see § 9.23, below, for a discussion of deemed use as a residence.

(n13)Footnote 273. *Wachtell, Lipton, Rosen & Katz v Commr*, TC Memo 1992-392 (1992) , *affd* 979 F2d 383 (5th Cir 1993) ; *Byers v Commr*, 82 TC 919 (1984) ; *Fine v United States*, 647 F2d 763 (7th Cir 1981) *Buchholz v Commr*, TC Memo 1983-378 (1983) .

(n14)Footnote 274. Prop Treas Reg § 1.280A-1(c)(2). See § 9.30[4], below, for a discussion of rental pools.

(n15)Footnote 275. Prop Treas Reg § 1.280A-1(c)(2).

(n16)Footnote 276. *Colton v Commr*, TC Memo 1986-5 (1986) (Tax Court rejected claim that rooms rented to tenants in taxpayer's home constituted separate "apartments"). See Ltr Rul 8303007 .

(n17)Footnote 277. Prop Treas Reg § 1.280A-1(c)(2).

(n18)Footnote 278. See *Cunningham v Commr*, TC Memo 1996-141 (1996) , *affd per curiam without published opinion* 110 F3d 59 (4th Cir 1997) ; *Burkhart v Commr*, TC Memo 1989-417 (1989) ; *Horton v Commr*, TC Memo 1997-572 (1997) .

(n19)Footnote 279. IRC § 280A(c)(5).

(n20)Footnote 280. See IRC § 469(i)(1), (2). See Yang and Schulz, *The Tax Benefits of a Home Partly Rented to a Tenant*, 22 Tax Adviser 496 (Aug 1991).

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Federal Taxes Affecting Real Estate

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.23

§ 9.23 What Constitutes Use as a Residence

[1] 14 Day/10 Percent Rule

IRC Section 280A restrictions apply only if the taxpayer uses the dwelling unit with respect to which deductions are claimed as a residence. n281 Detailed rules clarify which uses by the taxpayer and others will constitute use as a residence. n282 In general, a dwelling unit is used as a residence for a taxable year if the taxpayer uses it or a portion of it for personal purposes for the greater of the following: n283

- 14 days; or
- 10 percent of the number of days during the year that the unit is rented at a fair rental.

For purposes of the 10-percent alternative of the residence test, a unit is not treated as rented at a fair rental for any day for which it is used for personal purposes. n284

[2] Personal Use of a Dwelling Unit

[a] Use That Is Treated as Personal Use

If a taxpayer makes personal use of a residence on a day, the residence cannot be considered rented out at a fair market value for that day. n285 This can be important because a reduction in the number of days a unit is treated as rented out at a fair rental likewise reduces the number of days the taxpayer must use the dwelling unit in order for it to be considered use as a residence. n286 This, in turn, may trigger the application of *IRC Section 280A*.

In general, a taxpayer is deemed to have used a dwelling unit for personal purposes for a day if the unit is used in any of the following ways for any part of that day: n287

- For personal purposes by (1) the taxpayer, (2) any other person who has an interest in the unit, or (3) a family member of either the taxpayer or other owner. n288 Any person who holds an interest in the unit (other than a security interest or an interest under a lease for fair rental) is considered to have an interest in a unit, even if there are no immediate rights to possession and enjoyment under the interest. n289

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- Use by any individual under an arrangement that enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of the other unit, and regardless of the length of time the taxpayer uses the other unit). n290 This is a typical house swapping arrangement.

- Use by any individual (other than an employee who is furnished lodging for the convenience of the employer that is excluded from the employee's gross income), n291 unless for that day the unit is rented at a fair rental. n292

- Charitable donation of the right to use the property, when the charitable organization sells the use of the unit at a fund-raising event, and the "purchaser" uses the unit. n293

- Certain use by a pass-through entity that has an interest in the dwelling unit. n294

Example:

Tom and his neighbor Eric are co-owners of a beach condominium. The unit is rented out throughout the year to third parties. The unit is not used as a principal residence by anyone. Tom uses the condominium for 15 days during the year but Eric does not use the unit at all. Because of the co-ownership, both Tom and Eric are treated as having made personal use of the unit during the period of Eric's use. n295

Example:

Jeff rents his beach condominium to Mary, and Mary rents her mountain cabin to Jeff. Both parties pay a fair rental price. Jeff is treated as making personal use of the beach condominium on the days that Mary uses it because her use is under an arrangement that allows Jeff to use Mary's cabin. For the same reason, Mary is treated as making personal use of her cabin on the days Jeff uses it. n296

NOTE:

Special rules apply for determining personal use of units that are in time-sharing arrangements and units that are in rental pools. n297 These rules come into play only with respect to rental use of property and are discussed in §§ 9.30[3], and § 9.30[4], below.

[b] Rental at Fair Market Value for Use as Principal Residence

A taxpayer is not treated as using a dwelling unit for personal purposes due to the existence of a rental arrangement for any period if for that period the unit is rented at a fair rental to any person for use as that person's principal residence. n298

Example:

Christine owns a rental property that she rents to her son. The son does not have an ownership interest in the property. He uses the property as his principal residence and pays a fair rental. The son's use of the property is not treated as personal use by Christine. n299

Additional requirements must be met to avoid personal use, however, if the dwelling unit is rented to a person having an ownership interest in it. In that case, the taxpayer is not treated as using the unit for personal purposes only if the rental is pursuant to a shared equity financing agreement. n300 The determination of whether a fair rental is charged under a shared equity financing agreement is determined as of the time the agreement is entered into, and taking into account the occupant's qualified ownership interest. n301

A shared equity financing agreement is an agreement under which: n302

- two or more persons acquire qualified ownership interests in a dwelling unit; and

- the person(s) holding one or more of those interests (1) is entitled to occupy the dwelling unit as a principal residence, and (2) is required to pay rent to at least one other person holding a qualified ownership interest in the dwelling unit.

A "qualified ownership interest" is an undivided interest for more than 50 years in the entire dwelling unit and appurtenant land being acquired in the transaction to which the shared equity financing agreement relates. n303 A taxpayer's rental agreement with a partnership of which he is a partner may qualify as a shared equity financing agreement. n304

Example:

S forms a partnership with his parents to purchase shares in a cooperative housing building. After the purchase, S pays a fair rental to the partnership and lives in the co-op. The partnership's expenses with respect to the co-op exceed its income, and S reports his share of partnership losses on his return. The rental agreement qualifies as a shared financing agreement because S and his parents, as partners of the partnership, each hold a qualified ownership interest in the co-op and because, under the lease with the partnership, S is entitled to occupy the co-op as his principal residence, and is required to pay rent to one or more persons holding a qualified interest in the co-op--i.e. the partners. The personal use limitation of *IRC Section 280A(c)(5)* does not apply, and S is entitled to deduct his share of the partnership's deductible rental losses. n305

[c] "Day" Defined

For purposes of *IRC Section 280A*, a *day* is any 24-hour period for which a day's rental would be paid. Thus, a personal using a dwelling unit from Saturday afternoon through the following Saturday morning would be treated as using the unit for seven days even though the person was on the premises on eight calendar days. n306

[d] What Constitutes "Fair Rental"

What constitutes a fair rental in any given situation is determined under a "facts and circumstances" standard. n307 The term *fair rental* is the amount at which property would change hands between a willing lessee and a willing lessor, neither being under any compulsion to enter into the transaction and both having reasonable knowledge of the relevant facts. n308 The IRS states that fair rental cannot be "substantially less" than the rents charged for similar properties. n309

An additional consideration applies with respect to co-owners. A co-owner is treated as charging a fair rental only if the co-owner charges an amount that is equal to the fair rental of the entire unit multiplied by that co-owner's fractional interest in the unit. n310

[3] Use of Dwelling Unit for Maintenance and Repairs

A dwelling unit is generally not used for personal purposes on any day it is principally used to perform repair or maintenance work. n311 Taxpayers who visit second homes sometimes claim that the main purpose of various visits is for maintenance, repair, inspection, or similar "non-personal use" purpose. Such a claim is likely to be rejected unless the taxpayer has evidence to support it, such as receipts, work reports, or time logs. The presence of additional family members who do not perform repairs or maintenance can also indicate personal use of the dwelling, unless the taxpayer is engaged in repair and maintenance on a "substantially full time basis" for that day. n312

Proposed regulations clarify when the use of a unit for repairs and annual maintenance does not constitute personal use. A taxpayer is not deemed to have used a dwelling unit for personal purposes on any day on which the principal purpose of the use of the unit is to perform repair or maintenance work. Whether repair or maintenance is the principal purpose of the use depends on all facts and circumstances, including the following: n313

- the amount of time devoted to repair and maintenance work;
- the frequency of the use for repair and maintenance purposes during a taxable year; and
- the presence of companions.

If a taxpayer is engaged in repair and maintenance on a substantially full time basis for a day, however, the dwelling unit cannot be treated as used for personal use by the taxpayer merely because other individuals who are on the premises are not engaged in repair and maintenance. n314

[4] Personal Use of Unit Owned by Pass-Through Entities

Special rules apply in determining personal use in a dwelling unit in which a partnership (or LLC treated as one), trust, estate, or S corporation has an interest. n315 Any partner (or LLC member), beneficiary, or shareholder that owns an interest in one of these pass-through entities is referred to as beneficial owner of the entity. n316 Any of these pass-through entities is considered to have made personal use of a dwelling unit on any day on which any beneficial owner of the entity would be considered to have made personal use of the unit. Personal use is determined as if each beneficial owner had an interest in the unit. Thus, for example, use by a family member of a partner would be considered personal use by the partnership. n317

NOTE:

The effect of the above rules is that use of a dwelling unit by a beneficial owner of the entity can subject the other beneficial owners of the entity to the gross income limitations of *IRC Section 280A(c)(5)* with respect to their shares of tax items related to the unit.

There is an exception regarding personal use attribution for partnerships. A partnership may rent a dwelling unit to a partner for use as a principal residence without having that partner's use of the dwelling unit for that purpose treated as personal use of the unit by the partnership. The exception applies, however, only if the following requirements are met: n318

- the partnership owns an interest in the dwelling unit;
- a partner rents the unit at a fair rental for use as the partner's principal residence; and
- the items of income, gain, loss, deduction, or credit of the partnership related to the unit are allocated among the partners in accordance with their percentage ownership interests in the partnership.

When the exception applies, the partner making use of the unit is subject to the gross income limitations n319 with respect to items related to the unit that are allocated to that partner, but the other partners are not subject to those limits with respect to their allocable share of partnership items because the renting partner's use is not attributed to the partnership itself. n320

Another minor exception can come into play when a dwelling unit is rented at a fair rental to a third-party occupant, and a beneficial owner of the pass-through entity makes personal use of the unit in some manner other than by being a temporary guest of the occupant of the unit. n321 In that case, actual personal use by a beneficial owners is treated as personal use by the pass-through entity. Deemed personal use by a beneficial owner, n322 however, as by reason of the personal use of the unit by a family member of the beneficial owners, is not treated as personal use by the entity for this purpose. n323

[5] Special Rule for Use of Dwelling Unit as Principal Residence Before or After Qualified Rental Periods

For purposes of applying the gross income limitation n324 to deductions that are allocable to a qualified rental period, certain use of a dwelling unit as a principal residence by the taxpayer is disregarded. n325 There are two circumstances when the taxpayer's use of the residence is disregarded. The first is when the taxpayer rents the dwelling unit, or holds it for rental, at a fair rental for 12 or more consecutive months. The rental period may begin or end in the taxable year in which the taxpayer uses the property as a principal residence. In that case, the taxpayer's use of the property as a principal residence is ignored for purposes of determining whether the gross income limitation applies to deductions allocated to the period of rental. This exception is intended to cover situations where a taxpayer lives in a principal residence before or after renting it, as where a taxpayer moves elsewhere for a temporary job. n326

Example:

Jill moves out of her principal residence on February 28 of Year 1 to take a job in another city. She rents the residence at a fair rental price from March 15 of Year 1 until May 15 of Year 2. She moves back into the residence as her principal residence on June 1 of Year 2. Jill's use of the home from January 1 to February 28 of Year 1 and from June 1 to December 31 of Year 2 is ignored for purposes of determining if Jill makes personal use of the residence for purposes of applying the gross income limitation n327

The second circumstance arises when a taxpayer rents or tries to rent a home, and the rental period terminates because the home is sold or exchanged. This exception applies only if the taxpayer rents the dwelling unit or holds it out for rental, at a fair rental, for a consecutive period of less than 12 months, and that rental period begins in the same taxable year as the year the taxpayer uses the dwelling unit as a principal residence. n328

Example:

Terry moves out of his condominium on January 31 of Year 1. He has used it as his principal residence. He offers it for rent at a fair rental beginning February 1 of Year 1, but is unable to find a tenant until April 1 of Year 1. On November 1 of Year 1, Terry sells the condominium. Terry's use of the condominium during January is not treated as personal use for purposes of applying the gross income limitation to rental deductions attributable to the rental of the unit during the year. n329

NOTE:

The taxpayer's personal use of the home is disregarded *only* for purposes of applying the gross income limitation to deductions attributable to the rental use of the property. The use *is* treated as personal use for all other purposes of *IRC Section 280A*. Thus, the personal use by the taxpayer *is* taken into account for purposes of dividing expenses between personal/rental use of the property. n330

FOOTNOTES:

(n1)Footnote 281. *IRC § 280A(a)*.

(n2)Footnote 282. *IRC § 280A(d)*.

(n3)Footnote 283. *IRC § 280A(d)(1)*.

(n4)Footnote 284. *IRC § 280A(d)(1)*. See § 9.23[2], below, for what constitutes personal use of a dwelling unit.

(n5)Footnote 285. *IRC § 280A(d)(1)*.

(n6)Footnote 286. See *IRC § 280A(d)(1)*.

(n7)Footnote 287. *IRC § 280A(d)(2)*.

(n8)Footnote 288. Family members include siblings (either whole or half blood), spouses, ancestors, and lineal

descendants [IRC § 267(c)(4)].

(n9)Footnote 289. Prop Treas Reg § 1.280A-1(e)(1) (flush language).

(n10)Footnote 290. Prop Treas Reg § 1.280A-1(e)(1)(iii).

(n11)Footnote 291. See IRC § 119.

(n12)Footnote 292. Prop Treas Reg § 1.280A-1(e)(1)(iv).

(n13)Footnote 293. *Rev Rul 89-51, 1989-1 CB 89* . Although treated as personal use, no charitable deduction is allowed, however [see IRC § 170(f)(3)(A)].

(n14)Footnote 294. Prop Treas Reg § 1.280A-1(e)(5); see § 9.23[4], below, for a discussion.

(n15)Footnote 295. See Prop Treas Reg § 1.280A-1(e)(1)(i).

(n16)Footnote 296. See Prop Treas Reg § 1.280A-1(e)(1)(iii).

(n17)Footnote 297. *Prop Treas Reg § 1.280A-3(e), (f)*.

(n18)Footnote 298. *IRC § 280A(d)(3)(A)*; Prop Treas Reg § 1.280A-1(e)(2).

(n19)Footnote 299. See Prop Treas Reg § 1.280A-1(e)(2).

(n20)Footnote 300. *IRC § 280A(d)(3)(B)(i)*.

(n21)Footnote 301. *IRC § 280A(d)(3)(B)(ii)*.

(n22)Footnote 302. *IRC § 280A(d)(3)(C)*.

(n23)Footnote 303. *IRC § 280A(d)(3)(D)*.

(n24)Footnote 304. *Holmes v United States, 97-1 USTC P 50,265 (WD NY 1997)*.

(n25)Footnote 305. *Holmes v United States, 97-1 USTC P 50,265 (WD NY 1997)*.

(n26)Footnote 306. Prop Treas Reg § 1.280A-1(f).

(n27)Footnote 307. *IRC § 280A(d)(2)(C)*; Prop Treas Reg § 1.280A-1(e)(1)(iv).

(n28)Footnote 308. *Razavi v Commr, 74 F3d 125 (6th Cir 1996)* , *rev'd TC Memo 1993-624* .

(n29)Footnote 309. See IRS Publication 527, *Residential Rental Property (Including Rental of Vacation Homes)*.

(n30)Footnote 310. Prop Treas Reg § 1.280A-1(g)(1).

(n31)Footnote 311. *IRC § 280A(d)(2)*.

(n32)Footnote 312. See *Akers v Commr, TC Memo 2010-85 (2010)* . See *IRC § 280A(d)(2)* (flush language).

(n33)Footnote 313. Prop Treas Reg § 1.280A-1(e)(6). See *IRC § 280A(d)(2)* (statutory mandate for issuing regulations).

(n34)Footnote 314. *IRC § 280A(d)(2)*; Prop Treas Reg § 1.280A-1(e)(6).

(n35)Footnote 315. Prop Treas Reg § 1.280A-1(e)(5).

(n36)Footnote 316. Prop Treas Reg § 1.280A-1(e)(5)(i).

(n37)Footnote 317. Prop Treas Reg § 1.280A-1(e)(5)(ii).

(n38)Footnote 318. Prop Treas Reg § 1.280A-1(e)(5)(iii)(B).

(n39)Footnote 319. See *IRC* § 280A(c)(5).

(n40)Footnote 320. Prop Treas Reg § 1.280A-1(e)(5)(iii)(B).

(n41)Footnote 321. See Prop Treas Reg § 1.280A-1(e)(2) (second sentence).

(n42)Footnote 322. See Prop Treas Reg § 1.280A-1(e)(1).

(n43)Footnote 323. Prop Treas Reg § 1.280A-1(e)(5)(iii)(A).

(n44)Footnote 324. See *IRC* § 280A(c)(5).

(n45)Footnote 325. *IRC* § 280A(d)(4)(A). Prop Treas Reg § 1.280A-1(e)(4).

(n46)Footnote 326. *IRC* § 280A(d)(4)(A), (B)(i).

(n47)Footnote 327. See *IRC* § 280A(c)(5).

(n48)Footnote 328. *IRC* § 280A(d)(4)(A), (B)(ii).

(n49)Footnote 329. *IRC* § 280A(d)(4)(A), (B)(ii); see *IRC* § 280A(c)(5).

(n50)Footnote 330. Prop Treas Reg § 1.280A-(e)(4). See § 9.30[2], below, for a discussion of determining expenses attributable to rental periods.

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Federal Taxes Affecting Real Estate

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.24

§ 9.24 Exclusive and Regular Use Requirements Under IRC Section 280A

[1] Exclusive Use Requirement

[a] Exclusive Use Required for *IRC Section 280A* Deductions

Deductions are permitted under *IRC Section 280A* only if a portion of the dwelling is exclusively used on a regular basis for a qualifying purpose. Thus, both an "exclusive use" and a "regular basis" use requirement must be met. n331 "Exclusive use" requires that a portion of a dwelling unit be used solely for business. There can be no use of that portion at any time during the taxable year for other than business purposes. Any use for nonbusiness purposes will violate the requirement and prevent the deduction of home office expenses. Necessary repairs and maintenance, however, will not cause a taxpayer to violate the exclusion use requirement. n332

The "exclusive use" requirement is strict, unforgiving, and narrowly construed by both the IRS and courts. Even rare or occasional personal or family use of a home office, or personal use of space only during "nonbusiness" hours, violates the exclusive use test and precludes deductions under *IRC Section 280A*. n333

In one rare case in which the exclusive use requirement was given a *de minimis* exception, the court held that the storage of a lawn mower in a garage that was otherwise eligible for home office deductions did not prevent the exclusive use requirement from being met because whatever space was occupied by the lawn mower was *de minimis*. n334 Another case allowed the exclusive use to be met by a walk-in closet because the only other use made of it was to walk to and from the bathroom of the studio apartment. n335 Given the rarity of these cases, however, taxpayers should never expect a *de minimis* use exception to save them from the denial of a home office deduction. Apart from a *de minimis* exception, there are only two exceptions in which the exclusive use requirement does not apply with respect to home office deductions--the storage of inventory or product samples, n336 and the use of a home to provide day care services. n337

[b] Separately Identifiable Space

The portion of the dwelling unit that must satisfy the exclusive use requirement must be a room or other separately identifiable space. It is not necessary that the portion be marked off by a partition. n338 Thus, the "exclusive use" test can be an entire room or a portion of one, so long as that portion is separately identifiable. Whether there is a separately identifiable space for this purpose is a question of fact.

Not surprisingly, the resolution often resolves around issues of credibility. The absence of a wall, partition, curtain or some other divider is a factor considered by the courts, often to the taxpayer's detriment. The absence of a partition may cause a court to view the evidence with a somewhat more critical eye. n339 Thus, it is obviously helpful to a taxpayer's case if there *is* a physical partition--whether it be curtain or file cabinets--if only a portion of a room is used for a qualifying purpose. n340

Furnishings in a room may be relevant in determining whether there is a separately identifiable space. The presence of personal furniture--such as a television, sofa, or bed--in a "business use portion" of a dwelling unit can lead to a finding that the exclusive use test is not met, largely because it damages the taxpayer's credibility about how the area is in fact used. n341 The absence of personal furnishings, in contrast, can be helpful to the taxpayer's case, especially if the furnishings that are present are appropriate only for a business purpose. n342

The presence or absence of particular furnishings does not guarantee any particular result, however. It is merely one piece of evidence for a court to consider. The absence of personal furnishings will not save a taxpayer who uses a home office for both business and personal purposes. n343 Conversely, the presence of personal furnishings is not always fatal. In one surprisingly lenient case, the court allowed home office deductions with respect to a living room in an attorney's home, even though the room was furnished with two sofas, some easy chairs, a coffee table, a lamp table, and a piano. The court found credible the taxpayer's testimony that he and his wife rarely entertained and that the room was used only to meet with clients. The court also believed his testimony that he never played the piano in the year in issue. n344

The particular room for which exclusive business use is claimed also seems to play a part. Claims of exclusive business use for a kitchen or dining room are routinely rejected. While the summary explanation usually given is simply that the taxpayer has failed to show that the room was used exclusively for business purposes, an unstated rationale may be that it is hard for a court to imagine a taxpayer living in a home and not making personal use of those rooms without extraordinary evidence to the contrary. n345

[c] Multiple Businesses

The exclusive use requirement n346 does not demand that a home office be used exclusively in connection with only one business or only one of the types of uses enumerated in *IRC Section 280A(c)(1) (A), (B), and (C)*--i.e. principal place of business; place for meeting patients, clients or customers; or separate structure used in connection with a trade or business. Expenses attributable to the use of a home office in conducting two or more businesses are deductible if the requirements of *IRC Section 280A* are otherwise met. The existence of two or more businesses, *per se*, does not prevent the deductibility of expenses attributable to business use of a home. n347 Furthermore, it is not necessary that the business activities of each business be physically segregated. n348

If more than one business is conducted out of the home, however, the activities from each business must separately and independently satisfy all requirements of deductibility under *IRC Section 280A*. If they do not, the IRS and the Tax Court take a hard-line position that the entire home office area is thereby tainted because the exclusive use test is not met. As a result, no deductions are allowed either for that business or any other business conducted in the same space. n349

[2] Regular Use Requirement

Deductions are allowed under *IRC Section 280A* only if the portion of the dwelling unit is used exclusively for a qualifying purpose on a regular basis. n350 Proposed regulations offer little guidance as to what "regular basis" means, stating only that the determination of use on a regular basis must be made in light of all the facts and circumstances. n351 Courts offer more guidance, holding that regular use means use on a continuing basis. Occasional, intermittent, or

incidental use is insufficient, even if that portion of the dwelling is used for no other purpose. n352

The burden is on the taxpayer to prove regular use. If proof consists of nothing more than the taxpayer's testimony, deductions are likely to be denied. n353 The parameters of regular use are not at all clear, however, and the IRS can be surprisingly lenient on occasion. In one case, the IRC conceded "regular" use, even though the taxpayer did not provide any services connected with that use after January 8 of the calendar year in question. n354

[3] Storage Use of Dwelling Unit

An exception applies under *IRC Section 280A* with respect to certain storage use of a dwelling unit. Under it, deductions may be taken in full if all of the following requirements are met: n355

- the space is used on a regular basis as a storage unit;
- the items stored are inventory or product samples of the taxpayer;
- the stored items are held for use in the taxpayer's trade or business of selling products at retail or wholesale;
- the dwelling unit is the sole location of that trade or business; n356 and
- the space used is a separately identifiable space suitable for storage.

The storage unit includes only the space actually used for storage. Thus, if a taxpayer stores inventory in one portion of a basement, the storage unit includes only that portion, even if the taxpayer makes no other use of the basement. n357

Several points are worthy of note with respect to the storage use exception. First, it is not necessary that the space be used exclusively as a storage unit; only storage use on a "regular basis" is required. Thus, an area used for storage of inventory, but also for other purposes, can qualify for the storage unit exception. n358 The "regular basis" requirement is intended to prevent taxpayers from claiming a deduction when inventory or product samples are only stored occasionally at home. n359 Exactly how frequent storage must be to constitute storage on a "regular basis" is not clear, but presumably, the storage should be for most of the time or at least on a continuing basis. Proposed regulations offer little guidance, stating only that the determination of use on a regular basis must be made in light of all the facts and circumstances. n360

Second, the inventory/product sample and retail/wholesale selling business requirements impose strict limits on the materials that can be stored under the exception. n361 Deductions cannot be claimed for the storage of any other materials, such as business records or files, n362 or supplies or equipment used in a trade or business. n363

[4] Day Care Services

[a] Exclusive Use Not Required for Day Care Services

An exception under *IRC Section 280A* allows a deduction for items that are allocable to the use of any portion of a dwelling unit on a regular basis in the taxpayer's business of providing day care. The qualifying day care may be for children, individuals 65 or older, or individuals who are physically or mentally incapable of caring for themselves. n364 The day care exception is available only if state licensing requirements are met. n365 Day care services are those which are primarily custodial in nature and which are provided only certain hours during the day. Any educational, developmental, or enrichment activities provided must be incidental to the primary custodial services. Services that are primarily education or instructional in nature do not qualify as day care services. n366

Use of the home in providing day care services does not need to be exclusive, but it must be regular. To meet the regular use requirement, a day care business use must be continuous, ongoing, or recurring. Incidental or occasional use is insufficient. n367

[b] Allocation Formula When Day Care Use Is Not Exclusive

A day care provider should compute day care business use deductions for the home by multiplying total allowable costs by two fractions. The first fraction is the total square footage in the home that is available for day care use throughout each business day and that is regularly so used in that business, divided by the total square footage of the home. n368

A second fraction must then be computed under a statutory allocation formula, taking into account the number of hours of day care use (including substantiated preparation and clean-up time). The deductible amount is based on the ratio of the number of hours the portion is used for day care purposes to the total number of hours the portion is available for day care use, i.e. 24 hours a day, or 8,760 hours per year. n369 The IRS has ruled that for purposes of computing the ratio, if a portion of a residence is available for day care use throughout a business day and is regularly used for that purpose, that portion will be considered as used for day care throughout the business hours of that day. The taxpayer is not required to keep records of the specific hours of usage of that portion of the residence during business hours. Also, the occasional non-use of that portion of the residence during the day will not disqualify it from being considered regularly used for day care services. The ruling clarifies, however, that the occasional use of a room that is ordinarily not available as part of the routine provision of day care services (such as a bedroom ordinarily restricted from day care use but used occasionally for naps) will not be considered as used for day care throughout the business day. n370

The amount of the deductions as computed may be further limited by the statutory gross income limitation. n371

Example:

A, a calendar year individual, operates a full-time licensed day care facility. A's day care business is regularly operated 11 hours each day (from 7 a.m. to 6 p.m.), five days a week, 250 days a year. A also spends one-half hour before and one-half hour after regular business hours preparing for and cleaning up after the children. Thus, the total hours of use is 3,000 hours. During the business hours, A provides day care for several young children other than A's children. Some children arrive at A's home for day care at 7 a.m., and some do not leave A's home until 6 p.m. At any particular time during A's business day, A has at least one child (other than A's children) in A's home for day care. The total floor area of A's home is 1,600 square feet. Although no rooms in A's home are used exclusively for A's day care business, several rooms in A's home are available for day care use throughout A's business day and are regularly so used as part of A's routine provision of day care. The total floor area of these rooms is 1,200 square feet.

In addition to interest and taxes of \$5,000, A incurs \$4,000 of costs during the year for electricity, gas, water, trash collection, general maintenance, and insurance with respect to the use of the home for day care and as a personal residence. The total depreciation for A's home (computed as though the entire home were depreciable) is \$1,000. Thus, A's total costs for the year are \$10,000. Assume that the gross income limitation does not come into play to limit the deductions. n372

To compute allowable deductions under *IRC Section 280A(c)(4)* related to the day care business, A must multiply the total costs incurred during the year with respect to the home (\$10,000) by two fractions. The first fraction is the total square footage in A's home that is available for day care use throughout each business day and that is regularly so used in that business, divided by the total square footage of A's home [1,200/1,600]. The second fraction is the total hours in the year that the day care business is operated (including substantiated preparation and clean-up time), divided by the total number of hours in a year [3,000/8,760]. Thus, A may deduct \$2,568.49 [$\$10,000 \times (1200/1600) \times (3000/8760)$]. n373

FOOTNOTES:

(n1)Footnote 331. *IRC § 280A(c)(1)*.

(n2)Footnote 332. *Prop Treas Reg § 1.280A-2(g)(1)*.

(n3)Footnote 333. *Sam Goldberger, Inc v Commr*, 88 TC 1532 (1987) ; *Shiekh v Commr*, TC Memo 2010-126 (2010) (no deduction allowed because taxpayer produced no evidence that any specific area of his one-bedroom apartment was used exclusively for business purposes); *Coppin v Commr*, TC Memo 2009-221 (2009) (exclusive use not met for office located in bedroom); *Mullin v Commr*, TC Memo 2001-121 (2001) (claim of exclusivity of business use in small studio apartment rejected); *Weiner v Commr*, TC Memo 1997-387 (1997) (home law office, although principal place of business, was used by family after business hours); *Fingar v Commr*, TC Memo 1997-557 (1997) , *affd in unpublished opinion* 99-1 USTC P 50,392 (11th Cir 1999); *Whalley v Commr*, TC Memo 1996-533 (1996) ; *Sengpiehl v Commr*, TC Memo 1998-23 (1998) (court rejected taxpayer's "after-hours" personal use argument); *Langer v Commr*, TC Memo 1992-46 (1992) , *affd per curiam* 989 F2d 294 (8th Cir 1993) (use of office as social area during annual open house violate exclusive use requirement); *Stone v Commr*, TC Memo 1998-437 (1998) ; *Schnelten v Commr*, TC Memo 1993-264 (1993) ; *Russell v Commr*, TC Memo 1994-96 (1994) , *affd in unpublished opinion* 96-1 USTC P 50,096 (9th Cir 1995); *Stricker v Commr*, TC Memo 1995-530 (1995) ; *Shelley v Commr*, TC Memo 1994-432 (1994) ; *Speers v Commr*, TC Memo 1994-157 (1994) ; *Hall v Commr*, TC Memo 1993-198 (1993) ; *Odom v Commr*, TC Memo 1982-531 (1982) ; *Chauls v Commr*, TC Memo 1980-471 (1980) ; *Weiner v Commr*, TC Memo 1980-317 (1980) . But see *Culp v Commr*, TC Memo 1993-270 (1993) (storage of lawn mower in garage did not prevent exclusive business use of that garage).

(n4)Footnote 334. *Culp v Commr*, TC Memo 1993-270 (1993) .

(n5)Footnote 335. *Hughes v Commr*, TC Memo 1981-140 .

(n6)Footnote 336. *IRC § 280A(c)(2)*; see § 9.24[3], below, for a discussion.

(n7)Footnote 337. *IRC § 280A(c)(4)*; see § 9.24[4], below, for a discussion.

(n8)Footnote 338. *Prop Treas Reg § 1.280A-2(g)(1)*.

(n9)Footnote 339. *Plate v Commr*, TC Memo 1981-310 (1981) ; *Williams v Commr*, TC Memo 1991-567 (1991) ; *Hewett v Commr*, TC Memo 1996-110 (1996) (piano located in open alcove in living room; home office deductions allowed for alcove space based on taxpayer's testimony that the piano was used solely for teaching and practicing).

(n10)Footnote 340. See *Hewett v Commr*, TC Memo 1996-110 (1996) ; *Egner v Commr*, TC Memo 1984-473 (1984) ; *Plate v Commr*, TC Memo 1981-310 (1981) ; *Fingar v Commr*, TC Memo 1997-557 (1997) , *affd* 99-1 USTC P 50,392 (11th Cir 1999) (home office deduction denied to attorney for alleged home office located in the unpartitioned dining area between the living room and the kitchen); *Hefti v Commr*, TC Memo 1988-22 (1988), *affd without published opinion* 894 F2d 1340 (8th Cir 1989), *cert denied* 495 US 933 (1990).

(n11)Footnote 341. See *Gomez v Commr*, TC Memo 1980-565 (1980) (alleged office also contained living room furniture).

(n12)Footnote 342. See *Curphey v Commr*, 73 TC 766 (1980) (room contained only a desk, bookcase, filing cabinet, phone answering machine, and other items relating to the taxpayer's business); *Thalacker v Commr*, TC Memo 1984-488 (1984) (deduction allowed for a room containing only darkroom photography business items).

(n13)Footnote 343. See *Shaller v Commr*, TC Memo 1984-584 (1984) ; *Khinda v Commr*, TC Memo 1984-432 (1984) ; *Khinda v Commr*, TC Memo 1982-42 (1982) .

(n14)Footnote 344. *Sengpiehl v Commr, TC Memo 1998-23 (1998)* .

(n15)Footnote 345. *Sengpiehl v Commr, TC Memo 1998-23 (1998)* ; *Fingar v Commr, TC Memo 1997-557* , *affd in unpublished opinion 99-1 USTC P 50,392 (11th Cir 1999)*; *Baie v Commr, 74 TC 105 (1980)* (home kitchen used to prepare food in food vending business did not satisfy exclusive use requirement).

(n16)Footnote 346. See *IRC § 280A(c)(1)*.

(n17)Footnote 347. *Prop Treas Reg § 1.280A-2(g)(1)*.

(n18)Footnote 348. *Hamacher v Commr, 94 TC 348 (1990)* .

(n19)Footnote 349. *Hamacher v Commr, 94 TC 348 (1990)* ; *Wedemeyer v Commr, TC Memo 1990-324 (1990)* .

(n20)Footnote 350. *IRC § 280A(c)(1)*.

(n21)Footnote 351. *Prop Treas Reg § 1.280A-2(h)*.

(n22)Footnote 352. *Cally v Commr, TC Memo 1983-203 (1983)* (deduction denied because doctor with practice elsewhere saw patients at home only as needed); *Anderson v Commr, TC Memo 1982-576 (1982)* ; *Borom v Commr, TC Memo 1980-459 (1980)* .

(n23)Footnote 353. See *Cally v Commr, TC Memo 1983-203 (1983)* ; *Woods v Commr, TC Memo 2004-114 (2004)* ; *Irwin v Commr, TC Memo 1996-490 (1996)* ; *Browning v Commr, TC Memo 1988-293 (1988)* ; *Cristo v Commr, TC Memo 1982-514 (1982)* .

(n24)Footnote 354. See *Vaksman v Commissioner, TC Memo 2001-165 (2001)* .

(n25)Footnote 355. *IRC § 280A(c)(2)*; *Prop Treas Reg § 1.280A-2(e)*.

(n26)Footnote 356. See *Garvey v Commr, TC Memo 1982-176 (1982)* (deduction denied for home storage of prescription drugs because taxpayer's pharmacy was located elsewhere); *Barr v Commr, TC Memo 1989-69 (1989)* (deduction denied for storage art prints because the home wasn't the sole fixed location of the taxpayer's art publishing activity. He used a different address on contracts and met with artists elsewhere).

(n27)Footnote 357. *Prop Treas Reg § 1.280A-2(e)*.

(n28)Footnote 358. See *Prop Treas Reg § 1.280A-2(e)*.

(n29)Footnote 359. *Borom v Commr, TC Memo 1980-459 (1980)* ("intermittent" storage insufficient).

(n30)Footnote 360. *Prop Treas Reg § 1.280A-2(h)*.

(n31)Footnote 361. *IRC § 280A(c)(2)*.

(n32)Footnote 362. *Pearson v Commr, TC Memo 1982-295 (1982)* ; *Druker v Commr, 697 F2d 46 (2d Cir 1982)* , *cert denied 461 US 957 (1983)* ; *Banatwala v Commr, TC Memo 1992-483 (1992)* .

(n33)Footnote 363. *Clark-Hernandez v Commr, TC Summary Opinion 2001-15* (equipment and cleaning supplies used in taxpayer's cleaning business did not qualify as inventory or product samples); *Edwards v Commr, TC Memo 2002-169 (2002)* (audio and video equipment used to make films and music was not inventory).

(n34)Footnote 364. *IRC § 280A(c)(4)(A)*.

(n35)Footnote 365. *IRC § 280A(c)(4)(B)*.

(n36)Footnote 366. *Prop Treas Reg § 1.280A-2(f)(2)*.

(n37)Footnote 367. *Uphus v Commr, TC Memo 1994-71 (1994) ; Neilson v Commr, 94 TC 1 (1990)* (taxpayers allowed to consider time spent in clean-up and preparation when determining number of hours day care is operated).

(n38)Footnote 368. See *IRC § 280A(c)(1); Rev Rul 92-3, 1992-1 CB 141* .

(n39)Footnote 369. *IRC § 280A(c)(4)(C)*.

(n40)Footnote 370. *Rev Rul 92-3, 1992-1 CB 141* .

(n41)Footnote 371. *IRC § 280A(c)(5)*. See § 9.21[5], above, for a discussion.

(n42)Footnote 372. See *IRC § 280A(c)(5)*.

(n43)Footnote 373. *Rev Rul 92-3, 1992-1 CB 141* .

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Federal Taxes Affecting Real Estate

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.25

§ 9.25 Trade or Business Requirement

[1] Taxpayer Must Engage in Trade or Business

The business use exceptions under *IRC Section 280A* that qualify for deductions all require a connection with a trade or business of the taxpayer. n374 No trade or business requirement applies for the rental use exception. n375 Any trade or business of the taxpayer may qualify; it need not be a taxpayer's only or even primary trade or business. n376

The Code does not contain a general definition of "trade or business" for general application, however, or a special definition of the term for purposes of *IRC Section 280A*. Courts do offer guidance--a trade or business is present only if the taxpayer is involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity is for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify. n377 In addition, activities undertaken in preparation to enter a trade or business do not qualify as a trade or business. n378

[2] Investing and Trading Activity as a Trade or Business

No deductions are allowed under *IRC Section 280A* for the use of a home in connection with an activity that is merely for the production of income, but which is not a trade or business. Numerous cases involve investors who claim that their management of their personal investments is a trade or business. Cases uniformly hold that that a full-time investor is not engaged in a trade or business no matter how extensive or substantial the investments might be. Therefore, no deductions are allowed under *IRC Section 280A* for an area of the home used to manage those investments. n379 The absence of any suitable office or other place outside the taxpayer's residence in which the taxpayer may manage investments does not change this result. n380

Traders, as opposed to mere investors, *are* considered to be engaged in a trade or business and may qualify for deductions under *IRC Section 280A*. Taxpayers are considered to be traders only if their trading is substantial and they seek to profit from short-term swings in the market. n381 Investors, in contrast, generally seek profit through interest, dividends, and capital appreciation of securities. n382

The difference between a trader and an investor is not always clear, and there is no clear line beyond which a level of activity goes beyond investing and becomes a trade or business of being a trader. In one case, taxpayers were held to be investors, rather than traders, even though they made 326 sales of stock during the year, involving approximately \$9 million worth of stocks or options which had been purchased for approximately \$10 million. In addition, over 62

percent of the sales involved stocks held for less than 31 days. A triggering factor in the court's decision was that most of the activity took place in the first quarter of the year, with virtually no activity in the last quarter. In addition, the taxpayer had substantial income from other activities. Finally, the taxpayer was not a member of any stock exchange nor was he licensed under any state or federal laws as a dealer or sales person of stocks or securities. n383

[3] Ownership and Management of Rental Property as a Trade or Business

The ownership and management of rental properties may constitute a trade or business for purposes of claiming deductions under *IRC Section 280A*. Courts distinguish ownership and management of real property from ownership and management of stocks and securities, and have held that the rental of even a single parcel of real property for the production of income can constitute a trade or business. n384 The management activities connected with the property, however, must be substantial, regular and continuous, or no trade or business will be present. n385

FOOTNOTES:

(n1)Footnote 374. *IRC § 280A(c)(1), (2), (4)*.

(n2)Footnote 375. *IRC § 280A(c)(3)*.

(n3)Footnote 376. *Prop Treas Reg § 1.280A-2(b)(1), (c); Curphey v Commr, 73 TC 766 (1980)* .

(n4)Footnote 377. *Commr v Groetzinger, 480 US 23 (1987)* (full-time gambling held to be a trade or business); *Edwards v Commr, TC Memo 2002-169 (2002)* (physician failed to show that his alleged filmmaking and music writing and selling activities were a trade or business).

(n5)Footnote 378. *Wedemeyer v Commr, TC Memo 1990-324 (1990)* .

(n6)Footnote 379. *Higgins v Commr, 312 US 212 (1941)* ; *Curphey v Commr, 73 TC 766 (1980)* ; *Moller v United States, 721 F2d 810 (Fed Cir 1983)* ; *Kurzet v Commr, TC Memo 1997-54 (1997)* , *affd 2000-2 USTC P 50,671 (10th Cir 2000)*; *Nehus v Commr, TC Memo 1994-631 (1994)* , *affd without published opinion 97-1 USTC P 50,276 (9th Cir 1997)*; *Dougherty v Commr, TC Memo 1994-597 (1994)* ; *Shaller v Commr, TC Memo 1984-584 (1984)* ; see *Rev Rul 86-148, 1986-2 CB 43* .

(n7)Footnote 380. *Kurzet v Commr, TC Memo 1997-54 (1997)* , *affd 2000-2 USTC P 50,671 (10th Cir 2000)*.

(n8)Footnote 381. *Paoli v Commr, TC Memo 1991-351 (1991)* ; *Purvis v Commr, 530 F2d 1332 (1976)* , *affg TC Memo 1974-164 (9th Cir 1976)* ; *King v Commr, 89 TC 445 (1987)* .

(n9)Footnote 382. See *Mayer v Commr, TC Memo 1994-209 (1994)* ; *Shaller v Commr, TC Memo 1984-584 (1984)* ; *Moller v United States, 721 F2d 810 (Fed Cir 1983)* ; *Estate of Yaeger v Commr, 889 F2d 29 (2d Cir 1989)* , *affg in part and revg in part TC Memo 1988-264 (1988)* .

(n10)Footnote 383. *Paoli v Commr, TC Memo 1991-351 (1991)* .

(n11)Footnote 384. *Curphey v Commr, 73 TC 766 (1980)* ; *Fegan v Commr, 71 TC 791 (1979)* , *affd 81-1 USTC P 9436 (10th Cir 1981)*; *Elek v Commr, 30 TC 731 (1958)* , *acq 1958-2 CB 5 (1958)* ; *Lagreide v Commr, 23 TC 508 (1954)* .

(n12)Footnote 385. *Anderson v Commr, TC Memo 1982-576 (1982)* (management of 80-acre farm not a trade or business because day-to-day responsibilities were handled by tenant-farmer, and taxpayer only occasionally paid bills, stored records, and talked to the tenant).

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Federal Taxes Affecting Real Estate

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.26

§ 9.26 Principal Place of Business Requirement

[1] Determining a Taxpayer's Principal Place of Business

If the trade or business requirement and exclusive and regular use requirements are met, n386 deductions are allowed for expenses allocable to a portion of a dwelling unit that is used as the "principal place of business" for any trade or business of the taxpayer. n387 A taxpayer's "principal place of business" is not simply an important or necessary place of business, but rather the "most important, consequential, or influential" one. n388

Although a taxpayer may have more than one trade or business, there may be only one principal place of business for any particular trade or business. A taxpayer with multiple trades or businesses may have a different principal place of business for each one. n389 In a given case, there may not even be a principal place of business for a taxpayer's trade or business. n390

The "principal place of business" requirement is obviously satisfied if all activities in the business are conducted from one location in a home office. If activities in the trade or business are conducted in multiple locations, however, whether the requirement is satisfied is often unclear. Subject to a statutory safe harbor for administrative and management activities conducted out of a home office, n391 a two-part standard applies in determining if a home office is a taxpayer's principal place of business. The standard was set forth in a US Supreme Court decision, *Commissioner v Soliman*. The two considerations taken into account are: n392

1. the relative importance of the activities performed at each business location where business activities are conducted; and
2. the time spent at each business location.

Soliman involved home office deductions claimed by a self-employed anesthesiologist who spent the majority of his time administering anesthesia and post-operative care in several local hospitals. None of the hospitals provided him with an office. He used his home office 10 to 15 hours per week for billing, scheduling appointments, various other paperwork and reading medical literature. Applying the considerations listed above, the U.S. Supreme Court found that the home office was not the taxpayer's principal place of business because the administrative functions performed in the home office were less important than the professional services performed in the hospitals. The Court therefore denied

the claimed home office deductions. n393

COMMENT:

The *Soliman* standard places great importance on whether the nature of the trade or profession requires the taxpayer to meet or confer with a client or patient or to deliver goods or services to a customer. If it does, the place where that contact occurs is likely to be the most important indicator of the principal place of business. n394 Thus, in the case, because the taxpayer provided anesthesiologist services in the hospitals, and because the hospitals had equipment with unique or special characteristics, his home office was not his principal place of business. The Court noted that although the functions performed in the home office may be necessary to the taxpayer's business, this is not a controlling factor, but only one factor to consider in assessing the relative importance of the functions performed at each of the competing locations. The Court also noted that there might be cases when there was no principal place of business, and the courts should not strain to conclude that a home office qualifies for the deduction simply because no other location seems to be the principal place of business. In short, a taxpayer's home office does not become a principal place of business by default. n395 Unless a home office qualifies for the administrative/management activities exception, the *Soliman* standard applies to determine whether a home office is a principal place of business. n396

The IRS has issued a revenue ruling indicating how it applies *Soliman's* "relative importance" and "time" tests. It first applies the "relative importance" test. The comparison of the relative importance of the different activities depends on the characteristics of each business. If the nature of the trade or business requires a taxpayer to meet or confer with clients or patients or to deliver services or goods to customers, the place where that contact occurs is given "great weight" in determining where the most important activities of the business are performed. If the nature of the business requires that its services are rendered or its goods are delivered at a facility with unique or special characteristics, this is a further and weighty consideration that the facility is where the most important activities of the business are undertaken. If the "relative importance" test yields no definitive answer to the principal place of business inquiry (which may occur, for example, if the taxpayer delivers goods or services to customers both at the home office and elsewhere), the IRS looks to the "time" test. The application of the two tests may result in a determination there is no principal place of business. n397

NOTE:

Revenue Ruling 94-24 continues to apply, to the extent not superseded by the later-enacted statutory safe harbor for administrative and management activities. n398 Thus, where administrative or management activities are not performed in the home office, *Soliman's* weighing analysis is still necessary.

Taxpayers in the following post-*Soliman* cases have been allowed home office deductions because their home office was their principal place of business:

- A textile designer whose main activity was designing textiles in her home. n399
- Professional musicians who use a portion of their home office for practicing. The Second and Ninth Circuits stress that much more of a musician's time is spent practicing at home than performing or recording. These courts have noted the necessity of daily practice to a professional musician, and rejected the Tax Court's analysis of a musician's performances to a "delivery of services" in weighing the importance of the activities performed at home and elsewhere. n400
- A band singer/manager who worked in the home office 30 hours per week doing various managerial and administrative activities; the band recorded and edited tapes at the home studio as well. n401
- A professional pianist who also used her home to give piano lessons. n402

The following taxpayers, however, have had home office deductions denied on the grounds that their home office was not their principal place of business:

- An attorney who did some work at home, but saw all clients at a principal office elsewhere. n403
- A minister, who used his home office to prepare for services that were performed elsewhere. n404
- An insurance agent who interviewed customers and made insurance sales outside the home office. n405
- A taxpayer who spent 60 percent of her time outside the home inspecting vintage items for a costume company, and 40 percent at her home office where she maintained a computer and sorted, researched, and labeled the inventory. n406
- An architect who performed most of his drafting activities required by his employment at his home office, but failed to show what activities he performed at the office of his employer and other work sites. The "relative importance" test did not provide an answer, and the taxpayer spent less time in his home office than elsewhere. n407
- A teacher who used a home office for drawing, preparing lessons, developing photographs and storing cameras and equipment. n408

A number of post-*Solimon* cases have denied home office deductions based on a finding that the administrative/managerial duties performed at the home office were less important than duties performed elsewhere, and that the home office was therefore not their principal place of business. These cases would likely be resolved differently under the statutory administrative/management activities exception. n409

[2] Safe Harbor for Administrative and Management Activities Conducted in a Home Office

The result in the *Solimon* case was felt by many to be harsh and unfair because it denied home office deductions to taxpayers who had no place but their home to conduct necessary administrative and managerial duties connected with their trade or business. In response, a statutory safe harbor was enacted. Under it, the "principal place of business" requirement is satisfied, and home office deductions may be permitted, if: n410

- the office is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer; and
- there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of that trade or business.

Thus, a taxpayer can qualify for home office deductions by performing *either* administrative *or* management activities at the home office, as long as the taxpayer conducts *neither* substantial administrative *nor* substantial management activities at another fixed location. n411 The IRS states that "occasional" administrative or management activities may be performed outside the home office without violating the safe harbor. n412

COMMENT:

The statutory safe harbor supersedes and overrules *Soliman's* weighing analysis. If the safe harbor is met, it makes no difference that the most important activities of a taxpayer's trade or business may be performed outside the home. The home office will still qualify as the taxpayer's principal place of

business. The statutory safe harbor also allows home office deductions for the many taxpayers who have no other fixed place of business, but spend most of their working time in a variety of locations outside the home. The availability of wireless internet accessibility, laptops, Blackberries, iPhones, iPads, and other communication devices have made the statutory framework for home office deductions somewhat anachronistic, if not obsolete, for many taxpayers. The safe harbor, however, allows taxpayers whose "office" travels with them to deduct expenses of maintaining a space in the home, provided that administrative or management activities of the trade or business are performed there. n413

Many administrative and management activities will satisfy the statutory safe harbor, and taxpayers should be sure that these functions are performed in the home office, if activities of the trade or business are performed in multiple locations. The IRS lists the following illustrative--but by no means exhaustive--examples of activities that are administrative or managerial in nature: n414

- billing customers, clients, and patients;
- keeping books and records;
- ordering supplies;
- setting up appointments; and
- forwarding orders or writing reports.

In accord with Conference Committee reports accompanying the legislation that enacted the safe harbor, the IRS has also indicated that the following activities will not disqualify a home office as a principal place of business: n415

- Others conduct the taxpayer's administrative or management activities at locations other than the home office. This could occur if another company does the taxpayer's billing from its own separate place of business.
- The taxpayer conducts administrative or management activities at places that are not fixed locations of the taxpayer's business, such as a car, hotel room or airport.
- The taxpayer occasionally conducts minimal administrative or management activities at a fixed location outside the home.
- The taxpayer conducts substantial non-administrative or non-management activities at a fixed location outside the home. This could involve meeting with or providing services to customers, clients, or patients at a fixed location of the taxpayer's business outside the home.
- The taxpayer has suitable space to conduct administrative or management activities outside the home office, but chooses instead to use the home office for those activities.

[3] Principal Place of Business When There Are Two or More Businesses

The determination of a principal place of business that is required when business activities are conducted in a home office and at other locations applies only when single trade or business is involved. No such determination needs to be made when a trade or business that is completely conducted out of the home is separate and distinct from some other trade or business that the taxpayer conducts elsewhere. In that case, the principal place of business for the business conducted out of the home is determined without reference to any separate trade or business of the taxpayer. n416

Whether a "separate" trade or business is present is not always clear; the determination of whether a separate trade or business exists is a question of fact, and depends on the nature of the activities and the duties involved. If the activity conducted out of the home office is closely related to the supposedly distinct and separate trade or business activity conducted elsewhere, the two may be found to be part of the same trade or business. If that occurs, the home office may be found not to be the taxpayer's principal place of business. n417 A taxpayer conducting two or more related businesses should completely segregate the operations of each in order to lessen the possibility of their being treated as a single trade or business. n418

More than one taxpayer may claim home office deductions with respect to a single residence. For example, a husband and wife conducting separate businesses in different parts of a home may each claim home office deductions if statutory requirements are met for each business. n419

FOOTNOTES:

(n1)Footnote 386. See §§ 9.24, 9.25, above, for a discussion.

(n2)Footnote 387. *IRC § 280A(c)(1)(A)*.

(n3)Footnote 388. *Commr v Soliman, 506 US 168 (1993)* .

(n4)Footnote 389. *IRC § 280A(c)(1); Anderson v Commr, TC Memo 1982-576 (1982) ; Green v Commr, 78 TC 428 (1982) ; Baie v Commr, 74 TC 105 (1980) ; Curphey v Commr, 73 TC 766 (1980)* .

(n5)Footnote 390. *Commr v Soliman, 506 US 168 (1993)* .

(n6)Footnote 391. *IRC § 280A(c)(1); see § 9.26[2], below, for a discussion.*

(n7)Footnote 392. *Commr v Soliman, 506 US 168 (1993)* .

(n8)Footnote 393. *Commr v Soliman, 506 US 168 (1993)* .

(n9)Footnote 394. See also *Jackson v Commr, 76 TC 696 (1981)* (real estate sales person denied home office deduction because most contact with customers was at broker's office or open houses).

(n10)Footnote 395. See *Commr v Soliman, 506 US 168 (1993)* .

(n11)Footnote 396. See *IRC § 280A(c)(1); see § 9.26[2], below, for a discussion.*

(n12)Footnote 397. *Rev Rul 94-24, 1994-1 CB 87* .

(n13)Footnote 398. *IRC § 280A(c)(1); see § 9.26[2], below.*

(n14)Footnote 399. *Margolis v Commr, TC Memo 1999-24 (1999) , affd 2000-1 USTC P 50,432 (4th Cir 2000)*.

(n15)Footnote 400. *Popov v Commr, 246 F3d 1190 (9th Cir 2001) , revg TC Memo 1998-374 ; Drucker v Commr, 715 F2d 67 (2d Cir 1983)* (applying prior "focal point" test, court found that home studio was professional musician's principal place of employment).

(n16)Footnote 401. *Genck v Commr, TC Memo 1998-105 (1998)* .

(n17)Footnote 402. *Hewett v Commr, TC Memo 1996-110 (1996)* .

(n18)Footnote 403. *Fingar v Commr, TC Memo 1997-557 (1997) , affd 99-1 USTC P 50,392 (11th Cir 1999)*.

(n19)Footnote 404. *Strohmaier v Commr*, 113 TC 106 (1999) .

(n20)Footnote 405. *Strohmaier v Commr*, 113 TC 106 (1999) .

(n21)Footnote 406. *Giesbrecht v Commr*, TC Memo 1995-118 (1995) .

(n22)Footnote 407. *Tokh v Commr*, TC Memo 2001-45, *affd* 2002-1 USTC P 50,128 (7th Cir 2001).

(n23)Footnote 408. *Bowles v Commr*, TC Memo 1993-222 (1993) .

(n24)Footnote 409. IRC § 280A(c)(1); see § 9.26[2], below, for a discussion.

(n25)Footnote 410. IRC § 280A(c)(1) (flush language), effective for tax years beginning after 12/31/98.

(n26)Footnote 411. IRC § 280A(c)(1).

(n27)Footnote 412. See IRS Publication 587, *Business Use of Your Home*.

(n28)Footnote 413. See IRC § 280A(c)(1); see Fellows and Yuhas, *The Home Office and the Tax Home: Where Are They in the Virtual World of the Wi-Fi Society?*, 86 Taxes 29 (Feb 2006). 86 Taxes 29 (Feb 2006).

(n29)Footnote 414. See IRS Publication 587, *Business Use of Your Home*.

(n30)Footnote 415. See IRS Publication 587, *Business Use of Your Home*.

(n31)Footnote 416. *Curphey v Commr*, 73 TC 766 (1980) .

(n32)Footnote 417. *Chong v Commr*, TC Memo 1996-232 (1996) (Tax Court refused to find that the taxpayer's anesthesiology practice was distinct and separate from the activity of billing and collecting from patients).

(n33)Footnote 418. See *Hoye v Commr*, TC Memo 1990-57 (1990) ; see also *Glenn v Commr*, 62 TC 270 (1974) ; *Eritzian v Commr*, TC Memo 1982-250 (1982) .

(n34)Footnote 419. *Coffman v Commr*, TC Memo 2000-7 (2000) .

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.27

§ 9.27 Home Office Used for Meeting Patients, Clients, or Customers

There is a "home office" exception to the general rule disallowing deductions connected to the taxpayer's residence. Deductions are allowed for any home office that is regularly and exclusively used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of the taxpayer's trade or business. The deduction is allowed whether or not the home office is the taxpayer's principal place of business. n420 The use of the dwelling unit by patients, clients, or customers must be "substantial and integral" to the conduct of the taxpayer's business. If meetings are merely occasional or irregular, the exception is not available. n421

NOTE:

Perhaps the most stringent and unreasonable requirement for home office deductions under this exception is that the patients, clients, or customers must be physically present on the premises. Telephone or other telecommunication contact will not suffice, regardless of how extensive or frequent that contact is. n422 This restriction assures that email and other forms of electronic communication would also not qualify.

The term "patients, clients, and customers" has not been clearly defined. In one case involving an editorial page editor of the *New York Times*, the editor made frequent telephone contact with *New York Times* employees, prominent politicians, community leaders, and others. Although home office deductions were denied because the contact from the home office involved only contact by telephone, the court stated that politicians, labor leaders, and community leaders would qualify as "patients, clients, or customers" under the statute. n423 The term probably does not include partners, co-employees or consultants, however. The term has been interpreted to exclude students. n424

PLANNING GUIDE:

Because of the importance of regular meetings, taxpayers seeking to claim home office deductions under the *IRC Section 280A(c)(1)(B)* exception should, whenever possible, schedule meetings at the home office rather than elsewhere. A taxpayer should also maintain and keep records to establish the frequency and regularity of meetings in the home office. Failure to do so may result in a denial of home office deductions. n425

FOOTNOTES:

(n1)Footnote 420. *IRC § 280A(c)(1)(B)*.

(n2)Footnote 421. *Prop Treas Reg § 1.280A-2(c)*; *Cally v Commr, TC Memo 1983-203 (1983)* (deduction denied for doctor with practice elsewhere who saw patients at home only as need arose); *Crawford v Commr, TC Memo 1993-192 (1993)* ; *Jackson v Commr, 76 TC 696 (1981)* (real estate sales person denied home office deduction because she usually saw customers at an outside broker's office and only seldom in her home office).

(n3)Footnote 422. *Prop Treas Reg § 1.280A-2(c)*; *Frankel v Commr, 82 TC 318 (1984)* ; see *Chong v Commr, TC Memo 1996-232 (1996)* .

(n4)Footnote 423. *Frankel v Commr, 82 TC 318 (1984)* .

(n5)Footnote 424. *Chauls v Commr, TC Memo 1980-471 (1980)* (students of a music teacher at a school who practiced at the teacher's home were not "patients, clients, or customers").

(n6)Footnote 425. *Crawford v Commr, TC Memo 1993-192 (1993)* ; *Cally v Commr, TC Memo 1983-203 (1983)* .

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1-9 Federal Taxes Affecting Real Estate § 9.28

§ 9.28 Home Office Deductions for Separate Structures

One "home office" exception to the general rule disallowing deductions connected with a taxpayer's home applies to separate structures. With respect to a separate structure that is not attached to the dwelling unit used by the taxpayer as a residence, deductions are allowed if the structure is used exclusively on a regular basis "in connection with" the taxpayer's trade or business. There is no requirement that the structure be the taxpayer's principal place of business, nor is it necessary that customers, clients, or patients ever be present. n426

PLANNING GUIDE:

The "in connection with" standard is less stringent than the standards for home office deductions for offices that are inside the dwelling unit. Taxpayers will find therefore it easier to claim home office deductions for offices in non-attached structures. A detached garage or any other building standing away from the house will qualify. There are no restrictions as to the type of free-standing structure that would qualify, other than that it be "appurtenant to, but not attached to" the dwelling unit. An artist's studio, a florist's greenhouse or carpenter's workshop would all qualify. n427

The statute and proposed regulations do not define the term "appurtenant," but in one case, the Tax Court said the term meant directly related to something else, but not an essential part of it or not attached to it. In the case, the court found that an office building was appurtenant to the taxpayer's house because it was only 12 feet from the house and on the same residential lot. Although the court rested its determination primarily on physical proximity, it also mentioned that all of the expenses for the property, taxes, utilities, interest, and insurance, were included in common bills. This close relationship convinced the court that the office building was appurtenant to the house. Deductions related to the office building were therefore subject to *IRC Section 280A*. It did not matter that the taxpayer later obtained a different address for the office building. n428 A carport attached to a home is not a separate structure. n429

FOOTNOTES:

(n1)Footnote 426. *IRC § 280A(c)(1)(C)*.

(n2)Footnote 427. *Prop Treas Reg § 1.280A-2(d)*. See *Scott v Commr*, 84 TC 683 (1985) , *acq* 1987-2 CB 1 (1987)

(n3)Footnote 428. *Scott v Commr*, 84 TC 683 (1985) , *acq* 1987-2 CB 1 (1987) .

(n4)Footnote 429. *Borom v Commr, TC Memo 1980-459 (1980)* .

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1-9 Federal Taxes Affecting Real Estate § 9.29

§ 9.29 Use of Home Office by Employee for the Convenience of the Employer

[1] Qualifying Employee Use of Home Must Be for Convenience of Employer

An employee may be entitled to home office deductions under any of the business use exceptions only if the exclusive use of the home office is for the convenience of the employer. n430 Neither the statute nor the proposed regulations, however, provide any guidance as to when an office will be considered used for the convenience of the employer. n431

Cases have clarified when a home office is used for the convenience of the employer as follows:

- where the employee is required to maintain the office as a condition of employment; n432
- when the home office is necessary for the functioning of the employer's business; n433
- when the home office is necessary to allow the employee to perform duties properly. n434 or

A deduction is not allowed when an employee maintains the home office purely for his or her convenience, comfort, or economy. n435 That a home office may be appropriate or helpful to the employer does not automatically establish that the home office is maintained for the convenience of the employer. n436

NOTE:

The "convenience of the employer" standard of the statute is deceptively strict. n437 The phrase was added in 1976 in response to earlier Tax Court cases that had allowed home office deductions for employee home offices that were "appropriate and helpful" to the employer. n438 The absence of any clarification in the proposed regulations creates a mine field of sorts for employees hoping to deduct home office expenses. Court cases seeking to clarify the standard focus on the employer's needs and the employee's function within the employer's organization, but it is not at all clear how the employer's needs and the employee's position within the company are to be measured. In an audit, the employer's input would be important, especially regarding the specific functions that the employee must perform and how those functions are facilitated by a home office. For many situations, there is a colorable claim that an employee's home office assists the employer through efficient conduct of the employer's business, but whether the home office is "necessary" so as to meet the standard for convenience of the employer is a judgment call that may be contested by the IRS Whether the employer provides suitable office space is a

relevant factor, but the fact that an employer provides inadequate office facilities is not dispositive of whether a home office is for the convenience of the employer. n439 Especially in situations where offices provided by an employer are shared, are not private, or are unsafe, an argument can be made that a home office, by sparing an employer the cost of providing a suitable private office, thereby is for the convenience of the employer. Any facts offered by a taxpayer that would demonstrate why a private space is necessary to successfully perform job duties would be helpful. n440 Nevertheless, cases have found that the "convenience of the employer" standard is not met even when there is a strong showing of bad working conditions at the employer's office--typically at a college or school. That the provided office is small, crowded and noisy, or that the level of security for both property and personal safety is deplorable will not necessarily support a finding that a home office is for the convenience of the employer. n441

If an employer requires a home office, the convenience of the employer standard would seem to be automatically met. The IRS might question a manufactured employer "requirement" to maintain a home office that was requested by an employee. But if the employee were to make a request to an employer that a home office is required, and the employer wrote a letter imposing a home office requirement, or amended the employment contract to impose it, the IRS would likely find the standard to be met. Any requirement that the employee be available at the home office during specified hours should also be documented. Employees not infrequently are allowed to work from home one or two days a week, rather than commute to the employer's office. To the extent any employment arrangement allows this type of flexibility, home office deductions are more likely to be allowed if the home office requirement is structured as a condition of employment. n442 Of course, the employee would still need to meet exclusive use and other requirements of *IRC Section 280A* in order to deduct home office expenses.

[2] Treatment of Rental by Employee to Employer

A special statutory disallowance rule disallows any deductions otherwise allowable under *IRC Section 280A* that are attributable to the rental of a dwelling unit (or a portion of it) by a taxpayer to an employer during any period in which the taxpayer uses the dwelling unit or a portion of it in performing services as an employee for the employer. n443 The disallowance applies both to deductions related for exclusive home office use by the employee n444 and to deductions attributable to rental use of the dwelling unit. n445 The provision was added to overturn a Tax Court decision that allowed a taxpayer to claim offsetting rental expenses under *IRC Section 280A(c)(3)* against an above-market rental payment from the taxpayer's corporation to maintain an office (and related garage space) in his home. The taxpayer could not have claimed business expenses relating to its use because space rented did not meet the requirements for home office deductions under *IRC Section 280A(c)(1)*. n446

The IRS has explained the statutory rule in a technical assistance memorandum involving an S corporation of which the taxpayer was the sole shareholder and sole employee. The taxpayer rented a portion of his home to his S corporation for a reasonable rent. During the period of rental, the taxpayer used the rented portion in performing services as an employee. The taxpayer also used the dwelling unit as a principal residence. The IRS ruled that the taxpayer could not deduct business expenses related to the rental. The taxpayer could deduct home mortgage interest, real property taxes, and personal casualty losses to the extent permitted by other statutory provisions, n447 but could not deduct otherwise allowable trade or business expenses, n448 business casualty losses, n449 or depreciation n450 to the extent those expenses and losses were attributable to the use by the employee of the dwelling unit in performing services for the employer. n451

[3] Itemized Deduction Restriction for Employees

Employees may deduct home office expenses if they meet the "convenience of the employer" standard, as noted in § 9.29[1], above. n452 Any employee home office deductions, however, must be deducted as miscellaneous itemized

deductions on Schedule A. As such, they are deductible only to the extent that they, along with other specified deductions, exceed two percent of the taxpayer's adjusted gross income. n453 Furthermore, for taxable years beginning before January 1, 2010, n454 they, along with other itemized deductions, are subject to phase-out if the taxpayer's adjusted gross income exceeds specified amounts. n455

FOOTNOTES:

(n1)Footnote 430. *IRC § 280A(c)(1)* (flush language).

(n2)Footnote 431. See *Prop Treas Reg § 1.280A-2(g)(2)*.

(n3)Footnote 432. *Hamacher v Commr*, 94 TC 348 (1990) ; *Green v Commr*, 78 TC 428 (1982) , *revd on other grounds* 707 F2d 404 (9th Cir 1983) .

(n4)Footnote 433. *Hamacher v Commr*, 94 TC 348 (1990) ; *Frankel v Commr*, 82 TC 318 (1984) ; *Drucker v Commr*, 715 F2d 67 (2d Cir 1983) , *revg* 79 TC 605 (1982) (home practice area used by professional musician was for convenience of the employer); *Mathes v Commr*, TC Memo 1990-483 (1990) .

(n5)Footnote 434. *Hamacher v Commr*, 94 TC 348 (1990) ; *Frankel v Commr*, 82 TC 318 (1984) ; *Drucker v Commr*, 715 F2d 67 (2d Cir 1983) , *revg* 79 TC 605 (1982) ; *Mathes v Commr*, TC Memo 1990-483 (1990) .

(n6)Footnote 435. *Bernard v United States*, 11 Cl Ct 437 (1986) (convenience of employer standard not met when employee maintained a home office only because it was comparatively quiet); *Bodzin v Commr*, 509 F2d 679 (4th Cir 1975) , *cert denied* 423 US 825 (1975) (employer maintained an office for him, but the taxpayer found it more pleasant and convenient to work at home).

(n7)Footnote 436. *Hamacher v Commr*, 94 TC 348 (1990) (actor/acting school administrator not allowed home office deductions in part because employer provided an office and was not even aware of the home office); *Sharon v Commr*, 66 TC 515 (1976) *affd* 591 F2d 1273 (9th Cir 1978) ; *Coppin v Commr*, TC Memo 2009-221 (2009) (mere "implied consent" of employer was not sufficient).

(n8)Footnote 437. See *IRC § 280A(c)(1)*.

(n9)Footnote 438. See *Green v Commr*, 707 F2d 404 (9th Cir 1983) .

(n10)Footnote 439. *Christine v Commissioner*, TC Memo 2010-144 (employer newspaper provided far fewer desks and chairs than there were writers; taxpayer who wrote articles from home at times still denied home office deduction); see *Dudley v Commr*, TC Memo 1987-607 (1987) , *affd without publ opinion* 860 F2d 1078 (6th Cir 1988) (no home office deduction allowed to professor; he used home office only for teaching-related activities, and was not required to do research and writing unrelated to teaching).

(n11)Footnote 440. *Weissman v Commr*, 751 F2d 512 (2d Cir 1984) *revg* TC Memo 1983-724 (1983) (home office deduction allowed to professor who used home office to conduct research and writing apart from teaching because no proper space was provided on campus for research).

(n12)Footnote 441. *Weightman v Commr*, TC Memo 1982-674 (1982) .

(n13)Footnote 442. See *Hamacher v Commr*, 94 TC 348 (1990) .

(n14)Footnote 443. *IRC § 280A(c)(6)*.

(n15)Footnote 444. See *IRC § 280A(C)(1)(A), (B), (C)*.

(n16)Footnote 445. *IRC § 280A(c)(6)*; see *IRC § 280A(c)(3)*. *Roy v Commr*, TC Memo 1998-125 (1998) (rental of

property on which his home was located to employer S corporation).

(n17)Footnote 446. See *Feldman v Commr*, 84 TC 1 (1985) , *affd* 791 F2d 781 (9th Cir 1986) .

(n18)Footnote 447. See IRC §§ 163(h)(3), 164(a)(1), 165(c)(3), (h).

(n19)Footnote 448. See IRC § 162.

(n20)Footnote 449. See IRC § 165(c)(1).

(n21)Footnote 450. See IRC §§ 167, 168.

(n22)Footnote 451. CCA 200121070 ; IRC § 280A(c)(6).

(n23)Footnote 452. IRC § 280A(c)(1) (flush language).

(n24)Footnote 453. IRC § 67(a).

(n25)Footnote 454. See IRC § 68(g).

(n26)Footnote 455. IRC § 68(a).

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.30

§ 9.30 Rental Use of Residence

[1] Deductions Allowed for Rental Use of Residence

An exception to the general disallowance rule of *IRC Section 280A* allows taxpayers to deduct items that are attributable to the rental of the dwelling unit or a portion of it. n456 The manner and extent to which *IRC Section 280A* applies in a given rental situation depends on the amount of use made of the rental property by the taxpayer:

- If the taxpayer does not use the property for personal purposes at all, *IRC Section 280A* will not apply to restrict the deductions related to the rental. n457
- If the taxpayer makes personal use of the property for at least a single day during the taxable year, but not enough to constitute use of the property as a residence (i.e. the taxpayer's use does not exceed the greater of 14 days or 10 percent of the days the unit is rented at a fair rental), n458 then an attribution of rental expenses between rental use periods and other periods must be done in accordance with *IRC Section 280A(e)*. The gross income limitation, however, does not apply. n459
- If the taxpayer's personal use of the property constitutes use of the property as a residence, n460 then an attribution of rental expenses between rental use periods and other periods must be done in accordance with *IRC Section 280A(e)*. Often, an additional allocation of expenses will be necessary between rental use/personal use, as when a taxpayers rent part of their home to tenants who share part of the taxpayers' own living space. n461 In addition, any deductions related to the rental of the property are subject to the gross income limitation of *IRC Section 280A(c)(5)*.

[2] Determining Expenses Attributable to Rental

The amount of rental expenses that is deductible under the rental use exception is determined after applying the attribution rule for those expenses under *IRC Section 280A(e)*. n462 The attribution of expenses attributable to rental must be done for any year in which the taxpayer n463 makes use of a dwelling unit for personal purposes *on any day during the taxable year*. A single day of personal use will therefore trigger the attribution rule for rental expenses, even if the taxpayer's use does not constitute use of the dwelling unit as a residence under the 14 day/10 percent of the days the unit is rented at a fair rental rule. n464

NOTE:

If the taxpayer uses the dwelling unit for a single day, but does not make personal use of the unit that constitutes use as a residence, n465 only part of *IRC Section 280A* applies. In that case, *IRC Section 280A(e)* comes into play, and an attribution of expenses between rental and personal use based on the periods of rental use must be made (in the manner discussed immediately below). Because there is no personal use of the dwelling by the taxpayer as a residence, however, the gross income limitation does not limit the deductions attributable to the rental activity. n466 Therefore, a taxpayer may be able to claim a loss from the rental during the year if attributable rental expenses exceed rental income. In contrast, if the taxpayer's personal use of the dwelling unit constitutes use of the unit as a residence, n467 the gross income limitation does limit the amount of attributable rental expenses that can be deducted. n468

Under the attribution rule, the amount of deductible expenses attributable to the rental of the unit cannot exceed the amount of those expenses multiplied by a fraction. The numerator of the fraction is the number of days during the year that the unit or portion of it is rented at a fair rental, and the denominator is the total number of days during the year that the unit or portion of it is used for any purpose during the year. n469 That a unit may be used for personal purposes by the taxpayer on a particular day does not prevent that day from being counted as a day on which the unit is rented for fair rental. Days on which the principal use of the unit is the making of repairs or maintenance work are disregarded in both the numerator and denominator of the fraction. n470 The attribution rule does not apply to deductions that would be otherwise deductible whether or not the unit was rented, such as mortgage interest and property taxes. n471

NOTE:

One might think that the "total number of days during the year that the unit or portion of it is used for any purpose during the year" in the denominator would include all 365 days of the year, but that is not the case, at least for maintenance-type expenditures related to rental of the unit. Only days in which the unit is rented at fair rental or actually used by the taxpayer are taken into account in determining the amount of deductible expenditures, at least with respect to maintenance expenditures. Days in which the unit is idle and not used by anyone, and days the unit is used for repair and maintenance are not included for purposes of determining the percentage of maintenance expenses that are deductible under attribution fraction. n472

However, for mortgage interest and real property taxes, which accrue ratably over the entire year, the allocation to rental use is determined according to the ratio of the number of days a unit is rented over the total number of days in the entire year--i.e. 365 days. n473 This is to the taxpayers' benefit. Because interest and taxes on the property are deductible whether or not connected to business use of the property, attributing a smaller of those items to rental use allows taxpayers to claim a larger amount of otherwise non-deductible maintenance expenses related to that rental use.

Example:

S owns a vacation home that is held out for rent for 180 days a year. During the year, it is actually rented out for only 120 days. S is deemed to have made personal use of the home for 15 of those 120 days. The unit is used for one or more purposes (other than repair or maintenance) on 160 days during the taxable year. The amount that S may claim as repairs, maintenance, and similar rental expenses may not exceed 120/160 of the total expenses paid or incurred with respect to the unit during the year. As for mortgage interest and real property taxes, which are deductible without regard to the rental use of the unit, 120/365 of those items are attributable to rental use of the vacation home. If S itemizes deductions, S may deduct the remaining 245/365 of those items on a Schedule A. n474

[3] Time-Sharing Arrangements**[a] Time-Sharing Generally Treated as Personal Use**

A time-sharing arrangement is any arrangement whereby two or more persons with interests in a dwelling unit agree to exercise control over the unit for different periods during the taxable year. It doesn't matter whether the co-owners have undivided interests in the unit for the entire year, or each has the sole interest in the unit for a stated length of time during the year. n475

Each person with an interest in dwelling unit subject to a time-sharing arrangement is treated as making personal use of the unit during any period the unit is used by another owner of a time-share interest in the unit. n476 This result comes about because each person with an interest in a unit subject to a time-sharing arrangement is considered to have a continuing interest in the unit, regardless of the terms of the interest under local law. n477 Because the interest is a continuing one, the general attribution of use between co-owners applies throughout the year with respect to all the owners with an interest in the unit. n478 Therefore, if the time-share owners as a group use the dwelling unit for the greater of 14 days or 10 percent of the total days it is rented to others at a fair rental price, then each of the owners of a time-share interest in the unit is treated as using the unit as a residence during the year. n479

[b] Allocation Under Time-Sharing Arrangements

If a person with an interest in a dwelling unit under a time-sharing arrangement makes personal use of the unit during any day of the year, n480 then an allocation of expenses must be made in accordance with *IRC Section 280A*, based on the taxpayer's expenses for the unit, the number of days the unit is rented at a fair rental, and the number of days during the taxable year that the unit is used for other purposes. n481 The gross income limitation on deductions n482 is applied on the basis of the taxpayer's rental income and expenses with respect to the unit. n483

[4] Rental Pools

[a] "Rental Pool" Defined

A *rental pool* is an arrangement under which multiple dwelling units are made available for rental, and persons with interests in the units agree to share at least a substantial part of the rental income from the units without regard to actual use of the various units. That an occupancy fee or other payment may be made for actual use of a unit does not prevent the arrangement from constituting a rental pool if the percentage of the rental income in which the participants in the arrangement share is substantial. n484 Rental pools typically allow the taxpayer use of a unit for a specified period. For other times, the unit is made available for rent to third parties. Rental pools typically guarantee some rental payment for a dwelling unit even when a unit is not rented, and a greater payment when the unit is rented. n485 A rental pool can also involve a fixed rent regardless of whether a unit is ever rented to any third parties. n486

Proposed regulations dealing with rental pools provide a definition, include rules for determining personal use of a taxpayer of a unit in a rental pool, and provide an election to average rental use. n487

[b] Personal Use Under Rental Pools

The key issue dealing with personal use with respect to rental pool units comes into play with respect to the second prong of the test for determining whether a dwelling unit is used as a residence, so as to trigger the restrictions of *IRC Section 280A*--i.e. does the taxpayer make personal use of the unit for more than 10 percent of the days the unit is rented to others at a fair rental price? n488

A taxpayer's own use of his own unit in a rental pool generally constitutes personal use under *IRC Section 280A*, for purposes of determining whether the taxpayer uses the unit as a residence. n489 Some rental pools have reciprocal use arrangements under which a participant whose unit is rented may use another unit in the pool on that day. Any use of a taxpayer's unit by another participant in the pool under such an arrangement is treated as personal use of the unit by the taxpayer for that day. n490

Unless a taxpayer elects to average rental use, n491 then for purposes determining the use of the unit as a residence and allocation of items to different uses, the number of days on which the unit is rented at fair rental and the number of days on which the unit is used for any purpose is determined according to actual use of the unit. n492 Availability of a unit for rental through a rental pool on a day does not ordinarily constitute rental at a fair rental for that day, or use of the unit for any purpose. The unit must actually be rented. If the unit is so rented, the day counts as a day of rental at fair rental even if the taxpayer receives only a portion of the rent paid. n493

One case, however, has carved an exception under which a unit in a rental pool may be treated as being rented at a fair rental on any day it is available for rent in the pool, even if the unit is not rented. The case involved a rental pool arrangement in which the managing association paid a guaranteed fixed rent under a lease agreement, regardless of whether the taxpayer's particular unit was rented out or not. The court found this to constitute a fair rental for each day during the entire period the unit was in the pool, including days the unit was not actually rented. The court was persuaded both by the amount of rent paid (an amount comparable to fair market rate on an annual basis for other properties) and the relatively long length of time the lease covered (30 months). In addition, the amount negotiated under the lease was based on the amount the managing association felt would be generated from the taxpayer's specific unit, rather than on an average profit that would be derived from all units in the rental pool. (The taxpayer was also entitled to additional rent if the total rent received from the unit exceeded a specified amount, but this event never occurred. The rental rate for other units in the pool did not affect the amount the taxpayer would receive.) n494 The court distinguished two other cases, which involved pooling agreements that guaranteed some payment when the units were not rented, but a greater payment when the units were rented. n495

COMMENT:

The end result in *Razavi* was that the taxpayer was not treated as using the unit in the rental pool as a residence for the year. This was because of the larger number of days the unit was found to be held for fair rental--which increased the number of days under the "10 percent test" that the taxpayer could make personal use of the unit without having it be treated as use of the unit as a residence. Therefore, the restrictions of *IRC Section 280A* were not triggered. n496

[c] Election to Average Rental Use

A taxpayer with a unit in a rental pool may elect to average rental use. If the election is made, the number of fair rental use days a unit has is determined by an averaging formula. n497 The election may be made only as follows:

- the taxpayer must sign and furnish to the pool management a document stating that the taxpayer irrevocably consents to the averaging of rental use for the pool season;
- all pool participants must unanimously consent to the averaging of rental use for the season; and
- the pool management must send to the taxpayer a written notice stating that participants have given unanimous consent in electing average rental use. The notice must also provide the taxpayer with information necessary to comply with the average rental use election regulations.

NOTE:

A consent may apply for more than one pool season. In the event there is not unanimous consent, or if the pool management fails to provide the required notice, the IRS may require all participants to determine the use of the units according to their actual use. n498

If the election is made, all taxpayers with units in the pool must determine the number of days that a unit is rented at fair rental during its participation in the rental pool during the pool season in accordance with a formula. Use of the unit on

days other than participation days and all use of the unit other than use at fair rental is determined according to actual use of the unit. n499 Under the averaging formula, the number of days that a unit in the rental pool is treated as rented at fair rental is determined by (1) dividing the number of days the unit participates in the pool by the aggregate number of participation days of all units, and (2) multiplying this figure by the number of days all units in the pool are rented at fair rental. n500

Example:

Peggy has a dwelling unit in rental pool all the units in which have elected to average rental use. Peggy's unit participates in the pool for 80 days, and the aggregate number of participation days of all units in the electing pool is 480. The units in the participating pool are rented at a fair rental for a total of 300 days.

Peggy's unit is treated as rented at a fair rental for a total of 50 days, determined as follows: n501

$$80/480 \times 300 = 50 \text{ days}$$

If a single pool season for which an average rental use election has been made overlaps two taxable years, the number of days of fair rental allocated to a unit must be allocated between the years according to the number of days in each year that the unit participates in the pool divided by the total number of participation days during the pool season. n502

[d] Gross Rental Income from Rental Pools

A taxpayer participating in rental pool may have gross rental income even if the taxpayer's particular unit is not actually rented. The rental income would include all amounts received or accrued by reason of participation in the pool (including payments such as occupancy fees). Amounts that are clearly not rental income need not be included; this would include items such as interest earned on deposits held in escrow on behalf of rental pool participants. n503

[5] Rental of Less Than 15 Days

If a dwelling unit used by a taxpayer as a residence during a taxable year, and it is actually rented for less than 15 days during that year, then (1) no deduction otherwise allowable because of the rental is allowed, and (2) any rental income is not included in gross income. This rule applies notwithstanding any other provisions in *IRC Section 280A*, or the for-profit rules of *IRC Section 183*. n504 There is no requirement in this provision that a fair rental be charged. Therefore, a below-market rental of a residence for more than 15 or more days in the year will prevent this exception from applying. n505

FOOTNOTES:

(n1)Footnote 456. *IRC § 280A(c)(3)*.

(n2)Footnote 457. *IRC § 280A(a)*.

(n3)Footnote 458. See *IRC § 280A(d)(1)*; see § 9.23, above, for a discussion.

(n4)Footnote 459. *IRC § 280A(c)(5)*.

(n5)Footnote 460. See *IRC § 280A(d)(1)*; see § 9.23, above, for a discussion.

(n6)Footnote 461. *Prop Treas Reg § 1.280A-2(i)(3)*; see § 9.21[4], above, for a discussion.

(n7)Footnote 462. *IRC § 280A(c)(3)*.

(n8)Footnote 463. Taxpayers subject to this rule include S corporations and individuals.

(n9)Footnote 464. *IRC § 280A(e)(1)*; see *IRC § 280A(d)(1)*.

(n10)Footnote 465. See *IRC § 280A(d)(1)*.

(n11)Footnote 466. See *IRC § 280A(c)(5)*.

(n12)Footnote 467. See *IRC § 280A(d)*; see § 9.23[2], above, for a discussion.

(n13)Footnote 468. *IRC § 280A(c)(5)*.

(n14)Footnote 469. *IRC § 280A(e)(1)*; *Prop Treas Reg § 1.280A-3(c)(1)*. See § 9.23[2][d], above, for a discussion of what constitutes fair rental.

(n15)Footnote 470. *Prop Treas Reg § 1.280A-3(c)(1)*; see *Prop Treas Reg § 1.280A-1(e)(6)* (repairs and maintenance).

(n16)Footnote 471. *IRC § 280A(e)(2)*; see *IRC §§ 163(h), 164(a)(1)*. *Prop Treas Reg § 1.280A-3(c)(3)*.

(n17)Footnote 472. *IRC § 280A(e)(1)*; *Prop Treas Reg § 1.280A-3(c)(1)*. See also *Prop Treas Reg § 1.280A-3(c)(4)* (example excluding days of maintenance and repair).

(n18)Footnote 473. See *IRC § 280A(e)(2)*; *Bolton v Commr*, 77 TC 104 (1981) , *affd* 694 F2d 556 (9th Cir 1982) ; *McKinney v Commissioner*, TC Memo 1981-377 (1981) , *affd* 732 F2d 414 (10th Cir 1983) .

(n19)Footnote 474. *Prop Treas Reg § 1.280A-3(c)(4)*. *Bolton v Commr*, 77 TC 104 (1981) , *affd* 694 F2d 556 (9th Cir 1982) .

(n20)Footnote 475. *Prop Treas Reg § 1.280A-3(f)(2)*.

(n21)Footnote 476. See *Prop Treas Reg §§ 1.280A-1(e)(1)(i), 1.280A-3(f)(1), (3)*.

(n22)Footnote 477. *Prop Treas Reg § 1.280A-3(f)(3)*.

(n23)Footnote 478. See *Prop Treas Reg § 1.280A-1(e)(1)(i)*.

(n24)Footnote 479. See *IRC § 280A(d)(1)*.

(n25)Footnote 480. See *Prop Treas Reg § 1.280A-3(f)(2), (3)*.

(n26)Footnote 481. *Prop Treas Reg § 1.280A-3(f)(5)*.

(n27)Footnote 482. See *Prop Treas Reg § 1.280A-3(d)*.

(n28)Footnote 483. *Prop Treas Reg § 1.280A-3(f)(6)*.

(n29)Footnote 484. *Prop Treas Reg § 1.280A-3(2)(2)*.

(n30)Footnote 485. *Fine v United States*, 647 F2d 763 (7th Cir 1981) ; *Byers v Commr*, 82 TC 919 (1984) .

(n31)Footnote 486. *Razavi v Commr*, 74 F3d 125 (6th Cir 1996) , *revd* TC Memo 1993-624 (1993) .

(n32)Footnote 487. *Prop Treas Reg § 1.280A-3(e)*.

(n33)Footnote 488. See *IRC § 280A(d)(1)*.

(n34)Footnote 489. *IRC § 280A(d)(2)*; see § 9.23[2][a], above.

(n35)Footnote 490. *Prop Treas Reg § 1.280A-3(e)(6)*.

(n36)Footnote 491. See § 9.30[4][c], below.

(n37)Footnote 492. *Prop Treas Reg § 1.280A-3(e)(4)(ii)*.

(n38)Footnote 493. *Prop Treas Reg § 1.280A-3(e)(4)(ii)*. *Fine v United States*, 647 F2d 763 (7th Cir 1981) ; *Byers v Commr*, 82 TC 919 (1984) ; *Buchholz v Commr*, TC Memo 1983-378 (1983) .

(n39)Footnote 494. *Razavi v Commr*, 74 F3d 125 (6th Cir 1996) , *revg TC Memo 1993-624 (1993)* .

(n40)Footnote 495. See *Fine v United States*, 647 F2d 763 (7th Cir 1981) ; *Byers v Commr*, 82 TC 919 (1984) .

(n41)Footnote 496. *Razavi v Commr*, 74 F3d 125 (6th Cir 1996) , *revg TC Memo 1993-624 (1993)* . For a discussion of the *Razavi* case, see Gardner, Randall, and Steward, *Does **Razavi** Provide a Blueprint for Section 280A Rental Agreements?*, 24 J of Real Estate Txn 199 (Winter 1997).

(n42)Footnote 497. *Prop Treas Reg § 1.280A-3(e)(5)*.

(n43)Footnote 498. *Prop Treas Reg § 1.280A-3(e)(5)(i)*.

(n44)Footnote 499. *Prop Treas Reg § 1.280A-3(e)(5)(ii)*.

(n45)Footnote 500. *Prop Treas Reg § 1.280A-3(e)(5)(iii)*.

(n46)Footnote 501. *Prop Treas Reg § 1.280A-3(e)(5)(iii)*.

(n47)Footnote 502. *Prop Treas Reg § 1.280A-3(e)(5)(iv)*.

(n48)Footnote 503. *Prop Treas Reg § 1.280A-3(e)(3)*.

(n49)Footnote 504. *IRC § 280A(g)*.

(n50)Footnote 505. *Roy v Commr*, TC Memo 1998-125 (1998) .

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CHAPTER 9 Personal Residences *

1-9 Federal Taxes Affecting Real Estate § 9.31

§ 9.31 Application of For-Profit Rules to Deductions Under IRC Section 280A

When *IRC Section 280A* applies to a dwelling unit for a taxable year (i.e. the taxpayer uses the dwelling unit as a residence and claims business or rental deductions connected with its use), the "for-profit" or hobby loss rules of *IRC Section 183* generally do not apply to the unit for that year. This rule allows taxpayers who rent out a portion of a dwelling unit to offset rental income with expenses attributable to the rental use of the residence that are otherwise allowable, such as mortgage interest paid. The offset is permitted without regard to profit motive. n506

The taxable year is taken into account for purposes of applying the 5-year profit presumption of *IRC Section 183(d)*, however. n507 Under that presumption, an activity is presumed to be engaged in for profit (so that deductions are allowable and are not limited to the gross income from the property) if gross income exceeds deductions from the activity in any three of five consecutive tax years, unless the IRS proves otherwise. n508

If *IRC Section 280A* does not apply for a taxable year, *IRC Section 183* may limit deductions related to an activity conducted in a dwelling unit if the activity is not engaged in for profit. Deductions in that case are limited to the following: n509

- deductions that would be allowable without regard to whether the activity is engaged in for profit (i.e. qualified mortgage interest and real property taxes); and
- other deductions that would be allowed if the activity were engaged in for profit, but only to the extent that the gross income from the activity exceeds the deductions allowed in paragraph (1).

FOOTNOTES:

(n1)Footnote 506. *IRC § 280A(f)(3)(A)*; *Ruggiero v Commr, TC Memo 1997-423 (1997)* (although there was no profit motive, taxpayers could offset rental income by mortgage interest expenses under *IRC § 280A* because the wife used the house as a residence for four months of the year).

(n2)Footnote 507. *IRC § 280A(f)(3)(B)*; see *IRC § 183(d)*.

(n3)Footnote 508. *IRC § 183(d)*; only two of seven years need show a profit in the case of horse breeding, training, showing, or racing.

(n4)Footnote 509. *IRC § 183(b)*.

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CHAPTER 9 Personal Residences *

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CHAPTER 10 Dealer Versus Investor Status

1-10 Federal Taxes Affecting Real Estate 10.syn

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CHAPTER 10 Dealer Versus Investor Status

1-10 Federal Taxes Affecting Real Estate § 10.01

§ 10.01 Tax Effect of Dealer Versus Investor Status: An Introduction

How a real estate owner is characterized for tax purposes--as a "dealer" or, instead, as an "investor"--has a profound impact on the tax treatment accorded to the real estate he owns. One of the major tax distinctions between dealer and investor status concerns the tax rate to which gains or losses are subject: Gains from sales of real property by a dealer are usually subject to ordinary income rates, while gains realized by an investor are usually eligible for preferential capital gains rates. With losses, a dealer is typically permitted a deduction for the full amount of the loss, while an investor may have the deductibility of any capital loss limited by *IRC Section 1211*.

Another area where the dealer/investor distinction is important is depreciation. Dealers usually cannot depreciate property they hold for sale to customers, while investors can take deductions for depreciable property.

Dealers generally cannot use the installment method to report their property dispositions and cannot use the like-kind exchange rules under *IRC Section 1031* to defer gains on the property they hold primarily for sale. In addition, dealers and investors are afforded different treatment for their sale expenses, such as commissions, legal fees, advertising, etc. A dealer treats these expenses as ordinary business deductions, while an investor treats them as a reduction of the sale proceeds.

For all these reasons, a taxpayer's characterization as a dealer or investor has significant tax ramifications. Unfortunately, the law provides few "bright line" tests to help taxpayers determine which category they fall into. As the following discussion shows, this makes it difficult to predict how the Service or the courts will treat a particular taxpayer.



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CHAPTER 10 Dealer Versus Investor Status

1-10 Federal Taxes Affecting Real Estate § 10.02

§ 10.02 Statutory Underpinnings

[1] In General

When a taxpayer sells real estate, he will typically want capital treatment if the sale produces a gain or ordinary income treatment if the disposition produces a loss. The first place to look to determine the taxpayer's chances of success is *IRC Section 1221*, which defines the term "capital asset."

Paragraph (a)(1) of that section says that the term excludes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." If a taxpayer's sale falls into this category, his gain or loss will not be capital. ⁿ¹ Moreover, the transaction will not qualify for the special treatment *IRC Section 1231* affords. ⁿ² Only in those relatively rare circumstances where the taxpayer falls within the provisions of *IRC Section 1237* can he hope to get capital gain treatment. (As discussed in *Section 10.05*, below, Section 1237 provides that, under certain circumstances, subdividing real property, coupled with active sales efforts, will not by themselves cause a taxpayer to lose his investor status.)

The statutory phrasing quoted above appears to contemplate three requirements for the exclusion from capital asset status:

- (1) the taxpayer must hold the property primarily for sale to customers,
- (2) in the ordinary course and
- (3) as part of the taxpayer's trade or business.

This analysis suggests that real estate held primarily for sale to customers could, nonetheless, be considered a capital asset (or eligible for Section 1231 treatment) if the sale is *not* in the ordinary course or effected as part of the taxpayer's trade or business. Thus, some taxpayers have argued that they were entitled to capital treatment when they liquidated their real estate holdings, rather than selling them in the ordinary course. Similarly, some taxpayers have argued that a particular sale was not done as part of a trade or business.

Although there are some exceptions, discussed in *Section 10.03[2]* and *[3]*, below, most courts have ignored this

three-pronged analysis and, instead, focused on just the first. n3 If the court determines that a taxpayer holds the property primarily for sale to customers, it takes a "cut to the chase" approach--labeling the seller as a "dealer" rather than an "investor"--and accords the transaction ordinary income treatment. n4

[2] Self-Employment Tax

Only rental income received by an individual in the course of a trade or business as a real estate dealer is included in determining net income from self-employment for purposes of the self-employment tax. n4.1 Other rental income from real estate and from personal property leased with it is not taken into account. Whether an individual is a real estate dealer for purposes of the self-employment tax is determined using the same principles as under the regular income tax. n4.2

FOOTNOTES:

(n1)Footnote 1. *IRC* 1222. See also *IRC* 64.

(n2)Footnote 2. *IRC* 1231(b)(1)(B), which uses the same language as *IRC* 1221(a)(1).

(n3)Footnote 3. For an example of decisions that use this three--pronged analysis, see *Suburban Realty Co v US*, 615 F2d 171 (5th Cir) , *cert den* 449 US 920 (1980) ; also see *Medlin v Commr*, *TC Memo* 2003-224 .

(n4)Footnote 4. It is well-established that a taxpayer can be in more than one trade or business. Thus, a taxpayer can be a real estate dealer, even though he has another trade or business which produces the bulk of his income. See, eg, *Biedenharn Realty Co v US*, 526 F2d 409 , 76-1 USTC P 9194 , 37 AFTR2d 76-679 (5th Cir 1976) , *cert den* 429 US 819 ; *Bynum v Commr*, 46 TC 295 (1966) ; *Ackerman v US*, 335 F2d 521 , 64-2 USTC P 9670 (5th Cir 1964).

(n5)Footnote 4.1. *Treas Reg* § 1.1402(a)-4(a).

(n6)Footnote 4.2. *Treas Reg* § 1.1402(a)-4(a).



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CHAPTER 10 Dealer Versus Investor Status

1-10 Federal Taxes Affecting Real Estate § 10.03

§ 10.03 Distinction Between Dealer and Investor

The distinction between dealer and investor has been a continuing source of litigation. In one case, the court prefaced its opinion by stating:

"This controversy brings before us the 'old, familiar, recurring, vexing and oft-times elusive' problem of whether to treat profit arising out of sales of subdivided real estate as capital gains or ordinary income." n5

Basically, a dealer is anyone who holds property primarily for sale to customers in the ordinary course of a trade or business, n6 such as a builder or developer. In an important tax decision involving a taxpayer holding property for more than one purpose, the Supreme Court said that "primarily" means "of first importance" or "principally." Thus, a taxpayer's principal reason for holding property is the one considered when a court must determine whether the taxpayer is a dealer with respect to the property. n7

An investor is a passive owner of property who holds it for future accretion in value. An investor also may be a person who holds property for its present income-producing potential, such as a landlord.

Although the distinction between dealer and investor appears simple, litigation arises because a taxpayer's status must necessarily be interpreted from his activities in connection with the real estate. Whether the real estate was being held primarily for sale to customers is a question of the taxpayer's intention or motive. Intent, of course, can be determined only by considering the taxpayer's overt acts at the time he purchased the property, during his ownership of it, and at the time of sale.

Further complicating matters are several decisions concluding that a taxpayer can be a dealer with respect to some assets, while an investor with respect to others. n8 Of course, the Service and the courts are inclined to question a dealer's argument that a particular asset was held just for investment--particularly if the real property has appreciated. n9 Nonetheless, taxpayers have sometimes prevailed on this issue. n10

A dealer who wishes to treat some assets as held for investment must, at a minimum, make a clear distinction for those assets in books and records of the various properties held. Failure to segregate investment properties may result in ordinary income treatment on their disposition. n11

Each question of dealer or investor status typically presents its own set of unique circumstances. This makes it difficult for a taxpayer to proceed in this area with any definite degree of assurance about the type of gain being generated, except in the most clear-cut situations. The discussion that follows should, however, help a taxpayer focus on the facts that are most important to the Service and the courts.

[1] Factors to Consider

Repeated litigation in the dealer/investor area has resulted in the development of a list of factors which courts routinely consider to determine a taxpayer's status. These factors, roughly in order of importance, are discussed below. Except in rare situations, a taxpayer will be considered a dealer only if several of these factors point in that direction.

[a] Number and Frequency of Sales

Numerous and frequent sales are the hallmark of a dealer. Thus, this is usually the first, and most significant, n12 factor that a court considers when deciding a taxpayer's status. Although there are some exceptions, n13 numerous sales over an extended period of time make it difficult for a taxpayer to convince a court that he is an investor. n14

On the other hand, infrequent sales favor a finding that the taxpayer is an investor. n15 In fact, the Fifth Circuit n16 and Tax Court n17 have entertained the notion that a taxpayer is automatically entitled to investor status if the taxpayer sells an entire property in a single sale and has not previously been involved in similar sales. The Tax Court has subsequently questioned this notion, concluding that it may not produce the correct result if, for example, the seller subdivides the parcel prior to the bulk sale, or the transaction involves a prearranged sale of a building which the seller has constructed to the purchaser's specifications. n18 Thus, the notion of automatic investor treatment in these circumstances seems limited to the Fifth Circuit.

Taxpayers often assume that there is some set number of transactions which will push them into the dealer category. In fact, the cases indicate this is not so. The Tax Court has held that just one sale in one year was enough for dealer status where the seller, before the property's acquisition, agreed to sell the property to a third party. n19 The Fifth Circuit, on the other hand, has held that a taxpayer was not a dealer when selling 90 homes in one year. n20 And there are many other decisions falling in between, with little consistency from case to case. n21 While this produces little certainty for taxpayers, one fact seems certain: The fewer the taxpayer's sales, the greater his chance of being characterized as an investor.

[b] Extent of Improvements

In many instances, a taxpayer improves property to put it in a salable condition. These enhancements are activities which courts typically associate with dealers, rather than investors. Thus, extensive development activities n22--which may significantly increase a seller's profit--may also significantly increase the likelihood that the taxpayer will be treated as a dealer. n23 This is so even if the taxpayer disposes of the improved and subdivided property in a bulk sale. n24

It is usually clear whether a taxpayer's activities will be treated as improving the real estate he owns. Subdivision, n25 dedication of streets, installation of sewers and utilities, and the like, fall into this category. n26 So does the removal of liens, if doing so makes the property more marketable. n27 Moreover, it makes no difference if the taxpayer makes the improvements without any immediate expectation of selling the property. It is enough that the improvements actually make the property's sale easier. n28

In one case, however, the taxpayers bought a large tract where they built their dream home. They built their home, but later subdivided the rest of the tract into 10 smaller lots. They made significant improvements to develop and sell the

excess lots, but many of these were necessary for the building of their own home, even if the tract had not been divided. For this and other reasons, the court found that the taxpayers were not dealers with respect to the excess lots. n28.1

Development of property is such an important indication of dealer status that some cases state that this factor, together with frequent sales, is usually sufficient for a court to find dealer status. n29 Failure to develop a property, however, does not necessarily prove that a taxpayer holds that property as an investor rather than as a dealer, especially if the taxpayer's business typically involves real estate sales both with and without development. n29.1

[c] Sales Efforts

The courts have routinely considered the activity of the taxpayer and his agents in advertising and otherwise promoting sales in determining whether a taxpayer is a dealer. n30 A taxpayer who engages in extensive marketing efforts is more likely to be considered a dealer than one who takes a passive marketing approach. n31

Whether this approach makes sense is another question. An investor is presumably as interested in maximizing his profit as is a dealer. Thus, extensive marketing efforts would not seem to be inconsistent with a seller's investor status. On the other hand, a taxpayer's casual approach to selling may simply be an indication that his real estate is so desirable that he can wait for sellers to approach him. While some courts have questioned the significance of a taxpayer's marketing activities in determining his tax status, n32 many others treat these activities as an important indication that the taxpayer is a dealer. n33

Sales activities which courts have found noteworthy range from the relatively modest effort of putting up a "for sale" sign, n34 to the more significant effort required to maintain a sales staff and sales office. n35 Advertising is another fact which the courts sometimes consider as indicative of a dealer, n36 unless there is such demand that the seller need not advertise, n37 or the potential buyers are so few that word of mouth is an adequate marketing method. n38

A taxpayer need not personally conduct real estate sales to be a dealer; he may act through agents. Unfortunately, the cases differ on when it is proper to attribute an agent's activities to the principal, for purposes of determining the principal's tax status. Some cases have not attributed an agent's actions when the taxpayer did not supervise or closely control the agent, but reached an opposite result where there has been close supervision of the agent. n39 Other cases hold that the degree of the taxpayer's supervision and control is irrelevant and will always attribute the agent's action to the principal. n40

A few things in this area, however, seem relatively certain. For obvious reasons, the activities of a *purchaser's* broker should not be attributed to the seller for purposes of determining the *seller's* status as a dealer or investor. n41

Perhaps for less obvious reasons, the courts are generally more willing to consider a seller's activities separately from those of his agent when the seller has acquired the real estate by inheritance or devise. n42 As discussed in *Section 10.03[1][e]*, below, courts are usually inclined to treat a taxpayer as an investor when he tries to sell property "thrust upon" him following the death of the prior owner. Allowing this type of seller to use an agent to isolate himself from day-to-day marketing activities may simply be another manifestation of the special tax treatment these taxpayers often receive.

Whatever the rationale for this approach, a person acquiring property from a decedent should seriously consider delegating sales activities to agents if the person wants to be considered an investor. This will be particularly important if the property has experienced significant post-death appreciation. n43

[d] Purpose For Acquiring, Holding and Selling the Property

Sometimes a taxpayer's purpose for acquiring property is the same as his reason for holding and subsequently selling the

property. A person may, for example, purchase a parcel expecting to quickly subdivide it and then sell it piecemeal. Under such circumstances, a court would have little problem concluding that the taxpayer held the property primarily for sale to customers in the ordinary course of his trade or business. n44 Consequently, he would be treated as a dealer.

Similarly, a person with few real estate assets may purchase a small rental property, collect rents for an extended period of time, and then sell the whole property to one purchaser. n45 Here, the taxpayer's behavior indicates an opposite result. n46

Unfortunately, life is typically not so cut and dried. A taxpayer may purchase a lot, holding it as an investment for several years. When he is finally ready to sell the property, he may realize that improving and subdividing it will significantly increase what he can receive for the asset. In deciding the seller's tax status, should it make a difference that his original purpose for acquiring the property was to hold it as an investment? Or should his tax status be based on his purpose at the time of disposition?

Here, as with other investor/dealer issues, the courts have not been consistent. The notion appears to be that the taxpayer's purpose in acquiring the property is of interest, n47 and is properly considered in determining the purpose for which the taxpayer holds the property at the time of sale, n48 but will not carry the day when there has been a change in his purpose. Put another way, most courts give greater weight to the taxpayer's intent or purpose at the time of sale rather than to his purpose when he acquires the property or during the period he holds it. n49 The primary exception to this rule is the case where unanticipated events outside of the taxpayer's control make it impossible for him to continue the property's original use. n50 In one case, a taxpayer had initially acquired lots for development and sale in the ordinary course of business. Litigation relating to the development resulted in the taxpayer's selling 56 lots to another developer. That developer defaulted on the sales contract, and, as part of the settlement, 28 lots were eventually returned to an entity controlled by the taxpayer. Although the entity provided financing and received 96 percent of the sales proceeds, the other developer continued to perform the developing, marketing and sales. The Tax Court held that the proceeds received by the taxpayer's controlled entity from the sale of 28 lots were capital in nature, because the initial plan to develop and sell lots had been abandoned, and its purpose for holding the lots at the time of sale was simply to dispose of them and thus facilitate the settlement with the other developer. n51

An interesting variation on this subject involves a taxpayer who constructs an apartment building, intending to rent the apartments. If he subsequently decides to sell the property, his situation appears to be somewhat different from the person who improves and subdivides undeveloped land: Unlike that person, our taxpayer has done nothing to "carve up" his property, except to build apartments at the beginning of his holding period. If he has been a passive investor with respect to the apartments following their construction, he may have a better chance than the subdivider of being characterized as an investor when he sells the building.

In fact, there is some authority supporting investor status if the taxpayer sells the entire building in a bulk sale, or sells individual units with relatively little marketing. n52 The taxpayer's chances of prevailing on this issue increase the longer the taxpayer holds the rental property prior to sale. n53

[e] Manner in Which Property Was Acquired

Courts frequently consider the manner in which real estate is acquired as relevant to the question of the taxpayer's intent. Acquisition by inheritance or devise, n54 dissolution of a trust, n55 liquidation of a corporation, or by foreclosure of a mortgage n56 tends to favor a finding that the seller is holding the property as an investor.

The courts have often been very liberal in allowing estate beneficiaries to retain their investor status even after they have made significant efforts to improve and market the decedent's real estate. n57 However, an estate beneficiary who sells the decedent's real estate and reinvests the proceeds in other real estate may have a harder time convincing the court that he is merely a passive investor. n58

At least one court has concluded that the donee of a lifetime gift should be treated differently from an estate beneficiary in determining whether the taxpayer is an investor. n59 The event that causes an estate beneficiary to become the real estate's new owner--i.e., the prior owner's death--is not normally something that is motivated by tax planning objectives. The same cannot be said for a lifetime gift. For example, a real estate dealer might make a gift of real estate to her college-student-daughter in the hope that the daughter's investor status might apply to the transferred property--thereby producing a lower tax when the daughter sells the property. In these situations, the donor's activities are likely to be attributed to the donee--particularly if the property is sold shortly after the donee receives it. n60

[f] Holding Period

A typical dealer is interested in turning over his inventory as quickly as possible. An investor, on the other hand, is likely to take a long-term view, hoping that his asset will appreciate over time.

Because of this distinction, courts have considered the length of time a taxpayer holds an asset as some indication of the taxpayer's status as a dealer or investor. A long holding period is, obviously, viewed as buttressing the taxpayer's argument that he is an investor rather than a dealer. n61 A short period points to the taxpayer's being a dealer. n62

A long holding period does not, however, insure investor status. n63 The taxpayer may have been an investor for a lengthy period before substantially improving and extensively marketing subdivided parcels of the property. It is likely, in these circumstances, that a court would conclude that the taxpayer, at the time of sale, is a dealer, notwithstanding the long holding period. n64

[g] Miscellaneous Factors

Courts have considered a variety of other factors in determining a taxpayer's status. They are typically afforded less weight than the factors discussed previously, but, in close cases, they may tip the balance one way or the other.

(1) *Taxpayer's Real Estate Income.* If most of a taxpayer's income over an extended period is from real estate, this increases the likelihood that any particular disposition will be treated as if the property was held for sale to customers. n65 Minimal real estate income, on the other hand, suggests that the taxpayer is an investor, especially if that income is a small percentage of the taxpayer's total income. n66

(2) *Use of the Sale Proceeds.* Dealers need to replace sold inventory with new inventory. If a taxpayer uses the proceeds from the sale of the real estate in question to purchase additional real estate, a court is more likely to conclude that the seller is a dealer, rather than an investor. n67 Taxpayers who retain the proceeds are less likely to be dealers, but will instead be treated as selling a capital asset. n67.1

(3) *Taxpayer's Public Image As Dealer.* A taxpayer who belongs to a real estate dealers' association or who publicizes personal involvement in the real estate business is likely to be treated as a dealer by the courts and the IRS. The nature of the taxpayer's business as shown in press releases, directory listings, and tax returns can be relevant in this regard.

[2] The "Ordinary Course" Requirement

As noted in *Section 10.02, above*, *IRC Section 1221(a)(1)* technically provides three requirements that must be met before property can be excluded from capital asset treatment. The second of these requirements is that the asset be disposed of in the "ordinary course" of his trade or business. If a taxpayer's sales are not in the "ordinary course," the taxpayer may be entitled to have the property treated as a capital asset under *IRC Section 1221* or, more likely, taxed under *IRC Section 1231*.

Most of the cases in this area involve dispositions that the taxpayer attempted to characterize as liquidations, rather than as sales in the ordinary course. In the typical case, the taxpayer has held the property for *investment* purposes. n68 However, he disposes of the property in a way that--without other facts--would normally result in the courts' characterizing him as a dealer.

Just as there are no hard and fast rules for determining whether a taxpayer is an investor or dealer, the reported decisions do not provide clear tests for determining whether a taxpayer has liquidated--rather than sold--his investment. It certainly helps if there is some exigency compelling the sale n69 or if the taxpayer can show that continued ownership is unlikely to be profitable. n70

A taxpayer's activities must, of course, be consistent with a liquidating intent. For example, his case is strengthened if he liquidates his holdings expeditiously, since a lengthy disposition period suggests that the taxpayer has, in fact, become a real estate dealer. n71 His chances of a favorable result are also greater if he makes few, if any, improvements to the property after deciding to sell it, and if he does not reinvest the sale proceeds in real estate. n72

[3] The "Trade or Business" Requirement

The third requirement under *IRC Section 1221(a)(1)* is that the asset be disposed of as part of the taxpayer's "trade or business." If the taxpayer's sales do not rise to the level of a trade or business, the taxpayer may be entitled to have the property treated as a capital asset under *IRC Section 1221* or, more likely, taxed under *IRC Section 1231*.

As a practical matter, this third requirement provides relatively little independent assistance to taxpayers trying to avoid ordinary income treatment. The courts that have deigned to separately consider this third requirement typically determine whether there is a trade or business by using the same tests that they use to determine whether the taxpayer is a dealer. n73 Thus, a taxpayer who is found to be a dealer under the first test described in *Section 10.03[1]*, above, should expect the court to conclude that he is also engaged in a trade or business.

[4] Sale By Bankruptcy Trustee

A sale of real estate by a bankruptcy trustee of a corporation will take the same character it would have had the sale occurred in the ordinary course of the bankruptcy debtor's trade or business. Working with a trustee to liquidate assets does not constitute a new business, so as to automatically give ordinary gain or loss treatment to the sale. Therefore, if real property sales would not be in the ordinary course of the bankruptcy debtor's trade or business, a sale by the bankruptcy trustee will be given capital gain or loss treatment. One court held that this result ensues even if the real property was acquired after the debtor filed for bankruptcy. n73.1

Note:

A possible exception to the automatic carryover characterization from the bankruptcy debtor's trade or business could occur if a trustee is given authority by order of the bankruptcy court to expand or change the nature of the debtor's trade or business in a way that might cause recharacterization of gains or losses from a sale.

FOOTNOTES:

(n1)Footnote 5. *Biedenharn Realty Co v US*, N 4, above.

(n2)Footnote 6. *IRC § 1221(a)(1)*; *Hancock v Commr*, *TC Memo 1999-336* (sale of four lots in two years showed dealer status because 36 lots had been sold in prior 8 years).

(n3)Footnote 7. *Malat v Riddell*, 383 US 569 , 66-1 USTC P 9317 , 17 AFTR2d 604 (1966) . This case generated a

number of articles. See, eg, Bernstein, "Primarily for Sale a Semantic Snare," 20 *Stan L Rev* 1093 (1968); Altman, "Does Malat Signal Trouble Ahead for Real Estate Dealers Seeking Capital Gain?" 26 *J Tax'n* 118 (1967); Note, "Tax Aspects of Property Held Primarily for Sale," 18 *W Res L Rev* 605 (1967).

(n4)Footnote 8. See, eg, *Tollis v Commr*, TC Memo 1993-63, 65 TCM 1951 (1993), *aff'd without published opinion* 46 F3d 1132, 95-1 USTC P 50,076 (6th Cir 1995) (taxpayer/developer's condominiums managed separately from other properties; condominiums deemed investments; other properties deemed sales made in real estate business); *Case v US*, 633 F2d 1240, 80-2 USTC P 9764 (6th Cir 1980); *Pritchett v Commr*, 63 TC 149 (1974), *acq* 1975-1 CB 2; *FH Taylor & Son v Commr*, TC Memo 1973-82, 32 TCM 362 (1973) (dealer was forced to acquire one parcel of land in order to acquire a second; *held*, taxpayer was not a dealer as to the first parcel); *Hoagland v Commr*, TC Memo 1971-310, 30 TCM 1326 (1971) (govt's appeal to 9th Circuit dismissed) (dealer was able to prove that he could not develop his land; *held*, the land was not held primarily for sale to customers in the ordinary course of his business); *Comm'r v Pontchartrain Park Homes*, *aff'd per curiam* 349 F2d 416, 65-2 USTC P 9631, 16 AFTR2d 5535 (5th Cir 1965); *Grimaldi v Commr*, TC Memo 1963-156, 22 TCM 739 (1963).

(n5)Footnote 9. See, eg, *Jarret v Commr*, TC Memo 1993-516, 66 TCM 1224 (1993); *Dunwoody v Commr*, 64 TCM 1556, TC Memo 1992-721 (1992); *Graves v Commr*, 867 F2d 199, 89-1 USTC P 9170 (4th Cir 1989); *Major Realty Corp v Commr*, 749 F2d 1483, 85-1 USTC P 9124 (11th Cir 1985); *Slappey Drive Indus Park v US*, 561 F2d 572, 77-2 USTC P 9696 (5th Cir 1977); *Cousins Properties, Inc v US*, 77-2 USTC P 9508 (Ct Cl 1977).

(n6)Footnote 10. See cases cited in N 8, above, and: *Olstein et al v Commr*, TC Memo 1999-290; *Stevenson v Commr*, TC Memo 1999-280 (real estate broker held two lots for investment); *Fraley v Commr*, TC Memo 1993-304, 66 TCM 100 (1993); *Huey v US*, 504 F2d 1388, 74-2 USTC P 9766 (Ct Cl 1974); *Municipal Bond Corp v Commr*, 341 F2d 683, 65-1 USTC P 9247 (8th Cir 1965); *Mathews v Commr*, 315 F2d 101, 63-1 USTC P 9360 (6th Cir 1963).

(n7)Footnote 11. *Daugherty v Commr*, 78 TC 623 (1982). See also *Tollis v Commr*, N 8, above.

(n8)Footnote 12. See *Graves v Commr*, N 9, above; *Norris v Commr*, TC Memo 1986-151, 51 TCM 852 (1986); *Royster v Commr*, TC Memo 1985-258, 49 TCM 1594 (1985), *aff'd per curiam* 820 F2d 1156, 87-2 USTC P 9398 (11th Cir 1987); *Byram v US*, 705 F2d 1418, 83-1 USTC P 9381 (5th Cir 1983); *Suburban Realty Co v US*, 615 F2d 171 (5th Cir 1980); *Wood, Jr v Commr*, TC Memo 2004-200, *aff'd in unpubl opinion* 2005-1 USTC P 50,434 (11th Cir 2005); *Harris v Commr*, TC Memo 1983-774, 47 TCM 760 (1983); *Biedenharn Realty Co v US*, N 5, above. *Matz v Commr*, TC Memo 1998-334 (taxpayer failed to convince court he was a dealer, and therefore could not claim ordinary losses from sale of real estate).

(n9)Footnote 13. See, eg, *Buono v Commr*, 74 TC 187 (1980), *acq* 1981-1 CB 1 (sales mandated by government entities).

(n10)Footnote 14. See, eg, *Sanders v US*, 740 F2d 886, 84-2 USTC P 9767 (11th Cir 1984); *Jarret v Commr*, TC Memo 1993-516, 66 TCM 1224 (1994) (case involving real estate attorney who sold property); *US v Winthrop*, 417 F2d 905, 69-2 USTC P 9686 (5th Cir 1969); *Gault v Commr*, 332 F2d 94, 64-2 USTC P 9517 (2nd Cir 1964). See also *Suburban Realty Co v US*, N 3, above, an extreme case where the number and frequency of sales factor, by itself, was sufficient to classify the taxpayer as a dealer. Usually, a court will not characterize a taxpayer as a dealer unless there is at least one other factor, in addition to frequent sales, indicating dealer status. See, eg, *Byram v US*, 705 F2d 1418, 83-1 USTC P 9381 (5th Cir 1983); *Goldberg v Commr*, 223 F2d 709, 55-1 USTC P 9519 (5th Cir 1955).

(n11)Footnote 15. See, eg, *Rymer v Commr*, TC Memo 1986-534, 52 TCM 964 (1986); *Adam v Commr*, 60 TC 996 (1973); *Scheuber v Commr*, 371 F2d 996, 67-1 USTC P 9219 (7th Cir 1967); *Cole v Usry*, 294 F2d 426, 61-2 USTC P 9651 (5th Cir 1961); *Smith v Commr*, TC Memo 1961-42, 20 TCM 232 (1961).

(n12)Footnote 16. *Bramblett v Commr*, 960 F2d 526, 92-1 USTC P 50,252 (5th Cir 1992).

(n13)Footnote 17. *Buono v Commr*, N 13, above; *Thomas v Commr*, TC Memo 1981-387, 42 TCM 496 (1981) .

(n14)Footnote 18. *S & H, Inc v Commr*, 78 TC 234 (1982) .

(n15)Footnote 19. *Id.*

(n16)Footnote 20. *Goldberg*, N 14, above.

(n17)Footnote 21. See, eg, *Rice v Commr*, TC Memo 2009-142 (8 lots in 8 years eligible for capital gains); *Ayling v Commr*, 32 TC 704 (1959) (13 lots over four years eligible for capital gains treatment); *Olstein et al v Commr*, TC Memo 1999-290 (sale of 28 developed lots resulted in capital gain); *Harris v Commr*, TC Memo 1983-774, 47 TCM 760 (1983) (taxpayer is dealer when 26 lots were sold over five years); *Brodnax v Commr*, TC Memo 1970-164, 29 TCM 733 (1970) (taxpayer is investor when 28 properties sold over three years); *Jenkins v Commr*, TC Memo 1970-53, 29 TCM 240 (1970) (taxpayer is investor when 10 properties sold in two years); *Sottong v Commr*, TC Memo 1966-268, 25 TCM 1366 (1966) (taxpayer is dealer when 71 properties sold over three years); *Oace v Commr*, 39 TC 743 (1963) (taxpayer is investor when roughly 10 properties sold over five years).

(n18)Footnote 22. To determine the extent of a taxpayer's improvements, some courts look at the actual dollar amount which the taxpayer expends. *Scheuber v Commr*, TC Memo 1961-43, 20 TCM 235 (1961) . Others focus on the expenditures compared to the pre-improvement value of the property. *Kaltreider v Commr*, 255 F2d 833 , 58-2 USTC P 9542 (3rd Cir 1958). At least one court has accepted the notion that improvements to previously-subdivided property do not, by themselves, require a finding that the taxpayer was a dealer. *Dunlap v Oldham Lumber Co*, 178 F2d 781 , 50-1 USTC P 9134 (5th Cir 1950).

(n19)Footnote 23. See, eg, *Jarret v Commr*, TC Memo 1993-516, 66 TCM 1224 (1993) ; *Sanders v US*, N 14, above; *Turner v Commr*, 540 F2d 1249 , 76-2 USTC P 9660 (4th Cir 1976); *Byram v Commr*, N 4, above; *Gault*, N 14, above. See also *Rev Rul 59-91*, 1959-1 CB 15 . But for cases where the taxpayer was found to be an investor, despite substantial improvements, see, eg, *Simpson v Commr*, TC Memo 1962-71, 21 TCM 371 (1962) ; *Ayling v Commr*, 32 TC 704 (1959) , *acq* 1959-2 CB 3 . Many of the cases permitting investor status where the taxpayer has made significant improvements involve taxpayers who acquired their property by inheritance or devise. See 10.03[1][e], below.

(n20)Footnote 24. See, eg, *Lawrie v Commr*, 36 TC 1117 (1961) ; *Engassar v Commr*, 28 TC 1173 (1957) .

(n21)Footnote 25. Just arranging for subdivision may not, by itself, constitute improvement. See *Buono v Commr*, N 13, above. But cf *Rev Rul 57-565*, 1957-2 CB 546 ; *Weil v Commr*, 3 TCM 528 (1944) ; *Chapman v Commr*, 3 TCM 604 (1944) . See also *Ayling v Commr*, 32 TC 704 (1959) , *acq* 1959-2 CB 23 (land-use studies and topographical surveys can be undertaken without causing dealer status) and *Ltr Rul 9331013* .

(n22)Footnote 26. But see *Gangi v Commr*, TC Memo 1987-561, 54 TCM 1048 (1987) (\$100,000 paid for maintenance and cosmetic improvements to convert an apartment building to condominiums does not preclude capital gain treatment).

(n23)Footnote 27. *Miller v Commr*, TC Memo 1962-198, 21 TCM 1070 (1962) , *Brady v Commr*, 25 TC 682 (1955) , *acq* 1956-1 CB 3 .

(n24)Footnote 28. *Van Sickel v Commr*, 55 TCM 407, TC Memo 1988-115 (1988) (in determining whether taxpayer was a dealer, the court considered improvements undertaken to protect the property's zoning, rather than to sell the property).

(n25)Footnote 28.1. *Rice v Commr*, TC Memo 2009-142 .

(n26)Footnote 29. *Biedenharn Realty Co v US*, N 5, above; *Gault*, N 14, above; *Achong v Commr*, 246 F2d 445 ,

57-2 USTC P 9828 (9th Cir 1957)

(n27)Footnote 29.1. See *Medlin v Commr*, TC Memo 2003-224 .

(n28)Footnote 30. See, eg, *Byram v US*, 705 F2d 1418 , 83-1 USTC P 9381 (5th Cir 1983); *Biedenharn Realty Co v US*, N 5, above; *Brodnax v Commr*, TC Memo 1970-164, 29 TCM 733 (1970) ; *US v Winthrop*, N 14, above; *Crosswhite v US*, 369 F2d 989 , 67-1 USTC P 9123 (Ct Cl 1966).

(n29)Footnote 31. *Hancock v Commr*, TC Memo 1999-336 ; *Rice v Commr*, TC Memo 2009-142 (only advertising involved a sign on the property; all lots were sold to friends or by word of mouth); but see *Erfurth v Commr*, TC Memo 1987-232, 53 TCM 767 (1987) (capital gain treatment for bulk sale of advertised and subdivided property when sale made following foreclosure threat).

(n30)Footnote 32. See, eg, *Suburban Realty*, N 3, above; *Jersey Land & Development Corp v US*, 539 F2d 311 , 76-2 USTC P 9587 (3rd Cir 1976); *Thompson v Commr*, 322 F2d 122 , 63-2 USTC P 9676 (5th Cir 1963); *Chandler v US*, 226 F2d 403 , 55-2 USTC P 9740 (7th Cir 1955).

(n31)Footnote 33. See, eg, *Huey v US*, 504 F2d 1388 , 74-2 USTC P 9766 (Ct Cl 1974); *Temple v US*, 355 F2d 67 , 66-1 USTC P 9165 (5th Cir 1966); *Fishback v US*, 215 F Supp 621 , 63-2 USTC P 9555 (DSD 1963).

(n32)Footnote 34. See, eg, *Sottong v Commr*, TC Memo 1966-268, 25 TCM 1366 (1966) .

(n33)Footnote 35. See, eg, *Wood v Commr*, 25 TC 468 (1955) .

(n34)Footnote 36. See, eg, *Galena Oaks Corp v Scofield*, 218 F2d 217 , 55-1 USTC P 9127 (5th Cir 1954).

(n35)Footnote 37. See, eg, *Koch v US*, 457 F2d 230 , 72-1 USTC P 9291 (7th Cir 1972); *Winthrop*, N 14, above; *Nevin v Commr*, TC Memo 1965-53, 24 TCM 294 (1965) ; *Thompson*, N 32, above; *Patrick v Commr*, 275 F2d 437 , 60-1 USTC P 9334 (7th Cir 1960). See also *Daugherty v Commr*, 78 TC 623 (1982) ; *McManus v Commr*, 583 F2d 443 , 78-2 USTC P 9748 (9th Cir 1978) , cert den 440 US 959 (1979); *Juleo, Inc v Commr*, 483 F2d 47, 73-2 USTC P 9529 (3rd Cir), cert den 414 US 1103 (1973); *Stockton Harbor Ind Co v Commr*, 54-2 USTC 9664, 216 F2d 638 (9th Cir 1954) , cert den, 349 US 904 (1955) , indicating that a dealer will still be treated as a dealer when property he is holding for sale to customers is, instead, taken in a condemnation proceeding. But see *Ridgewood Land Co v Commr*, 477 F2d 135 , 73-1 USTC P 9308 (5th Cir 1973), and *Commr v Tri-S Corp*, 400 F2d 862 , 68-2 USTC P 9541 (10th Cir 1968), suggesting that, under these circumstances, a switch to investor status is possible in the Fifth and Tenth Circuits.

(n36)Footnote 38. *Daugherty*, N 37, above; *Mensik v Commr*, TC Memo 1968-8, 27 TCM 28 (1968) , app dismissed (7th Cir, 6/2/69); *Gault*, N 14, above; *Yara Engr Corp v Commr*, TC Memo 1963-283, 22 TCM 1448 (1963) , aff'd per curiam 344 F2d 113 , 65-1 USTC P 9354 (3rd Cir 1965).

(n37)Footnote 39. See, eg, *Sanders v US*, N 14, above; *Williams v US*, 84-1 USTC P 9384 (ND Tex 1983); *Pointer v Commr*, 419 F2d 213 , 70-1 USTC P 9118 (9th Cir 1969); *Voss v US*, 329 F2d 164 , 64-1 USTC P 9290 , 13 AFTR2d 834 (7th Cir 1964) ; *Freberg v Commr*, TC Memo 1964-129, 23 TCM 784 (1964) ; *Est of Walton*, 21 TCM 346, TC Memo 1962-63 (1962) ; *Bauschard v Commr*, 279 F2d 115 , 60-2 USTC P 9533 (6th Cir 1960); *Smith v Dunn* 224 F2d 353 , 55-2 USTC P 9543 , 47 AFTR 1418 (5th Cir 1955) ; *Achong v Commr*, 246 F2d 445 , 57-2 USTC P 9828 , 51 AFTR 899 (9th Cir 1957) . See also TAM 8415002 .

(n38)Footnote 40. See eg, *Brown v Commr*, 143 F2d 468 , 44-2 USTC P 9376 , 32 AFTR 1007 (5th Cir 1944) ; *Hansche v Commr*, 457 F2d 429 , 72-1 USTC P 9304 , 29 AFTR2d 72774 (7th Cir 1972) ; *Yunker v Commr*, 256 F2d 130 , 58-1 USTC P 9487 , 1 AFTR2d 1559 (6th Cir 1958) . The division on this issue is particularly acute in the Fifth Circuit, where several cases have permitted capital gain treatment based, in part, on the taxpayer's use of an agent (*Cole v Usry*, N 15, above; *Gamble v Commr*, 242 F2d 586 , 57-1 USTC P 9516 (5th Cir 1957); *Fahs v Crawford*, 161 F2d

315 , 47-1 USTC P 9233 (5th Cir 1947); *Smith v Dunn*, N 39, above), while other decisions of the same Circuit have cited the taxpayer's failure to use an agent in support of finding the taxpayer entitled to capital gain treatment (*Barrios Est v Commr*, 265 F2d 517 , 59-1 USTC P 9377 (5th Cir 1959); *Alabama Mineral Land Co v Commr*, 250 F2d 870 , 58-1 USTC P 9162 (5th Cir 1957); *Consolidated Naval Stores Co v Fahs*, 227 F2d 923 , 56-1 USTC P 9132 (5th Cir 1955); *Ross v Commr*, 227 F2d 265 , 55-2 USTC P 9773 (5th Cir 1955)).

(n39)Footnote 41. *Williams v US*, 84-1 USTC P 9384 (ND Tex 1983).

(n40)Footnote 42. See, eg, *Est of Mundy v Commr*, 36 TC 703 (1961) , acq 1962-2 CB 5 ; *Yunker v Commr*, N 40, above; *Mackall v US*, 162 F Supp 522 , 57-2 USTC P 9882 (ED Va 1957); *Smith v Dunn*, N 39, above.

(n41)Footnote 43. Any pre-death appreciation would escape taxation because of the basis step-up afforded under IRC 1014.

(n42)Footnote 44. See IRC 1221(a)(1). For cases indicating that a real estate dealer is presumed to acquire real property as inventory, see *Drozda v Commr*, TC Memo 1984-19, 47 TCM 885 (1984) ; *Horton v Commr*, TC Memo 1954-161, 13 TCM 899 (1954) . See also *Walsh v Commr*, TC Memo 1994-293, 67 TCM 3134 (1994) , aff'd 95-2 USTC P 50,398 (8th Cir 1995). A real estate dealer may be able to be an investor with respect to real estate he segregates from his usual inventory, provided he also behaves like an investor with respect to the segregated property. See the cases cited in N 8, above.

(n43)Footnote 45. Property which generates current income, such as rental property, timberland, etc, is more likely to be considered as held for investment than property which does not throw off income. See, eg, *Rouse v Commr*, 39 TC 70 (1962) (rental property); *Bessemer Properties, Inc v Tomlinson*, 1962-1 USTC P 9277, 9 AFTR2d 790 (SD Fla 1962) (rental property); *Goldstein v US*, 1958 US Dist LEXIS 4642, 1958-1 USTC P 9365, 1 AFTR2d 1169 (ED Wash 1958) (rental property) ; *Dunlap v Oldham Lumber Co*, N 22, above (timberland). But see *Johnson v US*, 280 F Supp 412 , 67-2 USTC P 9752 (NDNY 1967), and *Starke v Commr*, 312 F2d 608 , 63-1 USTC P 9199 (9th Cir 1963), for examples of other cases where non-income-producing land was treated as held for investment when the taxpayer was generally passive with respect to the real estate, and did not engage in significant dealer-type activities.

(n44)Footnote 46. Acquiring real estate with the ultimate intention of reselling does not by itself result in a determination that the property was held primarily for sale in the ordinary course of business. See, eg, *Biedenharn Realty Co*, see N 4, above; *Dunlap v Oldham Lumber Co v Commr*, N 22, above; *Howell v Commr*, 57 TC 546 (1972) .

(n45)Footnote 47. See, eg, *Azar Nut Co v Commr*, 931 F2d 314 , 91-1 USTC P 50,257 (5th Cir 1991); *Buono v Commr*, N 13, above; *US v Winthrop*, N 14, above; *Gault v Commr*, N 14, above.

(n46)Footnote 48. *Hancock v Commr*, TC Memo 1999-336 (court noted that taxpayer's corporation had held lots as inventory, which indicated she was a dealer and could claim ordinary loss when she sold them); see *Parkside, Inc v Commr*, 571 F2d 1092 (9th Cir 1977) , rev'g TC Memo 1975-14 .

(n47)Footnote 49. See, eg, *Rice v Commr*, TC Memo 2009-142 (most of large tract bought for dream home was later subdivided; capital gains treatment was allowed); *Sanders v US*, N 14, above; *Biedenharn Realty Co, Inc v US*, N 5, above; *Home Co v Commr*, 212 F2d 637 , 54-1 USTC P 9399 (10th Cir 1954); *Ehrman v Commr*, 120 F2d 607 , 41-2 USTC P 9537 (9th Cir 1941).

(n48)Footnote 50. See, eg, *Erfurth v Commr*, N 31, above; *Cousins Properties, Inc v US*, 77-2 USTC P 9508 (Ct Cl Tr Div 1977); *Huey v Commr*, 504 F2d 1388 , 74-2 USTC P 9766 (Ct Cl 1974); *Oahu Sugar Co v US*, 300 F2d 773 , 62-1 USTC P 9309 (Ct Cl 1962); *Butler v Commr*, TC Memo 1960-218, 19 TCM 1219 (1960) ; *Barrios Est v Commr*, N 40, above. See also *Biedenharn Realty Co, Inc v US*, N 5, above.

(n49)Footnote 51. *Olstein et al v Commr*, TC Memo 1999-290 .

(n50)Footnote 52. See, eg, *Goldberg v Commr*, N 14, above; *Delsing v US*, 186 F2d 59, 51-1 USTC P 9125 (5th Cir 1951); *Victory Housing No 2, Inc v Commr*, 205 F2d 371, 53-1 USTC P 9446 (10th Cir 1953). Extensive marketing efforts increase the likelihood that the seller will be treated as a dealer. See, eg, *Home Co v Commr*, N 49, above; *Rollingwood Corp v Commr*, 190 F2d 263, 51-2 USTC P 9374 (9th Cir 1951); *King v Commr*, 189 F2d 122, 51-1 USTC P 9304 (5th Cir 1951), cert den 342 US 829 (1951). See also *Ferguson v Commr*, TC Memo 1987-257, 53 TCM 864 (1987).

(n51)Footnote 53. See 10.03[1][f], below, which generally discusses the impact of the taxpayer's holding period on his status.

(n52)Footnote 54. See, eg, *Est of Simpson v Commr*, 21 TCM 371, TC Memo 1962-71 (1962); *Est of Walton*, 21 TCM 346, TC Memo 1962-63 (1962); *Est of Mundy v Commr*, 36 TC 703 (1961); *Riedel v Commr*, 261 F2d 371, 58-2 USTC P 9966 (5th Cir 1958); *Camp v Murray*, 226 F2d 931, 55-2 USTC P 9766 (4th Cir 1955). See also *Mackall v US*, 162 F Supp 522, 57-2 USTC P 9882 (ED Va 1957), where the court held that an estate beneficiary was an investor with respect to the property acquired from the decedent, even though the beneficiary had previously engaged in activities as a real estate dealer.

(n53)Footnote 55. *US v Rosebrook*, 318 F2d 316, 63-2 USTC P 9500 (9th Cir 1963).

(n54)Footnote 56. *Cebrian v US*, 181 F Supp 412, 420, 60-1 USTC P 9305 (Ct Cl 1960); *Alabama Mineral Land Co v Commr*, N 40, above.

(n55)Footnote 57. See, eg, *Yunker v Commr*, 256 F2d 130, 58-1 USTC P 9487, 1 AFTR2d 1559 (6th Cir 1958), and the cases cited in N 52, above. Use of an agent to sell the property may help the taxpayer's case, if he is interested in being treated as an investor. See the cases mentioned in N 42, above. For examples of situations where a court found that the taxpayer was a dealer, even though he acquired the property as an estate beneficiary, see *US v Winthrop*, N 14, above (taxpayer subdivided and sold the acquired land in parcels on a regular basis over a period of more than 25 years); *Ehrman v US*, 120 F2d 607, 41-2 USTC P 9537 (9th Cir 1941).

(n56)Footnote 58. See, eg, *Mathews v Commr*, 315 F2d 101, 63-1 USTC P 9360 (6th Cir 1963).

(n57)Footnote 59. *Bistline v US*, 260 F2d 77, 58-2 USTC P 9640 (9th Cir 1958).

(n58)Footnote 60. See, eg, *Moore v Commr*, 30 TC 1306 (1958).

(n59)Footnote 61. See, eg, *Nash v Commr*, 60 TC 503 (1973), acq 1974-2 CB 3; *Turner v Commr*, N 23, above; *Municipal Bond Corp v Commr*, 382 F2d 184, 67-2 USTC P 9633 (8th Cir 1967); *Scheuber v Commr*, 371 F2d 996, 67-1 USTC P 9219 (7th Cir 1967); *Starke v Commr*, 312 F2d 608, 63-1 USTC P 9199 (9th Cir 1963).

(n60)Footnote 62. See, eg, *Stanley, Inc v Shuster*, aff'd per curiam 421 F2d 1360, 70-1 USTC 9276 (6th Cir 1970), cert den 400 US 822 (1970); *Bauschard v Commr*, 279 F2d 115, 60-2 USTC 9533 (6th Cir 1960); *Clayton v Commr*, aff'd per curiam 245 F2d 238, 57-1 USTC 9447 (6th Cir 1957).

(n61)Footnote 63. See, eg, *Van Sickel v Commr*, 55 TCM 407, TC Memo 1988-115 (1988); *Margolis v Commr*, 337 F2d 1001, 64-2 USTC P 9755 (9th Cir 1964); *Broughton v Commr*, 333 F2d 492, 64-2 USTC P 9583 (6th Cir 1964); *Real Estate Corp v Commr*, 35 TC 610 (1961).

(n62)Footnote 64. See, eg, *Philhall Corp v US*, 546 F2d 210, 77-1 USTC P 9116 (6th Cir 1976); *Biedenharn Realty Co v US*, N 5, above; *US v Winthrop*, N 14, above; *Barney v Commr*, TC Memo 1967-17, 26 TCM 109 (1967); *Yara*, N 38, above.

(n63)Footnote 65. See, eg, *Suburban Realty Co v US*, N 3, above; *Gartrell v US*, 619 F2d 1150, 80-1 USTC P

9329 (6th Cir 1980); *Est of Segel v Commr*, 370 F2d 107 , 67-1 USTC P 9139 (2nd Cir 1966); *Vidican v Commr*, TC Memo 1969-207, 28 TCM 1099 (1969) ; *Nadalin v US*, 364 F2d 431 , 66-2 USTC P 9548 (Ct Cl 1966); *Miller v US*, 339 F2d 661 , 65-1 USTC P 9117 (Ct Cl 1965); *Tomlinson v Dwelle*, 318 F2d 60 , 63-1 USTC P 9493 (5th Cir 1963); *Kelley v Commr*, 281 F2d 527 , 60-2 USTC P 9635 (9th Cir 1960). But see *Biedenharn Realty Co v US*, N 5, above, where the IRS argued that this factor is irrelevant. The Fifth Circuit seemed to accept this argument in *Biedenharn*, but then appeared to reach a different conclusion in *Suburban Realty*. Note that a taxpayer may have significant real estate income in one year as a result of the bulk disposition of significantly appreciated real estate. Even if this income dwarfs the taxpayer's non-real estate income, it will not be considered as indicating that the taxpayer is a dealer, assuming the taxpayer's involvement with the real estate otherwise points to his being an investor. See *Crosswhite v US*, 369 F2d 989 , 67-1 USTC P 9123 (Ct Cl 1966); *Austin v Commr*, 263 F2d 460 , 59-1 USTC P 9245 (9th Cir 1959).

(n64)Footnote 66. See, eg, *Adam v Commr*, 60 TC 996 (1973) ; *Hoover v Commr*, 32 TC 618 (1959) .

(n65)Footnote 67. See, eg, *Mathews v Commr*, N 58, above.

(n66)Footnote 67.1. *Rice v Commr*, TC Memo 2009-142 .

(n67)Footnote 68. See, eg, *Gangi v Commr*, TC Memo 1987-561, 54 TCM 1048 (1987) . The liquidation theory appears to be of little help if the taxpayer has held the property as a dealer before the purported liquidation. See *US v Winthrop*, N 14, above. But see *Hay v Commr*, TC Memo 1992-409, 64 TCM 228 (1992) .

(n68)Footnote 69. *Erfurth v Commr*, TC Memo 1987-232, 53 TCM 767 (1987) ; *Heller Trust v Commr*, 382 F2d 675 , 67-2 USTC P 9626 (9th Cir 1967).

(n69)Footnote 70. See, eg, *Ltr Rul 9331013* (property management firm's reluctant sale of condominium apartment complex unit by unit after lease operations failed to generate a profit and where sales activities were handled by a third party was not a dealer disposition, but a liquidation of a capital asset entitled to installment sale treatment); *Curtis Co v Commr*, 232 F2d 167 , 56-1 USTC P 9406 (3rd Cir 1956).

(n70)Footnote 71. See *Heller Trust v Commr*, N 69, above; *Curtis Co v Commr*, N 70, above.

(n71)Footnote 72. See, eg, *Cottle v Commr*, 89 TC 467 (1987) ; *Bush v Commr*, 610 F2d 426, 80-1 USTC P 9118 (6th Cir 1979); *Biedenharn Realty Co v US*, N 4, above.

(n72)Footnote 73. See, eg, *Suburban Realty Co v US*, N 3, above. See also *S & H, Inc v Commr*, N 18, above.

(n73)Footnote 73.1. *Reed v US*, 2006 US Dist LEXIS 25040, 2006-1 USTC P 50,334 (DC Texas 2006) (involving Chapter 7 bankruptcy case).



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Federal Taxes Affecting Real Estate

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CHAPTER 10 Dealer Versus Investor Status

1-10 Federal Taxes Affecting Real Estate § 10.04

§ 10.04 Use of Controlled Entities

It is common for a person or partnership to purchase land, intending to hold it for investment. The property appreciates substantially after several years, and the taxpayer decides to subdivide and sell the property piecemeal.

A significant portion of the profit which the taxpayer enjoys on the property's sale is due to the appreciation which took place when the property was held for investment. The balance presumably relates to the taxpayer's efforts to improve and sell the property.

As indicated in *Section 10.03, above*, the taxpayer may be able to convince a court that the entire profit is entitled to capital gain treatment. If, however, the taxpayer is very active in improving the land and makes many sales following extensive marketing efforts, the taxpayer is likely to be characterized as a dealer, with the *entire* gain taxed as ordinary income.

This outcome seems unfair to the taxpayer, since a significant portion of the gain resulted from the period when the land was held for investment. It would be appropriate for this portion of the gain to receive capital gain treatment, even if the balance of the profit--resulting from the subdivision and improvements--was taxed as ordinary income.

Unfortunately, the courts have not bifurcated the gain in this fashion. The all-or-nothing approach which they use has encouraged taxpayers to fashion self-help remedies designed to increase the likelihood of capital treatment for the investment gain.

One way taxpayers have tried to do this is by selling the property to a controlled corporation. A common fact pattern involves a partnership which owns land that has appreciated during the investor phase. Before improving and marketing the property, the partnership makes an installment sale of it to a corporation which the partners control. n74 The hope is for capital gain treatment of the appreciation occurring before the sale to the corporation. n75 Subsequent gain, most of which will typically result from improvement and marketing of the property, is taxed as ordinary income to the corporation. To avoid double taxation, the shareholders should elect S corporation status.

The Service has used two theories to deny capital treatment for the gain resulting from the sale to the corporation: n76

- (1) The transfer of the real estate is a contribution of capital or a tax-free transaction under *IRC Section*

351. In either case, the transaction is not treated as a sale, and the transferor does not recognize gain on the transfer. The corporation takes the transferor's basis. n77

(2) Even if the transfer is taxable, the property sold to the corporation is already dealer property in the seller's hands when the sale is made.

[1] Treating the Transaction as a Sale

The Service had some early successes in the Fifth and Seventh Circuits, arguing that the sale to a controlled entity should be recast as a contribution to capital or as a Section 351 transaction. n78 More recent cases in the Claims Court and Fourth Circuit have found for the taxpayer, n79 at least when:

- (1) the property is sold to the controlled entity at its fair market value;
- (2) the controlled entity is not undercapitalized (so that the transaction has economic substance);
- (3) appropriate formalities are adhered to; and
- (4) assuming the corporation provides a note to the seller, the note is enforced. n80

[2] Preserving the Seller's Investor Status

The Service's second tack in combating the use of controlled corporations is to argue that the real estate is already dealer property at the time the taxpayer sells it to the controlled corporation. The courts have, in some cases, concluded that controlled entities were mere vehicles for the taxpayer's development activities, thus finding that the property was being held primarily for sale to customers even at the time of its sale by the taxpayer to the controlled corporation. n81 However, the fact that the corporation is controlled by the seller should not, by itself, result in the corporation's activities being attributed to the taxpayer. n82

Sometimes the taxpayer's activities before the sale to the corporation are sufficient to allow a court to treat the taxpayer as a dealer. n83 A taxpayer has the best chance of avoiding this result if the taxpayer is not otherwise a real estate dealer and has not previously sold real estate to a controlled corporation to avoid ordinary income treatment. Of course, the taxpayer should delay all development, marketing and actual sales until the corporation owns the property.

[3] Installment Sales Issues

The sale of appreciated land to a controlled corporation is typically structured as an installment sale. Assuming that the installment provisions are effective for tax purposes, the taxpayer defers tax on the appreciation occurring before the sale.

The primary risk in these situations is that the Service will be effective in characterizing the taxpayer as a dealer. Dealers are generally precluded from using the installment method. n84 This means that, if the taxpayer is a dealer, all of the gain through the time of sale will be immediately taxable, and at ordinary rates to boot! Compounding the problem is the fact that the cash the taxpayer receives from the sale will probably be much less than the resulting tax liability. (Remember that the purchaser, a controlled corporation, will probably be able to give the seller only a promissory note and a small cash down payment.)

Even if the taxpayer is treated as an investor, so that installment sale treatment is allowed, an additional problem may result from the application of *IRC Section 453A(c)*. That section requires a taxpayer to pay interest on certain tax liabilities deferred because of the installment method. n85 In cases where the property is both valuable and has

significantly appreciated, this interest expense may wipe out much of the savings the taxpayer hopes to achieve by having the pre-sale appreciation taxed at capital, rather than ordinary, rates. n86

FOOTNOTES:

(n1)Footnote 74. This tack can, of course, also be used by an individual owner. Note that it is generally disadvantageous for a partnership to sell the property to another partnership which the first partnership's partners control. The Service may be able to use the aggregation theory to deny the taxpayers any benefit from the sale. *IRC 707(b)(2)* may present other problems.

(n2)Footnote 75. This approach does not work with depreciable real estate because *IRC 1239* taxes gain on this kind of property as ordinary income when sold to a related party. See Chapter 6 for a discussion.

(n3)Footnote 76. But see *Biedenharn Realty Co, Inc v US*, N 4, above, a case that did not involve a sale to a controlled corporation. There, the Service actually argued that the taxpayer should have used such a sale if it wanted to have its pre-dealer appreciation taxed as capital gain. The Fifth Circuit chided the Service, noting that the Service would then probably have attacked the sale on the basis of *Ackerman v Commr*, 335 F2d 521 , 64-2 USTC P 9670 (5th Cir 1964), discussed in N 83, below.

(n4)Footnote 77. *IRC 362(a)*.

(n5)Footnote 78. *Burr Oaks Corp v Commr*, 365 F2d 24, 66-2 USTC P 9506 (7th Cir 1966), cert den 385 US 1007 (1967) ; *Aqualane Shores, Inc v Commr*, 269 F2d 116 , 59-2 USTC P 9632 (5th Cir 1959).

(n6)Footnote 79. *Bradshaw v US*, 683 F2d 365 , 82-2 USTC P 9454 (Cl Ct. 1982); *Piedmont Corp v Commr*, 388 F2d 886 , 68-1 USTC P 9189 (4th Cir 1968). These cases, and the ones in the preceding note, are discussed in detail in Bird, "Planning for the Sale of Land to a Controlled Corporation," 21 *J Real Est Tax'n* 264 (1994).

(n7)Footnote 80. These four requirements come from *Bradshaw v US*, N 79, above.

(n8)Footnote 81. For cases where the Service was successful with this argument, see, eg, *Cappuccilli v Commr*, 668 F2d 138 , 82-1 USTC P 9118 (2nd Cir 1981); *Boyer v Commr*, 58 TC 316 (1972) ; *Engassar v Commr*, 28 TC 1173 (1967) ; *Lakin v Commr*, 249 F2d 781 , 58-1 USTC P 9120 , 52 AFTR 923 (4th Cir 1957) ; *Burgher v Campbell*, 244 F2d 863 , 57-2 USTC P 9740 , 51 AFTR 463 (5th Cir 1957) . For cases where the argument did not succeed, see, eg, *Bramblett v Commr*, 960 F2d 526 , 92-1 USTC P 50,252 (5th Cir 1992); *Ronhovde v Commr*, TC Memo 1967-243, 26 TCM 1251 (1967) ; *Gordy v Commr*, 36 TC 855 (1961) , acq 1964-2 CB 5 .

(n9)Footnote 82. See *Bramblett*, N 81, above, citing *National Carbide v Commr*, 336 US 422 (1949) , as applied by *Commr v Bollinger*, 485 US 340 (1988) .

(n10)Footnote 83. See, eg, *Ackerman v US*, N 74, above; *Brown v Commr*, 448 F2d 514 , 71-2 USTC P 9634 (10th Cir 1971); *Browne v US*, 356 F2d 546 , 66-1 USTC P 9243 (Ct Cl 1966). For a different result, favorable to the taxpayer, see *Bramblett*, N 81, above; *Cary v Commr*, TC Memo 1973-197, 32 TCM 913 (1973) . For additional discussion of this subject, see Bird, "Treatment of Capital Gain on Sale of Land to a Related Development Corporation," 22 *J Real Est Tax'n* 225 (1995).

(n11)Footnote 84. See *IRC 453(b)(2)(A)* and Chapter 7.

(n12)Footnote 85. This is discussed in greater detail in Chapter 7.

(n13)Footnote 86. Note that, if the corporation sells some or all of the property within two years after the purchase from the taxpayer, *IRC 453(e)* treats the amounts the corporation receives as if the corporation paid them to the taxpayer. The agreement between the taxpayer and the corporation should provide that, in these circumstances, the

corporation will pay sufficient cash to the taxpayer so that the taxpayer can satisfy tax liabilities arising from these sales.



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CHAPTER 10 Dealer Versus Investor Status

1-10 Federal Taxes Affecting Real Estate § 10.05

§ 10.05 Intended Relief--IRC Section 1237

IRC Section 1237 deals with the type of gain to be realized on the sale of real property. It provides, in effect, a test for determining whether a taxpayer holds real property for sale in the ordinary course of business. It generally has limited application n87 but, when it does apply, the benefits can be significant. n88

The regulations contain perhaps the best analysis of the section's intent:

"This rule is to permit taxpayers qualifying under it to sell real estate from a single tract held for investment without the income being treated as ordinary income merely because of subdividing the tract or of active efforts to sell it." n89

[1] Benefits From Qualification

When a taxpayer meets the requirements of *IRC Section 1237*, partial capital gains treatment is available to the taxpayer. Classification of the gain under *IRC Section 1237* is somewhat complex, and is discussed at length below.

[2] Requirements for Qualification

There are several basic requirements for qualifying under this section: n90

- the taxpayer cannot be a C corporation; n91
- the taxpayer cannot have previously held the tract in question for sale to customers in the ordinary course of business;
- in the same tax year in which the sale occurs, the taxpayer cannot hold any other real property primarily for sale to customers in the ordinary course of business;
- the tract must have been held by the taxpayer for at least five years, except when acquired by inheritance; n92
- the seller cannot make any improvements to the property that will substantially enhance its value.

n93

As a practical matter, it is the final requirement which, in many cases, makes *IRC Section 1237* of extremely limited value.

[3] Qualification of the Taxpayer

For tax years beginning after 1996, the benefits of *IRC Section 1237* are available to taxpayers other than C corporations. Thus, S corporations may now take advantage of *IRC Section 1237*. n94 For tax years beginning before 1997, only noncorporate taxpayers could use *IRC Section 1237*. n95 Thus, S corporations were not able to take advantage of the provision for those years.

IRC Section 1237 is inapplicable to real estate dealers, n96 and thus it again puts at issue the distinction between a dealer and an investor. The taxpayer's status with respect to other real estate that he or she owns jointly or as a member of a partnership is considered in making the determination. n97 For purposes of determining whether a taxpayer owns other property for resale, the taxpayer is not generally considered to hold property owned by other family members, an estate or trust, or a corporation. n98

In determining whether a taxpayer is a dealer for purposes of *IRC Section 1237*, subdivision and selling activities are disregarded. n99 A taxpayer may be treated as a dealer under *IRC Section 1237*, however, if, in addition to the activities of subdividing and selling permitted under this section, there is other substantial evidence indicating dealer status. Such other evidence may include a taxpayer's activities in prior years in connection with the property, his intention at the time of acquisition and during his ownership of the property, or the establishment of a permanent real estate office. Other factors, such as holding a real estate dealer's license, selling other investment property, acting as a real estate salesperson, or merely owning other vacant property, will not result in dealer classification. However, any combination of the foregoing, taken in conjunction with the permitted activities with respect to the land in question, may result in dealer status. n100

NOTE:

It should be noted that failure to meet the requirements of *IRC Section 1237* does not prevent a taxpayer from attempting to qualify for capital gains treatment outside the provisions of *IRC Section 1237*. n101

[4] Qualification of the Property

IRC Section 1237 applies to sales of lots or parcels which are part of a real estate tract. The Service interprets this to preclude the applicability of *IRC Section 1237* upon the conversion of an apartment complex to a condominium because the realty interest sold is transferred exclusive of the land underlying the building. n102

The term "tract" is defined as a single piece of real property, or two or more pieces of real property, providing that they were contiguous at some time during the taxpayer's ownership. For purposes of determining whether the properties are contiguous, the interposition of a road, railroad, stream or similar property is ignored. n103

This section requires that the tract be held as an investment by the taxpayer for a period of five years or more, unless the property was acquired by inheritance. In the case of inherited property, the necessary holding period for capital gains treatment (more than 12 months) is mandated. n104 Inheritance does not include property acquired by survivorship in a joint tenancy, nor does inheritance appear to include the surviving spouse's one-half interest in community property. Generally, the usual holding period rules apply so that, in some cases, such as that of a gift, there is a tacking on of the prior owner's holding period.

[5] Requirement of No Substantial Improvements

IRC Section 1237 is inapplicable if the taxpayer or certain others make substantial improvements on the tract which substantially increase the value of the lot or parcel sold. n105 This is a dual test. The improvements must be substantial and, in addition, the improvements must substantially enhance the value of the parcel sold.

Under *IRC Section 1237(a)(2)*, improvements made by other parties may, in some cases, be considered to have been made by a taxpayer. These other parties include related interests, such as members of a taxpayer's family, a corporation more-than-50-percent-owned by a taxpayer (directly or constructively), an S corporation that included the taxpayer as a shareholder, or a partnership of which a taxpayer was a member at the time that the improvements were made. Also included are nonrelated interests, such as a lessee if the improvement takes the place of rental income, or a governmental body if the improvements constitute an addition to basis for the taxpayer. n106

Substantial improvements include the building of shopping centers, the construction of commercial or residential buildings, and the installation of hard-surface roads or utilities, such as sewers, water, gas or electric lines. n107

The building of temporary structures, surveying, filling, draining and clearing the tract, and the construction of all-weather access roads, including gravel roads where climatic conditions require, are not considered substantial improvements. n108

A special rule is available to neutralize the effect of substantial improvements when the tract has been held by the taxpayer for ten years or more. n109 In such cases, improvements consisting of the building or installation of water, sewer or drainage facilities or roads, including hard-surface roads, will not be considered substantial. This special rule has other conditions, however, in that the taxpayer must prove that without the improvement, the parcel sold would not be marketable at local prevailing prices for similar sites. Further, a taxpayer cannot claim any tax benefit for the cost of the improvement, either as an expense or as an addition to basis of the parcel sold. n110

A taxpayer must make an election, in accordance with regulations, to take advantage of this rule for property held at least 10 years. n111

PRACTICE TIP:

The election under *IRC Section 1237(b)(3)(C)* is binding only if the property would otherwise be considered property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business under *IRC Section 1221(a)(1)*. Because that determination is generally a question of fact, a taxpayer should make a protective election under *IRC Section 1237(b)(3)(C)* if substantial improvements have been made to property held at least 10 years. The election would become effective only if there is a determination that sales do not qualify for capital gains treatment under *IRC Section 1221*. n112 However, if the tract was acquired by foreclosure, the improvements may be made under this special rule without establishing that they were necessary to market the lots at prevailing prices. In such cases, the cost of the improvements may be capitalized as part of the cost of the land. n113

As stated above, the relief provided by *IRC Section 1237* will only be inapplicable if the improvement, in addition to being in itself substantial, directly and substantially enhances the value of the parcel sold. n114 This will necessarily involve some interpretation, since the regulations state that: "Whether improvements have substantially increased the value of a lot depends upon the circumstances in each case." n115

The increase in value is measured by the difference between the value of the improved parcel and an appraisal of the value of the parcel before improvement. The regulations provide guidelines in that an increase of 10 percent or less in the value of the parcel because of the improvement is not considered substantial. An increase of more than 10 percent, while not automatically considered substantial, would require consideration of other relevant factors. n116

Other parcels in the tract that are unaffected by the improvement would still be eligible for the special provisions of *IRC Section 1237*. n117

[6] Classification of Gain Under *IRC Section 1237*

The classification of the gain on the sale of property which qualifies under *IRC Section 1237* depends on the number of parcels sold from a particular tract and, to some extent, on the timing of the sales. The gain on the first five parcels sold is capital gain, providing that no additional parcels are sold in the same taxable year. n118

If a sixth parcel is sold in the same taxable year, ordinary income results to the extent of 5 percent of the selling price of all parcels. If the sixth parcel is not sold until the next taxable year of the taxpayer, the gain on the first five parcels retains its character as capital gain. The gain on the sale of all additional parcels is still ordinary income to the extent of 5 percent of the selling price.

Example:

Selling price	\$.....20,000
Basis (cost of parcel)	10,000
Gross gain on sale	10,000
Expenses of sale	600
Net gain on sale	9,400
Ordinary income:	
Five percent of selling price (5% x \$20,000)	\$.....1,000
Less--Expenses of sale	600
Amount of gain treated as ordinary income	400
Amount of gain treated as capital gain	\$.....9,000

In the computation of the amount of ordinary income, the section provides a benefit in that expenses of sale of the parcels are to be deducted first from the ordinary income portion of the gain. n119 Any remainder of these expenses must be applied as a reduction of the capital gain.

A taxpayer presumably may have more than one tract that qualifies under *IRC Section 1237*. Since the classification of the gain depends on the number of parcels sold from the same tract, the definition of a tract, as discussed previously, is of utmost significance.

[7] Limited Application of *IRC Section 1237*

Though generally limited in application, *IRC Section 1237* can be of substantial benefit to the investor faced with ordinary income treatment on certain property subdivided for sale. As indicated, the section transforms what would otherwise be ordinary income into capital gains. Care must be taken in the section's application, however, as no identifiable guideline is provided for qualification as an investor.

IRC Section 1237 points out the difficulties of legislating in the area of dealer versus investor. Of far greater benefit would be a more exact and liberal interpretation by the courts or the Treasury Department of the definition of an "investor" in real estate.

FOOTNOTES:

(n1)Footnote 87. For a somewhat less charitable assessment of the section's applicability, see Cook & Beckett, "Preserving Capital Gain Taxation on Appreciated Subdivided Real Property," 14 *Real Est Tax Digest* 72, 93 (1996) ("*IRC Section 1237 [is]* a provision that is rarely used because its stringent requirements render it virtually useless.") See also Chandler, "The Failure of Section 1237 in Dealing with Sales of Subdivided Realty," 60 *Minn L Rev* 275 (1978). For examples of the rare situations where the IRS has ruled that *IRC 1237* applies, see Ltr Ruls 9123026, 8637012 and 8038196 (all relating to the sale of residential lot fee interests to the lots' lessees).

(n2)Footnote 88. *IRC 1237* is discussed, generally, in Hamill, "Capital Gains for the Casual Subdivider: Can Section 1237 be Used as a Safe Harbor in the Post-RRRA'93 Environment?" 21 *J Real Est Tax'n* 253 (1994).

(n3)Footnote 89. *Treas Reg 1.1237-1(a)(1)*.

(n4)Footnote 90. *IRC § 1237(a)*.

(n5)Footnote 91. See [3], below, for a discussion.

(n6)Footnote 92. See [4], below, for a discussion.

(n7)Footnote 93. See [5], below, for a discussion.

(n8)Footnote 94. *IRC 1237(a)*.

(n9)Footnote 95. *IRC 1237(a)*, before amendment by Pub L No 104-188.

(n10)Footnote 96. *IRC § 1237(a)(1)*.

(n11)Footnote 97. *Treas Reg 1.1237-1(b)(3)*.

(n12)Footnote 98. *Treas Reg § 1.1237-1(b)(3)*; but see *Treas Reg § 1.1237-1(c)(5)(iv)(c)*.

(n13)Footnote 99. *Treas Reg § 1.1237-1(a)(2)*.

(n14)Footnote 100. *Treas Reg § 1.1237-1(a)(3)*.

(n15)Footnote 101. *Treas Reg 1.1237-1(a)(4)*; see *Ltr Rul 8212001* ; *Ltr Rul 8204031* .

(n16)Footnote 102. *Rev Rul 80-216, 1980-2 CB 239* .

(n17)Footnote 103. *IRC 1237(c)*.

(n18)Footnote 104. *Treas Reg 1.1237-1(d)(2)*. See also *IRC 1221*, defining capital asset.

(n19)Footnote 105. *IRC 1237(a)(2)*.

(n20)Footnote 106. See *Treas Reg § 1.1237-1(c)(2)* for improvements made or deemed to be made by the taxpayer.

(n21)Footnote 107. Treasury Regulation Section 301.9100. See, eg, *English v Commr, TC Memo 1993-111, 65 TCM 2160* (taxpayer not eligible for capital gains treatment under *IRC 1237* because taxpayer made substantial improvements (concrete access road and water service) that enhanced the value of the property by more than 10 percent).

(n22)Footnote 108. *Treas Reg 1.1237-1(c)(4)*.

(n23)Footnote 109. *IRC 1237(b)(3)*.

(n24)Footnote 110. *IRC § 1237(b)(3)*; *Treas Reg § 1.1237-1(c)(5)(i)*.

(n25)Footnote 111. *IRC § 1237(b)(3)(C)*; *Treas Reg § 1.1237-1(c)(5)(iii)*.

(n26)Footnote 112. See Ltr Rul 8626004 (protective election permitted).

(n27)Footnote 113. *Treas Reg § 1.1237-1(c)(5)(iv)*.

(n28)Footnote 114. *IRC § 1237(a)(2)*; *Treas Reg § 1.1237-1(c)(3)*.

(n29)Footnote 115. *Treas Reg 1.1237-1(c)(3)(ii)*.

(n30)Footnote 116. *Treas Reg § 1.1237-1(c)(3)(ii)*. See, eg, *English v Commr, N 107*, above (*IRC § 1237* capital gains treatment denied where improvements were substantial and enhanced the value of the property by more than 10 percent; taxpayer's argument that property values increased (without reference to improvements) by 40 percent was without merit since court found that the selling price per acre was far in excess of that amount).

(n31)Footnote 117. *Treas Reg § 1.1237-1(c)(3)(iii)*.

(n32)Footnote 118. *IRC 1237(b)(1)*.

(n33)Footnote 119. *IRC 1237(b)(2)*.



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CHAPTER 11 Subdivision and Tract Development

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CHAPTER 11 Subdivision and Tract Development

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§ 11.01 An Overview of Tax Planning for the Developer

The main tax problem tract developers face is how to allocate capitalizable costs to each unit so that income from sales can be properly determined. This chapter discusses various allocation techniques and explains how the developer can use them to its full advantage.

A more general tax concern for the tract developer is the timing of income and expenses from the development. Most developers are interested in deferring the recognition of taxable income.

The early stages of a real estate development project will often produce losses as a result of expenses that are currently deductible. (The extent to which these expenses are currently deductible is, in most cases, dependent on the application of the uniform capitalization rules, which are discussed in Chapter 3.) No income is generated because, in most developments, the creation and sale of a marketable asset requires more than one accounting period. However, the developer may consider selling some parcels of land in a raw state so that this gain absorbs the currently deductible expenses; this approach will also provide cash to finance improvements.

The early tax losses can be a valuable financial benefit which offsets ordinary income from the developer's other activities or investments. The extent to which the developer can do this will, to a large extent, depend on the application of the passive loss limitation rules. (These are discussed in Chapter 13.) To a lesser extent, loss carryover periods may create problems for a developer that expects losses to continue for such an extended period of time that the loss carryovers may expire before the anticipated profits are received. Detailed tax projections in these circumstances may highlight opportunities for timing income and expenses to produce the best tax result.

Tax considerations also come into play when a developer determines that it will not use certain lands. As discussed in *Section 11.04*, below, the developer may realize tax savings by making a charitable contribution, an abandonment, or a dedication of property to a governmental authority.



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Federal Taxes Affecting Real Estate

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CHAPTER 11 Subdivision and Tract Development

1-11 Federal Taxes Affecting Real Estate § 11.02

§ 11.02 Allocation of Land Costs

In a land development project, whether large or small, one of the critical elements from a tax standpoint is the allocation of the land development costs to different parcels within the project. The failure of many promising development ventures can be traced to defective cost allocations. A carefully planned cost allocation realistically reports income or loss and conserves vital cash flow through the proper payment or deferral of income taxes.

[1] General Principles of Allocation

After the developer has determined its land cost (see discussion in Chapter 2), the developer must apportion this cost among the several parcels in the development. The Regulations require that the cost basis be "equitably apportioned" among all parcels. n1 The developer cannot postpone the realization of gain or loss on the sale of individual parcels by arguing that the developer is first entitled to a tax-free recovery of the entire property's basis. n2

While "equitably apportioned" is a vague concept, some general guidelines do exist. "Equitable" does not necessarily mean "ratable;" that is, if the price of 100 acres is \$100,000, each acre would not necessarily carry a \$1,000 cost. n3 If some acres are obviously more valuable than others, they should receive a greater cost basis. n4 On the other hand, the taxpayer should refrain from unrealistic allocations because, if it fails the "equitable test," the Service has authority to make the allocation for the developer. n5

To ensure equitable apportionment, the Tax Court has generally required that the allocation be made at the time of purchase rather than at the time of sale. n6 This rule is based on the premise that the cost of an item is determined at the time of its acquisition, and should not fluctuate. In addition, this approach prevents the taxpayer from making "self-serving" allocations in years after the acquisition.

A developer can easily make an incorrect initial allocation, or there may be unanticipated subsequent events that affect the fairness of the allocation. There is some authority supporting a reallocation if the taxpayer erred when making the initial allocation. n7 Unanticipated subsequent events, however, are unlikely to permit the taxpayer to reallocate basis. n8

The taxpayer's allocation of its land cost usually has another effect: The allocation typically controls the legal fees and other indirect capitalized expenses apportioned to each parcel. n9

[2] Land Cost Allocation Techniques

The size and complexity of a project, the nature of the land, and the period of development all enter into deciding which allocation method should be used. Sometimes, in a large development, a combination of one or more methods is proper. The following sections discuss some of the more widely used basic techniques of allocating land costs.

[a] Acreage Method

The acreage method is the simplest and easiest allocation method to apply. The total cost of the property is allocated to the various parcels, either on a square-footage basis or on the basis of the number of equal-sized lots or parcels. This method is used when it is not shown that any particular part or parcel of the property is any more desirable than any other portion. n10

This allocation may be used in a development where all lots sell in the same price range and no land will be set aside for special purposes. In other situations, this method may result in a distortion of profits and, thus, cannot be used. For instance, a block of land may be hilly, with certain portions unusable or of marginal use. To allocate costs on a pro rata basis would result in allocating cost basis to land that may never be sold, or sold at a loss or profit that would be disproportionate to other parcels sold.

[b] Relative-Value Method

When evidence clearly establishes that certain portions of a tract are more desirable and more valuable than others, the allocation of cost should be made on the basis of relative value. n11 Relative value is computed by taking into account factors such as topography, geology, location, desirable features, natural landscape and proximity to improvements.

The developer has the burden of supporting its relative values, but it can rely on several sources. These include the assessed valuation by the local property tax assessor or by expert testimony, n12 mortgage release values determined by the secured creditor, offers from willing purchasers, and valuations by independent appraisers. On occasion, greater weight to support relative market values has been granted to actual offers received from willing buyers rather than to appraisals or mortgage release values. n13

In housing developments, corner lots and sites with good views generally are more valuable than others. Thus, a builder is justified in allocating greater costs to them. The accessibility and contour of the land must also be considered. Hilly or rough land that requires heavy grading and other developmental costs to convert the lots into a salable condition creates special problems. Generally, a developer should allocate a lower cost to land that requires high development costs, such as grading, filling, retaining walls, drainage facilities, etc. To do otherwise would distort the relative profit on these lots as compared with those without these costs.

On larger tracts, the projected use of a land parcel may affect the cost allocations. Such uses are varied and might include residential, commercial and industrial development; schools, churches and other public buildings; and community areas, such as parks, recreational facilities, golf courses, etc. A land development project may have one or more of these uses, each of which has a different relative value and each of which should carry a different cost. For instance, land set aside for single-family dwellings may have a greater value than land used for commercial development, or vice versa.

[c] Selling-Price Method

In limited circumstances, courts have considered the selling price of land as a basis of allocation, particularly when another allocation method cannot be well documented. Thus, the selling price may be used to allocate basis in a case where nothing occurred to change the relative values of two parcels between the dates of acquisition and sale. n14

[d] Unit Allocation Method

The unit allocation method is a modified form of the relative-value method. This method is especially effective in allocating improvement costs. It is explained and illustrated in *Section 11.03[3][a], below*.

[e] Discounting Present Value Method

This method takes into account the time value of money and the period in which the various components of a development are to be improved and sold. For a project that spans a number of years, a present-value concept of allocating land cost has been developed for financial accounting that could have application for tax purposes as well.

Discounting is a technique that can only be used in conjunction with one of the cost allocation methods previously discussed. The basic theory is that the sooner a parcel is developed and sold, the sooner the developer realizes the return of its capital and profit, and the sooner these proceeds can be reinvested. Financial resources and market conditions generally prevent the development of the entire project at one time; therefore, since the earlier-developed parcels help finance the later ones, the cash flow generated from the first sales is more valuable and should be shielded by a greater portion of the land costs. The result represents a conservative accounting technique which recognizes the time value of money and the inherent risk factor in normal tract development.

Use of the discounting method is not specifically authorized by the Code or the Regulations. However, the proper application of this method appears to produce an "equitably apportioned land cost allocation." n15

[f] Hybrid Methods

Many valid allocations must rely on a mixture of methods to match costs effectively with revenues. For example, the cost of an entire development could be allocated to several parcels according to a unit allocation method. Then, within each parcel, an acreage method could be used to allocate costs to several tracts. Once the tract cost is determined, the allocation to individual lots could be based on a relative-value method.

[3] Complications in Land Cost Allocation

Many special situations can arise that make land cost allocation difficult. The following sections discuss common complications:

[a] Step Purchases

If land for development is purchased in several steps at different prices, should each parcel bear its own cost or should all acquisition costs be lumped together and reallocated by one of the recognized methods? This problem requires analysis of the reasons for the differences in price. If several parcels are integrated into one development, the Tax Court n16 seems to feel that the costs should be lumped together and allocated as if the parcels had not been separately acquired. No standards for determining whether a given project is integrated have been delineated. Presumably, if the facilities and land planning are interdependent, the project is integrated. n17

If the price differential is caused by the peculiarities in the vendor's bargaining position, the difference in cost should be equitably apportioned throughout the entire development. Thus, if a landowner knows that the developer needs the landowner's land for access to parcels already purchased by the developer and is able to ask a premium on the sales price, the premium is properly allocable throughout the entire development. n18

[b] Unusable Land

When raw land is acquired in a large package, some portions may not be marketable. For example, sloping terrain,

marshy or rocky areas, or poor drainage may physically prevent development. Further, the marketing of other parcels may not be permitted by local law. Often, the developer will be required to set aside lots for schools, churches and other public buildings in order to receive approval for its subdivision map. In addition, the project's master plan may be required to provide for open areas or green belts.

Financial accounting generally requires allocation of the cost of the unusable land to the land to be developed and sold. For tax purposes, this land may be treated in several different ways.

If the developer maintains control of the unusable land, case law may disallow allocation of the cost to parcels currently being sold. n19 In one specific case, a developer owned an island but only developed lots around the shoreline; the center of the island was used as a park and recreational area. The taxpayer was required to carry the park area at its cost, which was determined by the relative-value method. The court indicated that the cost of unmarketed land can only be allocated if it is "permanently beyond the possibility of sale and gain." n20

However, if the developer can show that the land will never be developed, an allocation of the cost to the marketable lots may be allowed. In any event, the allocation should be clearly supported since the Service will not allow an allocation of unused land costs to current sales as a means of shifting income to future periods when the land is sold.

The more dependable method of increasing the cost of current sales is an irrevocable transfer of unusable property. n21 If this is not required by local subdivision law, a voluntary dedication to public use will achieve the same result. Presumably, the cost of dedicated land would be required to be allocated to marketable land (see *Section 11.04*, below).

Another tactic is abandonment. If the developer is willing to relinquish all proprietary rights to the property, the developer can achieve a current ordinary deduction as an abandonment loss, but the developer must establish a supportable cost basis. n22 The problem is that, if the developer is willing to abandon property, its basis may be difficult to establish, especially by a relative-value method.

Since the validity and timing of the abandonment depend upon the intent of the taxpayer, a quitclaim deed can avoid disputes with the Service. This, of course, presumes that the party to whom the land will be transferred will accept the quitclaim.

Abandonment of "unusable" land is not always advisable. Although the land cannot be developed as part of the developer's project, it still may have value to another party for another purpose. If that value is significant, the land should be sold rather than abandoned.

[c] Lower of Cost or Market

The developer may fully intend to develop a parcel of land and may even have begun subdivision work when it becomes apparent that further development would not be economical. Sound financial accounting treats this land, either developed or undeveloped, as inventory which should be valued at the lower of cost or market. However, cases and Service pronouncements prohibit the use of inventory accounting for real estate, thus barring a write down of land cost to a lower market value. n23

The courts have relied on three rationales for denying a write down of land cost:

- (1) The tax law requires an inventory accounting practice that "conform[s] as nearly as may be to the best accounting practice in the trade or business." n24 Since 1928, it has been settled that real estate cannot be accounted for under the tax law's usual inventory rules (now lodged in Section 471). n25
- (2) Annual revaluation of real estate is impractical since there are neither common markets nor frequent

transactions to aid in determining market price.

(3) All land is unique and one property does not necessarily establish the value of another property.

[d] Capital Gain Property

Not all the land in a single project will necessarily be held for sale to the public. The developer may designate some portion as investment property or property used in a trade or business. ⁿ²⁶ Of course, property held for investment or as property used in a trade or business may receive favorable capital gain treatment under *IRC Section 1222* or *Section 1231*.

For example, a taxpayer may be able to achieve Section 1231 treatment by holding property for lease as a commercial center or as an industrial park. The taxpayer can argue that this land is held in the trade or business of leasing property, and therefore is eligible for capital gain or ordinary loss treatment under Section 1231. In any event, support for this treatment should be established as soon as possible by a clear demarcation of this type of property: that is, the taxpayer should properly designate this property on the appropriate books and records, zoning, applications, and the overall master plan for the development.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.61-6(a)*; *Fasken v Commr*, 71 TC 650 (1979) ; *Rev Rul 72-255*, 1972-1 CB 221 ; *Fairfield Plaza, Inc v Commr*, 39 TC 706 (1963) ; *Cleveland-Sandusky Brewing Corp v Commr*, 30 TC 539 (1958) ; see *Norwest Corp and Subs et al v Commr*, 111 TC 105 (1998) . The developer should use the same method of allocation for both tax and financial accounting. See also Smith, "Issues and Problems in the Valuation of Real Estate," 30 NYU Inst on Fed Tax'n 209 (1972).

(n2)Footnote 2. See authorities cited in preceding note. For an example, see *Treas Reg § 1.61-6(a)*, Ex 1.

(n3)Footnote 3. However, for cases where the facts warranted a pro rata allocation based on area, see *Henning v Commr*, TC Memo 1960-90, 19 TCM 461 (1960) ; *Ayling v Comm'r*, 32 TC 704 (1959) , acq 1959-2 CB 3 . See also *Byram v Commr*, TC Memo 1975-35, 34 TCM 626 (1975) , *aff'd* 555 F2d 1234 , 77-2 USTC P 9541 (5th Cir 1977) (allocation based on area allowed in the absence of contrary evidence).

(n4)Footnote 4. *Soelling v Commr*, 70 TC 1052 (1978) ; *Vaira v Commr*, 52 TC 986 (1969), acq 1971-2 CB 3, modified on other issues 444 F2d 770, 71-1 USTC 9495 (3rd Cir 1971); *Luckey v Commr*, 334 F2d 719, 64-2 USTC P 9662 (9th Cir 1964); *Fairfield Plaza, Inc v Commr*, 39 TC 706 (1963) , acq 1963-2 CB 4 ; *Neese v Commr*, 12 TCM 1058 (1953) ; *Biscayne Bay Islands Co v Commr*, 23 BTA 731 (1931) , acq XI-2 CB 2.

(n5)Footnote 5. *Ewing v Commr*, TC Memo 1958-115, 17 TCM 626 (1958) . The burden of proof is on the taxpayer. *Stonegate of Blacksburg, Inc v Commr*, 33 TCM 956, TC Memo 1974-213 (1974) ; *Fairfield Plaza, Inc v Commr*, 39 TC 706 (1963) , acq 1963-2 CB 4 ; *Scott v Commr*, 6 BTA 761 (1927) .

(n6)Footnote 6. *Harchester Realty Corp v Commr*, 20 TCM 922, TC Memo 1961-184 (1961) ; *Ayling v Commr*, 32 TC 704 (1959) , acq 1959-2 CB 3 ; *Fairfield Plaza, Inc v Commr*, 39 TC 706 (1963) , acq 1963-2 CB 4 . But see *Clayton v Commr*, 245 F2d 238 , 57-1 USTC P 9447 (6th Cir 1957), where sales prices were used to allocate the taxpayer's original basis. The court said that no events occurred after the original purchase which were likely to change the relative values of the parcels.

(n7)Footnote 7. See *Rev Rul 70-7*, 1970-1 CB 175 ; *Commr v Superior Yarn Mills, Inc*, 228 F2d 736 , 56-1 USTC P 9155 (4th Cir 1955) (Commissioner allowed to reallocate after taxpayer erred in making initial allocation).

(n8)Footnote 8. See, eg, *Fairfield Plaza, Inc v Commr*, 39 TC 706 (1963) , acq 1963-2 CB 4 ; *Walton v Commr*,

TC Memo 1962-63, 21 TCM 346 (1962) ; Harchester Realty Corp v Commr, 20 TCM 922, TC Memo 1961-184 (1961) .

(n9)Footnote 9. *Dahling v Commr, TC Memo 1988-430, 56 TCM 131 (1988) ; Soelling v Commr, 70 TC 1052 (1978) ; Rev Rul 68-528, 1968-2 CB 331 .* For a discussion of how costs are capitalized under the uniform capitalization (UNICAP) rules, see Ch 3.

(n10)Footnote 10. *Ayling v Commr, 32 TC 704 (1959) , acq 1959-2 CB 3 .* For a discussion of allowable methods to allocate the costs of real property, see *Homes by Ayres v Commr, 795 F2d 832 , 86-2 USTC P 9572 (9th Cir 1986).*

(n11)Footnote 11. *Biscayne Bay Islands Co v Commr, 23 BTA 731 (1931) , acq XI-2 CB 2.* See also *Homes by Ayres v Commr, 795 F2d 832 , 86-2 USTC P 9572 (9th Cir 1986).*

(n12)Footnote 12. *Hoven v Commr, 56 TC 50 (1971)* (allowing valuation by expert testimony); *Almac's Inc v Commr, TC Memo 1961-13, 20 TCM 56 (1961)* (court gave weight to local property tax assessment where the assessment values nearly matched values given by expert); *Hendrick v Commr, 35 TC 1223 (1961) , acq 1962-2 CB 4 ; Cullinan v Commr, 5 BTA 996 (1927) , acq VII-1 CB 8* (allowing valuation by the local property tax assessor). Consider also *TAM 9110001*, reiterating that the IRS is inclined to accept allocations based solely on assessed values only when there is no other evidence available.

(n13)Footnote 13. *Ayling v Commr, 32 TC 704 (1959) , acq 1959-2 CB 36 .*

(n14)Footnote 14. *Clayton v Commr, TC Memo 1956-21, 15 TCM 105 (1956) , aff'd 245 F2d 238 , 57-1 USTC P 9447, 52 AFTR 599 (6th Cir 1957)* (The court held that the Commissioner's allocation of basis was fair. The court concluded that nothing occurred to change the relative values of the property, that the Commissioner's allocation substantially comported with selling price, and that no other information was introduced (like expert testimony).

(n15)Footnote 15. *Treas Reg § 1.61-6(a)* requires that there be an "equitably apportioned land cost allocation".

(n16)Footnote 16. *Davock v Commr, 20 TC 1075 (1953) , acq 1954-1 CB 4 . Rev Proc 92-29, 1992-1 CB 748 ,* which deals with the allocation of estimated future costs, provides an accounting method that applies on a "project-by-project" basis. The procedure, which is discussed in detail in § 11.03[2], below, provides a very liberal definition of "project," stating: "A developer may use any reasonable method to define a project in light of the common improvements to be provided." It would not be unreasonable to have the same standard apply when parcels are acquired at different times. See also *Treas Reg § 1.263A-10*, which deals with the capitalization of interest expense and provides a "unit of property" rule which may also provide some reasoning-by-analogy guidance in this area.

(n17)Footnote 17. *Krahl v Commr, 9 TC 862 (1947) .*

(n18)Footnote 18. *Wilson v US, 322 F Supp 1166, 27 AFTR2d 71-815 (DC Ala 1971)* (Court states the two allowable methods for allocating basis: apportioning cost to relative acreage or apportioning cost to relative fair market value. For the latter, see also *Treas Reg § 1.61-6(a)*, ex 2.).

(n19)Footnote 19. *Biscayne Bay Islands Co v Commr, 23 BTA 731 (1931) , acq XI-2 CB 2.*

(n20)Footnote 20. *Id.*

(n21)Footnote 21. *Rev Rul 68-478, 1968-2 CB 330 ; Perlmutter v Commr, 45 TC 311 (1965) ; Cooper v Commr, 31 TC 1155 (1959) .*

(n22)Footnote 22. *IRC § 165* (referring to *IRC §§ 1011, 1012*).

(n23)Footnote 23. *Rev Rul 69-536, 1969-2 CB 109 , amplified Rev Rul 86-149, 1986-2 CB 67 ; Atlantic Coast Realty v Commr, 11 BTA 416 (1928) .*

(n24)Footnote 24. *IRC § 471.*

(n25)Footnote 25. *Atlantic Coast Realty v Commr, 11 BTA 416 (1928)* . See also *Rev Rul 86-149, 1986-2 CB 67* ; *Homes by Ayres v Commr, 795 F2d 832 , 86-2 USTC P 9572 (9th Cir 1986)*; *Miller Development Co v Commr, 81 TC 619 (1983)* ; *Rev Rul 69-536, 1969-2 CB 109* .

(n26)Footnote 26. A taxpayer may have a dual status as a dealer and as an investor. See Chapter 10.



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CHAPTER 11 Subdivision and Tract Development

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§ 11.03 Allocation of Improvement Costs

Although the problems involved in allocating improvement costs to lots are similar in principle to those involving land costs, they do involve some unique issues. The following sections discuss some of these issues.

[1] Engineering, Planning and Legal Costs and Interest Expense

When a builder incurs engineering and surveying costs on an overall master plan for the development of a particular project, or legal fees associated with the project, the expenditures must be capitalized and allocated in the same fashion as the builder's basis in the land. ⁿ²⁷ Costs of engineering and subdivision planning allocable to specific projects or parcels must be allocated to these projects. Occasionally, certain specific planning costs will overlap two or more projects, in which case the costs must be allocated on some reasonable basis, such as acreage, front footage, or some other equitable method. The method need not be the same as that used to allocate land costs.

Interest expense which the taxpayer incurs in connection with the development of the project is subject to the uniform capitalization (UNICAP) rules provided in *IRC Section 263A(f)* and the regulations under that Section. These are discussed in Chapter 3.

[2] Estimation of Future Costs

Estimating the future cost of completing improvements for a tract is one of the most critical problems of successful real estate development planning. These costs are often substantial and extend over a period of several years, making this cost allocation difficult to anticipate successfully. Since many of the lots may be sold before the improvements are completed, failure to anticipate all estimated costs can result in several adverse consequences. First, if the sales price is based on estimated cost plus a reasonable profit, the sales price could be unrealistic when related to actual costs. In other words, the actual costs might eat up all or most of the anticipated profit. Second, an inadequate deduction for cost of sales would be taken on the tax return, and the advantage of deferring income tax liabilities would be lost. Third, lack of income tax deferral would unfavorably alter the development's projected cash flow.

Since the accurate determination of future costs is so important, most large developers continually review and update the cost pool through engineering and cost studies. Sound accounting and tax practice require that these be updated at least annually. ⁿ²⁸

Historically, developers of residential property were allowed to estimate the cost of future common improvements they were obligated to make with respect to property that had been sold and to include an allocable share of those estimated costs in the property's basis. Case law originally established the developer's ability to include these estimated future costs in basis. n29 The IRS accepted this approach, subject to certain procedural requirements, in Mimeographed Letter 4027 n30 and then in *Revenue Procedure 75-25* . n31

The situation changed in 1984 when Congress enacted the economic performance rules in *IRC Section 461(h)*. Although most commentators felt that the statutory provision was inapplicable to the estimated costs of future improvements, the preamble to the proposed Section 461(h) regulations, issued June 7, 1990, addressed the fate of *Revenue Procedure 75-25* as follows:

"[B]ecause economic performance must occur in order for a liability to be taken into account, the estimated cost of future improvements to subdivided real estate may not be added to the basis of lots sold if economic performance has not occurred with respect to those costs. Therefore, the statute and regulations override *Rev. Proc. 75-25* ." n32

In response to a barrage of adverse taxpayer comments and political pressure concerning *Revenue Procedure 75-25* , the Service issued Notice91-4 , n33 which provided significant relief to developers who would have been adversely affected by the proposed revocation of *Revenue Procedure 75-25* . In general, the Notice grandfathered taxpayers who had elected to use *Revenue Procedure 75-25* and allowed taxpayers to elect it on properties currently under development. The Section 461(h) rules would not apply to the estimated costs of future improvements for those taxpayers who had received IRS permission to use *Revenue Procedure 75-25* . Further, *Revenue Procedure 75-25* would continue to be available to taxpayers until further guidance was issued under Section 461(h).

When the regulations under Section 461(h) were finalized on April 10, 1992, the IRS concurrently issued *Revenue Procedure 92-29* to provide guidance in this area. n34 This revenue procedure allows developers to elect to allocate estimated future costs using the "alternative cost method." As discussed below, this method is somewhat less favorable than the method permitted by *Revenue Procedure 75-25* , but more favorable than the approach the Service took in the proposed regulations under Section 461(h).

[a] Overview of the Alternative Cost Method

By way of introduction to the alternative cost method, consider the following example:

Example:

A developer is building a subdivision with 10 homes of equal value. As part of the subdivision, the developer is contractually obligated to construct a tennis court and a swimming pool that will benefit all 10 of the homes equally. The tennis court and swimming pool will each cost \$250,000 to build (including the cost of the underlying land). The ownership of these improvements ultimately will be transferred upon completion to the home buyers. The following events occur:

	Number of Homes Sold	Amount Expended on Tennis Court During the Year	Amount Expended on Pool During the Year	Total Amount Expended on Common Improvements During the Year
Year 1	4	\$.....50,000	\$.....100,000	\$.....150,000
Year 2	4	\$.....175,000	\$.....100,000	\$.....275,000
Year 3	2	\$.....25,000	\$.....50,000	\$.....75,000

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		0	0	0
10	\$.....	250,000	\$.....250,000	\$.....500,000

Pre-Section 461(h) Treatment. Before the enactment of Section 461(h), the developer would have applied a ratable share of the estimated cost of the anticipated common improvements (including estimated future costs) to the basis of each of the homes sold. As a result, the additional basis created in each year would have been as follows:

Year 1:	4 homes sold x (\$500,000/10) =	\$.....200,000
Year 2:	4 homes sold x (\$500,000/10) =	\$.....200,000
Year 3:	2 homes sold x (\$500,000/10) =	\$.....100,000
		\$.....500,000

Thus, the taxpayer would be able to increase its basis in the homes sold in Year 1 by \$200,000, even though it had only spent \$150,000 on the common improvements by the end of that year.

Treatment under Section 461(h). Under the general economic performance rules of Section 461(h), a developer can only take into account the costs of common improvements as those costs actually are incurred. Thus, Section 461(h) would prevent the developer in the example above from taking into account anything more than the \$150,000 of actual common improvement construction costs incurred in Year 1. This \$150,000 would be allocated among all 10 homes, rather than just those homes sold. This would increase the basis of each of the 10 homes by \$15,000. Thus, the developer could increase his basis by only \$60,000 (4 homes sold x \$15,000) even though the developer actually spent \$150,000 on the improvements. n35

If the taxpayer does not elect the alternative cost method, this is the tax treatment that applies. Since Section 461(h) treatment typically results in the developer's recognizing income earlier than under the alternative cost method, most taxpayers make the election described immediately below.

Treatment under the alternative cost method. If the taxpayer elects the alternative cost method, *Revenue Procedure 92-29* requires it to first determine each unit's allocable share of total estimated common improvement costs. This amount is the same cost allocation that would have been made under pre-Section 461(h) law (i.e., \$50,000 per unit as in the example above). *Revenue Procedure 92-29* then modifies this result by limiting the amount of cost taken into account in any particular year to the *total* cost for which economic performance has occurred (and which has not yet been allocated to property sold in a previous taxable year). n36 This limitation is referred to as "the alternative cost limitation."

Using the facts of the example above, *Revenue Procedure 92-29* would allow the following costs to be included in the basis of property sold: n37

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	Allocable Share of Costs	Total Section 461(h) Costs	Costs Added to Bases of Homes Sold	
Year 1: 4 homes sold				
x (\$500,000/10) =	\$..... 200,000	\$.....150,0 00	x \$.....150,00 0	
Year 2: 4 homes sold				
x (\$500,000/10) =	\$..... 200,000	\$.....275,0 00	\$.....250,00 0	x
Year 3: 2 homes sold				
x(\$500,000/10) =	\$..... 100,000	\$.....100,0 00	\$.....100,00 0	**
	\$..... 500,000		\$.....500,00 0	
	_____		_____	
	_____		_____	
	_____		_____	
	_____		_____	

*Basis allocated to the 8 homes sold cannot exceed the pro rata share of the common costs (i.e., 8 x \$50,000 = \$400,000). Thus, even though a total of \$425,000 (\$150,000 + \$275,000) has been spent on common improvements by the end of Year 2, only \$250,000 of the \$275,000 in Year 2 costs may be allocated to the homes sold in Year 2.

**\$25,000 carryover of excess Section 461(h) costs from Year 2 plus \$75,000 of current cost from Year 3.

The Revenue Procedure 92-29 approach achieves a compromise result that is consistent with sound cost accounting principles and is within the parameters of the economic performance limitations. Any other result, such as assigning incurred costs ratably among all units, would result in mismatching income and expenses and, accordingly, would distort income.

[b] Definition of "Common Improvements"

Under the alternative cost method, a developer is allowed to include in the basis of property sold an "allocable share" of the "estimated cost of common improvements." n38 A "common improvement" is defined as any real property or real property improvement that benefits two or more properties that are separately held for sale by a developer. n39 Moreover, the developer must be contractually obligated or required by law to provide the common improvement, and the cost of the common improvement must not be properly recoverable through depreciation by the developer. *Revenue Procedure 92-29* specifically lists "streets, sidewalks, sewerlines, playgrounds, clubhouses, tennis courts, and swimming pools" as examples of common improvements. n40 A court has held that future period interest expense related to the construction of common improvements is not a common improvement and cannot be allocated under the alternative cost method. Instead, the statutory interest capitalization rule of *IRC § 263A(f)* applies and prevents allocation of that interest to a developer's costs bases in lots related to the common improvement. n40.1

In establishing the framework for accounting for future improvement costs, the Service faced the significant issue of applying the alternative cost limitation to separate common improvements. Thankfully, *Revenue Procedure 92-29* takes a workable and practical approach by applying the alternative cost limitation on a "project-by-project" basis without regard to the number of separate property improvements or the need to identify each common element separately. The

revenue procedure allows taxpayers to determine what constitutes a project by allowing them to "use any reasonable method to define a project in light of the common improvements to be provided." n41

[c] Requirements for Using the Alternative Cost Method

Revenue Procedure 92-29 set forth five requirements for using the alternative cost method: n42

(1) A developer must be required by contract or law n43 to provide the common improvement, and the cost of the improvement must not be recoverable by the developer through depreciation deductions. n44 It should be noted that if one other than the developer owns the improvement, the developer *may* use the alternative cost method. In one case, a court allowed a developer to use the alternative cost method with respect to the costs of constructing a golf course clubhouse, the costs of which were allocated to residential lots in the adjoining golf course residential community. Although the costs of the clubhouse improvements were admittedly depreciable, the developer had transferred its ownership interest in the clubhouse to a nonprofit membership corporation that would run the golf course. Thus, the costs were not depreciable by the developer. Accordingly, the Tax Court allowed the taxpayer to allocate a proportionate amount of the costs to each residential lot. n44.1

(2) A developer must consent to an extension of the statute of limitations on the assessment of a deficiency with respect to the use of the alternative cost method on a project-by-project basis. The statute of limitations extension is limited to the assessment of deficiencies attributable to the use of the alternative cost method and to the project covered by the consent. Additionally, with respect to a partnership that is subject to the unified audit and litigation provisions, the consent only needs to be filed by the tax matters partner on behalf of the partnership and not by each partner.

(3) To receive automatic consent n45 under *Revenue Procedure 92-29*, a developer must file a request, on a project-by-project basis, with the district director by the due date of the developer's timely filed tax return for the year in which the first benefited property is sold. n46 This request must contain a detailed description of the project and the types of improvements being made, as well as other related information. A copy of the request also must be included in the developer's timely filed tax return for that year. n47 The IRS may grant extensions of time to file requests under *Revenue Procedure 92-29*. n47.1

(4) An annual statement must be filed with the district director and attached to the taxpayer's tax return for each year during which the taxpayer is using the alternative cost method. The statement must contain the information enumerated in *Revenue Procedure 92-29*. n48 This information is similar to that required to be filed with the original request to use the alternative cost method.

(5) If the taxpayer wishes to continue to use the alternative cost method for a period that exceeds the extension of the statute of limitations, a supplemental request with a new extension of the statute of limitations must be filed for each project.

[d] Methods for Estimating Future Costs

The mechanics of *Revenue Procedure 92-29* first require a taxpayer to determine a property's allocable share of the estimated future costs of common improvements. The two methods available to estimate the amount of anticipated common improvement costs are discussed below.

[i] Ten-Taxable Years Method

Under the "ten-taxable years" method, the taxpayer can estimate the common improvement costs it will incur during the

ten succeeding taxable years. n49 Any costs expected to be incurred beyond this horizon are disregarded in computing total estimated costs of common improvements. This approach contemplates that the amount of anticipated costs may vary in each subsequent year due to revised estimates. A developer may not adjust the computation for any prior taxable years after filing the income tax return for that prior year, but may make the correction for the year in which the revised estimate is determined. n50

Example:

In the example in § 11.03[2][a], above, assume that in Year 2 the developer redetermines that the total cost to complete construction of both the tennis court and the swimming pool will be \$110,000 greater, in Year 3, than anticipated. Thus, the total cost of the project will be \$610,000 instead of \$500,000. The amount of the common improvement costs included in the basis of the units sold in Year 1 would not be recomputed. The developer would, instead, redetermine the allocable share of costs to those homes sold in Years 2 and 3 based on the revised projections.

[ii] Unlimited Taxable Years Method

A developer may request the Service to disregard the ten taxable year horizon in determining the anticipated future common improvement costs. To do so, the developer must file a ruling request with the IRS National Office within 30 days after the close of the tax year in which the first property benefited by the common improvements is sold. This procedure allows the developer of a very long-term project to match total revenue and expenses more accurately. *Revenue Procedure 92-29* contemplates that a developer ordinarily will be granted approval upon showing that the estimates are accurate and that the developer is likely to provide the improvements. n51

[iii] Improvements Not Completed by Time Required

In some instances a developer will not complete improvements within the period covered by the Service's consent. In these cases, the developer must submit a "supplemental request," substantiating:

- (1) that, for a valid reason, it was unable to complete all of the common improvements it is contractually obligated or required by law to provide within the period covered by the consent;
- (2) that it continues to be contractually obligated or required by law to provide the common improvements; and
- (3) that it has, to date, complied with the requirements of *Revenue Procedure 92-29*. n52

[e] Interaction with Interest Capitalization Regulations

Revenue Procedure 92-29 specifically states that the alternative cost method does not have any impact on the application of the general capitalization rules under *IRC Section 263A*: "Thus, common improvement costs incurred under section 461(h) of the Code are allocated among the benefitted properties and may provide the basis for additional computations (e.g., interest capitalization under section 263A(f))." n53 Applying this statute, a case has held that future period interest expense related to the construction of common improvements is not a common improvement and cannot be allocated under the alternative cost method to a developer's costs bases in lots related to the common improvement. n53.1

One situation considered in the regulations under Section 263A(f) involves the interaction of the capitalization rules and *Revenue Procedure 92-29* with respect to unsold units. The regulations state that the revenue procedure does not affect the determination of accumulated production expenditures of unsold units even if the costs of common improvements for those unsold units have been used to determine the alternative cost limitation for purposes of including common improvement costs in the basis of sold units. n54

[f] Taxpayers Who May Use Revenue Procedure 92-29

The application of *Revenue Procedure 92-29* appears to be limited strictly to "developers." (The revenue procedure uses this term to define those taxpayers who can avail themselves of the alternative cost method of accounting.) This may represent a change in the Service's view, since *Revenue Procedure 75-25* focused on a "subdivider of real estate" and Mimeographed Letter 4027 focused on the "vendor" or "taxpayer." The term "developer" may encompass a broader group of taxpayers than the term "subdivider of real estate."

The application of *Revenue Procedure 92-29* also is limited specifically to real property or real property improvements that benefit "two or more properties that are separately held for sale by a developer." n55 The two-property limitation is appropriate because *Revenue Procedure 92-29* is merely an allocation methodology. It does not allow any deductions in excess of what would otherwise be allowable under Section 461(h) principles; it merely establishes a framework for allocating those costs among various properties. Therefore, if there were only a single property, there would be no change in the amount of costs incurred with respect to that property even if *Revenue Procedure 92-29* did apply. However, this rule may prevent a taxpayer from classifying a single property as a "project" for purposes of applying the alternative cost method.

[g] Election Procedures**[i] Costs Determined Using the Ten-Taxable Year Horizon**

A developer willing to determine the estimated cost of common improvements using the ten-taxable year horizon uses an "automatic procedure" for the election. n56 The developer files a request with the District Director for the district in which is located the legal residence or principal place of business of the person required to make the return (assuming the developer is an individual, estate or trust), or the district in which is located the principal place of business or the principal office or agency (if the developer is a corporation or partnership). The request must be filed on or before the due date of the developer's original federal income tax return (determined with regard to extensions of time) for the taxable year in which the first benefited property in the project is sold.

The request must include information described in Section 6.04 of *Revenue Procedure 92-29* and a consent extending the period of limitation on the assessment of income tax. n57 The developer must also attach a copy of the request to its timely filed (determined with regard to extensions of time) original federal income tax return for the taxable year. No user fee is required.

The revenue procedure indicates that the Commissioner grants consent to a developer complying with this automatic procedure and the other applicable conditions of *Revenue Procedure 92-29*.

[iii] Costs Determined Without Regard to the Ten-Taxable Year Horizon

A developer interested in determining the estimated cost of future common improvements without regard to the ten-taxable year horizon must file a private letter ruling request. n58 The request must be filed within 30 days after the close of the taxable year in which the first benefited property in the project is sold. The request must include the same information and consent for extending the period of limitation as with the automatic application. In this case, however, a user fee is required for the request.

Revenue Procedure 92-29 indicates that a developer will ordinarily be granted consent to its ruling request if it can demonstrate that:

- (1) it is contractually obligated or required by law to provide the common improvements;

(2) its estimate of the cost of common improvements is accurate; and

(3) it is likely to provide the common improvements. n59

[h] Effective Date and Transition Rules

Revenue Procedure 92-29 generally is effective for sales of property after December 31, 1992. n60 However, generous transition rules allow taxpayers to adopt *Revenue Procedure 92-29* for taxable years including January 1, 1991, 1992, or 1993, regardless of whether benefited property from the project had been previously sold. In general, a taxpayer may use the alternative cost method under this transition rule by filing a request with the district director by the due date of its timely filed original tax return for the appropriate year and attaching a copy of the request to that year's tax return. A taxpayer adopting *Revenue Procedure 92-29* for a taxable year for which the tax return has already been filed must file a request with the district director on or before June 29, 1993, and attach a copy of the request to an amended tax return filed by June 29, 1993. The change to the alternative cost method of accounting must be implemented using the cut-off method. n61

Taxpayers who have received permission to use *Revenue Procedure 75-25* may continue to use *Revenue Procedure 75-25* for sales after December 31, 1992, that are covered by that consent. n62

[3] Off-Site Improvement Costs

The sales price of each subdivided parcel must bear a proportionate share of the cost of off-site improvements. These improvements (sometimes called off-tract improvements) are major expenditures that are made because they are required by state or local subdivision law or because the developer feels that the improvement will benefit the entire project and, therefore, enhance its marketability. For example, the developer may be required to build main roads, access roads, bridges and main utility lines (including electricity, water, sewage, storm drains and communications). To offer competitive housing projects, many developers also are providing parks, golf courses, country clubs, artificial lakes and a variety of other facilities.

Classifying an expenditure as an off-site improvement means that it will be allocated to the cost of all lots in the parcel instead of to only a portion of the lots or none at all. n63 Several standards are used to determine if an expenditure is an off-site improvement. n64 Often, an off-site improvement will constitute a capital expenditure whose cost is not recoverable through depreciation. n65 Because off-site improvements typically do not generate revenue, the only way of recovering the cost is to include proportionate amounts in the cost of sales of lots.

In one case, a developer was required to build a shelter on a park site to obtain approval of his subdivision plot. The improvement added no value to the remaining lots, so the developer treated the cost of the shelter as a current business expense. However, the Tax Court held that the construction of the shelter was a "capital outlay to be identified with the other costs of the subdivision project." Consequently, the classification of expenditures as off-site improvements depends on the manner in which their costs will be recovered rather than their effects on marketability. n66

If an off-site improvement is designed as a necessary part of the tract development but at the same time produces revenues, the legal title may affect the developer's right to include all or a portion of the cost as a current cost of sale. For example, occasionally a developer will construct and operate a utility system (e.g., a power plant or sewage treatment facility) which generates net income when the property is developed. If the developer permanently retains ownership of the system, the cost of this system must be depreciated rather than allocated to the cost of the lots sold. However, the retention of merely tenuous rights that have no practical value, such as a possibility of reverter, will not be interpreted as a retention of full ownership and control, and the cost of the utility can be allocated to the cost of the lots. n67

A developer can ensure a utility-cost allocation by divesting itself of ownership of the system. In a particular case, a developing corporation was unable to solicit the assistance of the local authorities, and the utility was built and transferred to an operating company which issued trust deeds granting to the homeowners rights and obligations over the system. The Tax Court held that the system's pro rata cost was includable in the basis of each house. n68

Occasionally, local authorities will agree to construct a utility and finance the construction by selling redeemable bonds to the developer as a condition of granting subdivision approval. If the purchase of the bonds is required and they are not marketable, their cost can be allocated as a cost of the development. n69

A developer may contract with a utility company to install a system where the developer finances construction by making unconditional payments. Even though the developer has the right to receive a percentage of the revenues in the form of either homeowner connection charges or a fraction of operating income, one case permitted the allocation of the system's cost to subdivided lots. n70 Two facts were important: first, the developer was not entitled to revenue in excess of his cost; second, the developer never had legal title to the utility.

Sometimes utility-refund payments will be guaranteed under local law and paid over a 15-to 25-year period. Since the risk element is sharply reduced or even eliminated in such a case, the Service is in a position to argue that none of the cost should be allocated. However, because the refunds will be received over an extended period of time, there is a strong argument to be made that the developer should be able to charge to lots sold at least the amount of the discount between face value and fair market value of the refund payments.

When a developer cannot include off-site improvement costs in the cost of sales, it should consider depreciating the improvements. Frequently, the Service will argue that the improvements merely enhance the value of the raw land, which is not depreciable. However, developers have been successful in depreciating private roads, landscaping, shrubbery, canals, waterways and lagoons. n71

The cost of off-site improvements may be allocated to the cost of land sales by the same method used to allocate land costs, although this practice could produce inaccurate results. The best method of allocation depends on the special circumstances confronting each developer. In addition to the methods of allocating land costs discussed above, other methods are particularly applicable to allocations of off-site improvement costs. Some of these methods are:

- (1) the unit allocation method;
- (2) the benefit allocation method; and
- (3) hybrid allocation methods.

[a] Unit Allocation Method

The unit allocation method is based on the economic desirability of the terrain. The development is divided into several zones, according to location and homogeneity. For example, a hilly area could make up one zone, a flat area another zone, and a lakeside area still another. Each zone is rated according to the average number of equivalent economic units that each acre with the zone will yield, such as the number of houses or lots that can be developed on each acre. The two most important factors in the rating are geology and slope.

The number of acres in each zone is then multiplied by the applicable rating. The unit allocation percentage is determined by dividing this result by the total rating of the development (i.e., the total number of houses or lots within the development.) Off-site improvements then are allocated according to the percentage components of each zone.

Example:

A developer spends \$2 million to construct a water plant system which improves a 445-acre parcel on which he will construct single-family homes. One zone in the parcel (Zone 1) consists of 120 relatively hilly acres, and it is expected that only one home will be constructed on each acre in Zone 1. A second zone (Zone 2) consists of 135 acres and two homes can be constructed on each acre in the zone. There are two other zones, the data for which is reflected in the following table. The table also indicates how much of the \$2 million water plant cost is allocated to each zone under the unit allocation method.

Unit Allocation

of Off-Site Improvements

Allocation of water plant system; total cost \$2,000,000.

Zone	Rating	Yield*	Acres	Total	Percent	Allocation
1	1		120	120	12%	\$.....240,000
2	2		135	270	27%	\$.....540,000
3	3		110	330	33%	\$.....660,000
4	3.5		80	280	28%	\$.....560,000
			445	1000	100%	\$.....2,000,000

*Based on number of houses or lots to be generated per acre.

[b] Benefit Allocation Method

The benefit allocation method can be used if the relative benefit of the off-site improvement to each land parcel can be specifically identified. This method can be illustrated by considering a golf course that will require an extensive supply of water (for maintaining the grass) but limited electricity and sewage facilities. The cost of a power plant should not be heavily allocated to the golf course since the acreage will receive little benefit as compared with that of a housing tract. On the other hand, the golf course will receive a significant allocation of the cost of a main water line. A proportionate allocation of the water system will increase the cost of the golf course as an off-site improvement which would, in turn, be allocated to the cost of subdivided lots.

[c] Hybrid Allocation Methods

Most acceptable systems of cost allocation will employ a hybrid method. For example, the cost of different off-site

improvements will be allocated differently. An access road could be allocated on a simple acreage basis, while a water main could be allocated on a benefit basis. Furthermore, one method of allocation might be used to allocate off-site costs to separate parcels, while another might be used to allocate the off-site costs of parcels to specific lots.

[d] Other Considerations

Several potential problems must be considered when an allocation of an off-site improvement is made. For example, although the relative value of land can be an appropriate method of allocating land costs, the relative value of raw land is not the same as the relative value of land plus improvements. Assume that two acres of land lie contiguous to a lake. One acre is planned for a restaurant overlooking the marina, and the other acre will only be used as a waterfront storage area. Which acre should receive a greater allocation of the cost of off-site improvement? The restaurant will probably receive a greater benefit, and thus should absorb the majority of the off-site improvement costs, even though the value of the raw acres alone is the same.

Here's another problem to consider: If two lots are the same size and contain the same type of house, except that one is a more valuable property with a much better view, the cost of basic utilities is no greater for the more valuable lot. But if greater costs of electricity, water, sewage systems, and main access roads are allocated to "view" properties, the early sales of the other houses will overstate financial and taxable income with unfavorable results. The gross profit ratio of the early sales would be overestimated since the cost of providing these lots with utilities will not have been adequately reported.

[e] Application of Off-Site Improvement Rationale to Commercial Property

The allocation of off-site improvement costs to individual lots usually occurs with the development of residential subdivisions. ^{n71.1} The same "basic purpose" allocation rationale could also apply in a commercial office building setting. Where a basic purpose of property is the enhancement of other properties to induce their sale, and the property does not have, in substance, an independent existence, the cost of that property could properly be allocated to the benefited properties. In one case, however, the Tax Court refused to allocate the cost of an atrium to adjoining office buildings because the basic purpose of constructing the atrium was not to induce sales of the adjoining properties. ^{n71.2}

[4] On-Site Improvement Costs

The distinction between on-site and off-site improvements may seem arbitrary, but identification is needed to allow the developer to organize the project and properly identify and control cost allocations. On-site improvements are expenditures that benefit only a particular parcel, tract or lot, whereas off-site improvements benefit the entire development.

For example, while the main access and arterial roads should be treated as off-site improvements and allocated to the entire project, roads that connect individual tracts to major access roads should be treated as on-site improvements and allocated only to the particular tracts that benefit from them. In this way, on-site improvements are an extension of the major off-site improvements.

The cost of utility hookups to the backbone of the system is another example of this type of on-site improvement. On-site improvements can also be special projects with limited scope, such as small parks or recreation centers which may benefit only a tract or a block within a tract. On-site costs of this nature are subject to allocation when they benefit more than one tract or project within a development.

Generally, the most significant on-site cost centers will be the construction costs of residential houses or commercial buildings which the developer markets in the ordinary course of its business. Included in this category would be all direct and indirect costs of material, labor, overhead and other costs incident to the construction of the housing or

commercial units. As the units are sold, these on-site construction costs, as well as a proportionate share of off-site improvement costs, would be charged to cost of sales so that gross profit can be determined on a unit-by-unit basis.

The allocation of on-site improvements requires that the developer make a factual evaluation of the improvements' benefit; that is, how many and which lots will the on-site improvements benefit?

After the scope of the benefits is determined, the cost should be allocated to the lots on the basis of an equitable method that matches costs with revenues. For example, a unit method could be used for allocating on-site utility hookups. The cost of on-site recreational facilities (e.g., a small park or recreation center) could be allocated on the basis of a relative-value method, since the proximity of the lot to the improvement may affect its value.

The location of a park, for example, can affect cost allocations in two ways. First, if a lot is located near the park, the relative value of the basic land may be greater than that of a more distant lot. Second, the nearby lot will receive a greater benefit and, thus, a greater allocation from the cost of the park. Conversely, if an undesirable improvement were erected instead of a park, the value of, and the cost allocations to, a nearby lot could be significantly decreased.

[5] Hybrid Improvement Costs

Some on-site improvements may also be classified as off-site improvements if they benefit the entire project in general as well as one tract in particular. Thus, an artificial lake may provide recreation and attractiveness to the whole project, while the lakeside property also becomes significantly more valuable. The developer must determine how much the lake improves the marketability of the adjoining lots.

Example:

Assume that an artificial lake costs \$200,000 for land and construction. The lake is surrounded by 80 lots which have an average relative cost of approximately \$15,000 each and which could have been marketed for \$25,000 before the lake addition. Having tested the market, the developer estimates that the addition of the lake will increase the average sales price per lot by 10 percent to \$27,500.

With these facts, the developer can rationally argue that the average lot cost has increased 10 percent to \$16,500 (\$1,500 per lot), or an aggregate of \$120,000 (80 x \$1,500) for all the lakeside properties. Therefore, the \$200,000 lake cost is allocated \$120,000 to the lots surrounding the lake as an on-site improvement, and \$80,000 to the entire project as an off-site improvement.

A further allocation problem arises when a developer constructs a hybrid improvement that it intends to operate as a business. Since the developer retains an interest in the improvement as a business activity, the cost is not properly allocable as an off-site or on-site improvement. A highly attractive country club and golf course illustrate this type of improvement. n71.3

A so-called "developer line of cases" addresses the issue of how to adjust the basis of property in the context of a common improvement that benefits lots in a residential subdivision. The cases focus on the common improvement and not directly on the lots held for sale. In order to properly allocate the cost of the improvement to the adjoining lots, two requirements must be met: n71.4

- the basic purpose of the taxpayer in constructing the common improvement must be to induce sales of the lots; and
- the taxpayer cannot retain too much ownership and control of the common improvement.

Under these tests, a developer who retains ownership of the common improvement, makes it a commercial venture in

and of itself (such as a golf course), and does not dedicate the improvement to the exclusive use of property owners cannot allocate the cost of the improvement to the adjoining lots. n71.5

Example:

Assume a land developer leases land for a 25-year period to construct golf course facilities. Instead of building a typical golfcourse and clubhouse facility, the developer decides to build and operate a championship course to expedite the promotion and sale of housing units within the tract. The cost of the facility is \$4.9 million.

Since the developer retains an interest in the facility as a business activity, the cost would not be properly allocable as an off-site or on-site improvement under the rationale of some cases. n72 However, a review of the future revenue projection of the course reveals that, as a business activity, a cost of no more than \$4.5 million could be justified for the golf course and clubhouse. This amount is not included in the basis of the housing tract. But, since the facility cost \$4.9 million, the developer obviously has spent an extra \$400,000 (\$4,900,000 - \$4,500,000) to promote the entire development.

The allocation of the \$400,000 would be either to on-site improvements or to off-site improvements, or a combination of both.

A recurring problem in land development tax law is the extent to which the retention of legal title to an improvement affects the developer's ability to allocate its cost to the remaining lots. If the developer retains ownership of an improvement to operate for nominal revenue, the Service may preclude the allocation of the major costs as off-site or on-site improvements.

A full cost allocation of the improvement can be achieved by transferring title to a neighborhood homeowners' association for no consideration. The transfer is usually made on the condition that the homeowners' association cannot subsequently dispose of the improvement. Even though this procedure has been sanctioned by the Service n73 and the Tax Court, n74 certain drawbacks must be considered.

Once the improvement has been transferred, the developer loses all future economic benefits. The appreciation will benefit the property owners, who are generally given voting rights over the use and control of the property. Therefore, the developer usually gives up its right to participate in future appreciation for the immediate benefit of allocating its cost basis to its current cost of sales.

If the developer does relinquish title in improvements to the homeowners, the developer, from a business standpoint, must have sufficient control to be guaranteed that the improvement is properly maintained. This can be done in a number of ways, such as:

- (1) a leaseback of the facility to the developer;
- (2) an agreement with the homeowners giving the developer operating responsibility for a given period of time;
- (3) the inclusion of maintenance standards in the agreement transferring title to the homeowners; or
- (4) retention of a reversionary interest under certain conditions.

The developer's retention of merely tenuous rights will not necessarily prevent the allocation of the improvement costs to the lots sold. n75

[6] Construction Costs and Allocations

All costs of construction must be capitalized as part of work in process and charged against income on a pro rata basis at the time of sale of each individual unit. Construction costs of a housing project or building include all architect's and contractor's fees and all direct costs of material, labor, supplies, services, etc. In addition, most overhead expenses must also be capitalized pursuant to the uniform capitalization (UNICAP) rules discussed in Chapter 3.

FOOTNOTES:

(n1)Footnote 27. See *Dahling v Commr*, TC Memo 1988-430, 56 TCM 131 (1988) (court held that costs involved for road, sewer, excavation and water should be allocated equally to all parcels, regardless of whether the value of the parcels increased pro-rata); *Soelling v Commr*, 70 TC 1052 (1978) .

(n2)Footnote 28. See Rev Proc 78-25, 1978-2 CB 505 ("remedy is to make the correction in and for the year the determination is made").

(n3)Footnote 29. See *Kentucky Land, Gas & Oil Co v Commr*, 2 BTA 838 (1925) ; *Mackay v Commr*, 11 BTA 569 (1928) ; and *Birdneck Realty Corporation v Commr*, 25 BTA 1084 (1932) .

(n4)Footnote 30. XIII CB 60 (1933).

(n5)Footnote 31. 1975-1 CB 720 .

(n6)Footnote 32. Notice of Proposed Rulemaking IA-258-84, 1990-2 CB 805 (proposed June 7, 1990).

(n7)Footnote 33. 1991-1 CB 315 , superseded by IRS Notice 92-4, 93-4, 94-4, 95-4, 96-4 .

(n8)Footnote 34. Rev Proc 92-29, 1992-1 CB 748 .

(n9)Footnote 35. Rev Proc 92-29 , § 4.02, Ex (1).

(n10)Footnote 36. Note that the total cost is considered for economic performance purposes in this situation, rather than just the cost allocated to the units sold. Thus, Section 461(h) costs added to basis in Year 1 total \$150,000 (the amount actually spent) rather than \$60,000 (the portion of the \$150,000 allocated to the four homes sold that year).

(n11)Footnote 37. For other examples, see Rev Proc 92-29 , § 4.02.

(n12)Footnote 38. Rev Proc 92-29 , § 1.

(n13)Footnote 39. Id at § 2.01.

(n14)Footnote 40. Id.

(n15)Footnote 40.1. *Hutchinson, et al v Commr*, 116 TC 172 (2001) .

(n16)Footnote 41. Id at § 4.01.

(n17)Footnote 42. Id at § 5. See also § 6.

(n18)Footnote 43. The reference to obligations established by law is an expansion of *Revenue Procedure 75-25* , which only referred to contractual obligations.

(n19)Footnote 44. See TAM 9609006 , where a drafting error resulted in the taxpayer's obligations being unclear. The taxpayer, a partnership, was formed to develop a golf community. The agreement between the taxpayer and the

homeowners' association said the taxpayer was obligated to complete the common improvements listed in Article II of the Declarations. That Article did not list the improvements but, instead, said that the homeowners' association had the responsibility for maintaining the community's roads, parking lots, landscape areas, and "all other improvements" the taxpayer made. The District Director concluded that the taxpayer was not entitled to use the alternative cost method under *Rev Proc 92-29* because it was not contractually obligated to finish the common improvements. The National Office overturned the District Director, holding that the agreement, when read with the Declarations, required the taxpayer to complete the improvements. Thus, the taxpayer satisfied this first requirement and could use the alternative cost method. But see also *Rev Rul 76-247, 1976-1 CB 217*, and *Bryce's Mountain Resort, Inc v Commr, 50 TCM 164, TC Memo 1985-293 (1985)* for examples of developers who were held not to be contractually obligated to make a common improvement.

(n20)Footnote 44.1. *Hutchinson, et al v Commr, 116 TC 172 (2001)* .

(n21)Footnote 45. For a discussion of the procedures required when the developer is not entitled to automatic consent because the improvements are determined without regard to the 10-taxable-year horizon, see § 11.03[2][d][ii], below, and *Rev Proc 92-29* at § 6.02.

(n22)Footnote 46. *Rev Proc 92-29* at § 6.01. But see *Ltr Rul 9538010* , where the Service permitted a taxpayer to make a tardy election, pursuant to *Treas Reg § 301.9100-1(a)* and *Rev Proc 92-85, 1992-2 CB 490* .

(n23)Footnote 47. *Rev Proc 92-29* at § 6.01.

(n24)Footnote 47.1. *Ltr Rul 9853025* .

(n25)Footnote 48. *Id* at § 8.

(n26)Footnote 49. *Rev Proc 92-29* states that "the estimated cost of common improvements as of the end of any taxable year is equal to the amount of common improvement costs incurred under section 461(h) of the Code as of the end of the taxable year, plus the amount of common improvement costs the developer reasonably anticipates it will incur under section 461(h) during the ten succeeding taxable years". *Id* at § 2.02(1).

(n27)Footnote 50. *Id* at § 2.02(1).

(n28)Footnote 51. *Id* at § 6.02.

(n29)Footnote 52. For these and additional requirements, see *id* at § 9.

(n30)Footnote 53. *Id* at § 4.01

(n31)Footnote 53.1. *Hutchinson, et al v Commr, 116 TC 172 (2001)* .

(n32)Footnote 54. *Treas Reg §§ 1.263A-10(b)(5) and 1.263A-10(b)(6), Ex (6)*.

(n33)Footnote 55. *Id* at § 2.01. It is not clear why the term "held for sale" is used in this context. This term does not appear to be an otherwise defined term of art (compare "property held primarily for sale" in *IRC § 1031(a)(2)(A)* and "property held primarily for sale to customers in the ordinary course of [a] trade or business" in *IRC § 1221(a)(1)*), and that may lead to disputes regarding the scope of *Rev Proc 92-29* . For example, does *Rev Proc 92-29* apply to a taxpayer qualifying for treatment under *IRC § 1237* (allowing capital gain treatment for certain small subdividers)?

(n34)Footnote 56. *Rev Proc 92-29* at § 6.01.

(n35)Footnote 57. The consent is limited to the assessment of deficiencies attributable to the use of the alternative cost method with respect to the project covered by the consent. *Rev Proc 92-29* at § 7.01. The consent procedure is

described id at § 7.03.

(n36)Footnote 58. *Rev Proc* 92-29 at § 6.02.

(n37)Footnote 59. *Id.*

(n38)Footnote 60. *Rev Proc* 92-29 at § 12.

(n39)Footnote 61. *Id.* at § 6.03.

(n40)Footnote 62. *Id.* at §§ 3 and 11.02.

(n41)Footnote 63. *Dahling v Commr, TC Memo 1988-430, 56 TCM 131 (1988)* .

(n42)Footnote 64. Some tax authorities classify off-site improvements as those expenditures which make "more salable the lots in the remaining property." *Rev Rul 68-478, 1968-2 CB 330* ; *Montclair Dev Co v Commr, 25 TCM 1029, TC Memo 1966-200 (1966)* (the court considered that the project was undertaken primarily to further sale of lots or houses).

(n43)Footnote 65. But see the text accompanying note 73, below, for situations where a taxpayer was able to depreciate certain off-site improvements.

(n44)Footnote 66. For a discussion of capital expenditures compared to deductible expenditures, see *Lots, Inc v Commr, 49 TC 541 (1968)*, *acq 1968-2 CB 2*, *aff'd per curiam 410 F2d 759, 69-1 USTC P 9368, 23 AFTR2d 69-1246 (5th Cir 1969)*.

(n45)Footnote 67. *Estate of Collins v Commr, 31 TC 238 (1958)* , *govt's app dismissed per stipulation 1959*.

(n46)Footnote 68. *Willow Terrace Development Co v Commr 40 TC 689 (1963)*, *acq 1968-2 CB 3*, *aff'd 345 F2d 933, 65-2 USTC 9449, 15 AFTR2d 1108 (5th Cir 1965)*.

(n47)Footnote 69. *Herzog Building Corp v Commr, 44 TC 694 (1965)* , *acq 1968-2 CB 2* .

(n48)Footnote 70. *Gersten v Commr, 28 TC 756 (1957)* .

(n49)Footnote 71. *Rev Rul 65-265, 1965-2 CB 52* ; *Aurora Village Shopping Center v Commr, 29 TCM 126, TC Memo 1970-39 (1970)* (taxpayer allowed to depreciate expenditures toward building, but not land; however, court accepted Commissioner's allocation due to taxpayer's failure to present any evidence); *Loveman & Son Export Corp v Commr, 34 TC 776 (1960)* , *acq 1961-2 CB 5* , *aff'd 296 F2d 732, 62-1 USTC P 9147, 9 AFTR 2d 62-303 (6th Cir 1962)* , *cert den 369 US 860* (contribution towards paving depreciable); *Clinton Cotton Mills v Commr, 78 F2d 292 , 35-2 USTC P 9449, 16 AFTR 380 (4th Cir 1935)* (taxpayer allowed amortization deduction for sidewalks, curbing, gutter and drains); *Tunnell v US, 367 F Supp 557 , 74-1 USTC P 9122, 33 AFTR2d 74-362 (D Del 1973)* (landscaping depreciable, grading of land not depreciable); *Rev Rul 74-265, 1974-1 CB 56* (landscaping depreciable).

(n50)Footnote 71.1. See *Estate of Collins v Commr, 31 TC 238 (1958)* ; *Willow Terrace Dev Co v Commr, 40 TC 689 (1963)* , *aff'd 345 F2d 933 (5th Cir 1965)* ; *Country Club Estates, Inc v Commr, 22 TC 1283 (1954)* .

(n51)Footnote 71.2. *Norwest Corp and Subs et al v Commr, 111 TC 105 (1998)* .

(n52)Footnote 71.3. See *Charlevoix Country Club, Inc v Commr, 2000-1 USTC P 50,502 (WD Mich 2000)*.

(n53)Footnote 71.4. See *Norwest Corp & Subsids v Commr, 111 TC 105 (1998)* ; *Estate of Collins v Commr, 31 TC 238 (1958)* ; *Willow Terrace Dev Co v Commr, 40 TC 689 (1963)* , *aff'd 345 F2d 933 (5th Cir 1965)* ; *Country Club*

Estates, Inc v Commr, 22 TC 1283 (1954) ; *Charlevoix Country Club, Inc v Commr*, 2000-1 USTC P 50,502 (WD Mich 2000) (cost of golf course and country club not allocable to adjoining lots because the developer retained ownership of the course and club).

(n54)Footnote 71.5. *Norwest Corp & Subsids v Commr*, 111 TC 105 (1998) ; *Estate of Collins v Commr*, 31 TC 238 (1958) ; *Willow Terrace Dev Co v Commr*, 40 TC 689 (1963) , *aff'd* 345 F2d 933 (5th Cir 1965) ; *Country Club Estates, Inc v Commr*, 22 TC 1283 (1954) ; *Charlevoix Country Club, Inc v Commr*, 2000-1 USTC P 50,502 (WD Mich 2000); *Lakeside Garden Developers, Inc v Commr*, TC Memo 1976-290 , *aff'd* 601 F2d 892 (5th Cir 1979) .

(n55)Footnote 72. See, eg, *Biscayne Bay Islands Co v Commr*, 23 BTA 731 (1931) , acq XI-2 CB 2; *Charlevoix Country Club, Inc v Commr*, 2000-1 USTC P 50,502 (WD Mich 2000).

(n56)Footnote 73. *Rev Rul 68-478*, 1968-2 CB 330 .

(n57)Footnote 74. *The Country Club Estates v Commr*, 22 TC 1283 (1954) , acq 1955-1 CB 4 .

(n58)Footnote 75. *Rev Rul 68-478*, 1968-2 CB 130 ; *The Country Club Estates v Commr*, 22 TC 1283 (1954) , acq 1955-1 CB 4 .



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CHAPTER 11 Subdivision and Tract Development

1-11 Federal Taxes Affecting Real Estate § 11.04

§ 11.04 Gifts to Charities and Municipalities

Contributions of land offer valuable opportunities for combining philanthropy with tax savings. If the developer can establish investment status for property it has held for more than one year, it may deduct the fair market value of the property and not be taxed on the appreciation. n76 The problem is that the burden is placed on the developer to prove that the contributed property was, in fact, being held for investment. Advance planning and factual substantiation (board of directors' minutes, memoranda, documents and the like) will be necessary to establish the requisite intent.

A developer that grants an option on real property to a charitable organization is allowed a charitable deduction for the year in which the organization exercises the option. n77 The amount of the deduction is the difference between the fair market value of the property on the date the option was exercised and the exercise price. n78

A valid contribution must satisfy the general conditions for charitable gifts and cannot violate the rules specifically applicable to real estate developments. The contribution will be denied if it is made "under the ostensible compulsion of compliance with a colorable legal requirement." n79 Thus, if the developer is required by law to dedicate or set aside land for specific purposes, no deduction is allowed. If the developer attaches conditions to or expects favors as a result of the contribution, the deduction is likely to be disallowed. n80 If the developer derives a direct benefit from the contribution, as opposed to a mere incidental benefit such as a benefit available to any member of the community, a charitable deduction will not be permitted. n81

However, gaining a benefit does not, in and of itself, disqualify a contribution. For example, a charitable deduction was allowed where land and cash were donated to the state highway department for construction of a secondary roadway, even though the new road benefited the taxpayer-bank. The bank owned adjoining land on which it later built a new office building, but the road was donated out of a sense of public spirit. The court noted that to deny the deduction would bar many contributions that generate goodwill for the donor. n82

In a subsequent case, however, a real estate developer donated the streets and sewers of a new subdivision it had developed to the municipality, subsequently claiming a charitable deduction for the value of the transferred property. The Tax Court disallowed the deduction, holding that the developer's motive was not generosity but rather: (1) a desire to avoid responsibility for future maintenance of the streets and sewers; and (2) a desire to enhance the value of its interest in the remaining property. n83

This case indicates that the developer's motive is a relevant consideration and that, in connection with determining motive, an indirect economic benefit may be considered. This appears to be a more restrictive standard for when a developer may claim a charitable contribution deduction for such costs.

See Chapter 6 for a detailed discussion of charitable contributions.

FOOTNOTES:

(n1)Footnote 76. *IRC § 170(e)(1)*.

(n2)Footnote 77. *Rev Rul 82-197, 1982-2 CB 72 ; Rev Rul 75-348, 1975-2 CB 75 .*

(n3)Footnote 78. *Rev Rul 82-197, 1982-2 CB 72 .*

(n4)Footnote 79. *Perlmutter v Commr, 45 TC 311 (1965) .* See also *Ottawa Silica Co v US, 699 F2d 1124 , 83-1 USTC P 9169 (DC Cir 1983)* (court held that taxpayer was not entitled to a charitable deduction upon the conveyance of land to a local high school because, at the time of the conveyance, the taxpayer expected that as a result of the contribution, his own land value would substantially increase).

(n5)Footnote 80. *Stubbs v US, 428 F2d 885 , 70-2 USTC P 9468, 26 AFTR2d 70-5010 (9th Cir 1970) , cert den 400 US 1009 ; Sutton v Commr, 57 TC 239 (1971) ; Collman v Commr, 511 F2d 1263 , 75-1 USTC P 9303, 35 AFTR2d 75-958 (9th Cir 1975) .*

(n6)Footnote 81. *Wolfe v Commr, 54 TC 1707 (1970)* (no charitable deduction allowed). But consider the court's discussion in *Seldin v Commr, TC Memo 1969-233, 28 TCM 1215 (1969)* (govt's appeal dismissed nolle pros) (9th Cir 1970), where the court allowed a charitable deduction. See also *Ltr Rul 9151031* , where an S corporation in the real estate development business was allowed to deduct the contribution of a golf course to a charity. The golf course was in a residential development which the taxpayer constructed. In concluding that the taxpayer was entitled to the deduction, the Service considered several factors, including the fact that most of the development's lots had been sold before the gift was made. Thus, the taxpayer would not be using the golf course as a marketing tool to promote lot sales.

(n7)Footnote 82. *Citizens and S Nat'l Bank of SC v US, 243 F Supp 900, 16 AFTR2d 5538 (DSC 1965) .*

(n8)Footnote 83. *McConnell v Commr, 55 TCM 1284, TC Memo 1988-307 (1988) .*



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate 12.syn

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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.01

§ 12.01 Introduction

The most common method of financing the acquisition of real property is by use of a mortgage to secure the unpaid balance of the purchase price. Although types of mortgages vary, they basically arise from a conveyance of property which allows the money lender (mortgagee) to reacquire the property if the borrower in possession (mortgagor) defaults in the payment or in some other material provision of the mortgage.

Numerous tax and business advantages exist in using a loan to acquire real property. A principal business advantage is that the property can be used and its income and possible appreciation realized when the owner has made only a modest cash outlay. A principal tax advantage is that the mortgage debt is usually included in the tax basis of the property acquired. This results in a basis for depreciation far in excess of the purchaser's cash outlay. n1

FOOTNOTES:

(n1)Footnote 1. In cases where the mortgage is non-recourse, the at-risk rules may limit the mortgagor's ability to take a current deduction for depreciation. The passive activity loss (PALs) rules may also defer the mortgagor's enjoyment of the depreciation deductions. These limitations are discussed in Chapter 13.



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.02

§ 12.02 "Nominee" or "Straw" Corporations

Many states impose usury restrictions on interest rates for individuals, but not for corporations. To avoid the individual interest rate limitations in time of high interest rates, the lender may require the use of a corporate borrower to accomplish funding of real estate projects. The individuals involved in the transaction may want to directly realize the tax and cash flow benefits associated with the real estate, either by holding the property individually or through a partnership. To meet the objectives of both the owner and the lender, there have been many instances in which a nominee or straw corporation has been used to hold the legal title to the real estate. In these situations, a corporation is formed to hold the legal title, but it is acknowledged to be a straw man for the benefit of noncorporate owners. The noncorporate owners then report the operations of the real estate project on their tax returns, either directly or as partners in the partnership owning the property.

Although taxpayers are generally able to achieve this objective when using a corporate straw man, it is possible, through carelessness, to have the corporation treated as a separate taxable entity. Then the income from the real estate is subject to taxation to the corporation, typically resulting in a significant added tax liability for the real estate investors. See Chapter 15 for a detailed explanation of the problems in this area.



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.03

§ 12.03 Alternatives to Conventional Fixed Term/Fixed Rate Mortgages

For many years lending institutions made long-term, fixed rate loans from sources that would qualify as short-term borrowings. Major swings in short-term interest rates caused these institutions to suffer losses. In response to this problem, lenders have developed a number of techniques, some of which are described below, to protect themselves from the potentially unfavorable effects of borrowing short and lending long.

[1] Adjustable-Rate Mortgages

One type of alternative financing is the adjustable-rate mortgage (ARM). During the term of the loan, the lender raises or lowers the applicable interest rate to track current market rates. Contractual provisions of the ARM limit the annual swing in the interest rate to several percentage points in any given year, while providing for a maximum limitation on changes in interest rates. Generally, the loan may not vary by more than five percentage points from the original rate.

Variable-rate mortgages (VRM) are an alternate form of adjustable-rate mortgage and are primarily issued by savings and loan institutions. Interest rates on a VRM bear a direct relationship to the rate the savings and loan must pay for current mortgage funds.

[2] Shared-Appreciation Mortgages

Shared-appreciation mortgages (SAMs) are yet another financing technique sometimes used in residential mortgage markets. Under this method, the buyer and lender share in the potential appreciation that would be realized upon sale. The lender, in exchange for its interest in the appreciation, offers a mortgage at a below-market rate. A dangerous pitfall with shared-appreciation mortgages is that lending institutions frequently require a provision in the agreement allowing the lender to collect its portion of the appreciation after a specified period of time, even if the house has not been sold!

The use of shared-appreciation mortgages can also produce an undesirable result because of the timing of certain interest deductions. Generally, a SAM involves two different interest components. First, the lender earns interest on the loan at an agreed rate. In addition, the lender earns interest composed of a percentage of the future appreciation. The deductibility of the second component depends, in part, on when and how it is paid. The Service has ruled that a cash-basis taxpayer is allowed to deduct the interest attributable to the appreciation when it is ultimately paid. n2

In the context of a personal residence, this means that the borrower can have a large interest expense in the year the

contingent amount is paid out. That amount will be deductible to the extent it constitutes qualified residence interest. However, the amount may exceed the borrower's taxable income in that year. If that occurs, the interest cannot be carried forward as a loss beyond that taxable year, since it is not an expense incurred in connection with a trade or business. n3

If a shared appreciation mortgage loan is refinanced with the same lender, the face amount of the new loan includes the appreciation due on the SAM. The contingent interest is deductible over the term of payment of the principal on the new mortgage. n4 Thus, it may be advantageous for the mortgagor to refinance the loan with another lender: Interest paid to one lender with funds borrowed from a second lender has been held to be deductible when the interest is paid to the first lender, not in the later year when the loan from the second lender is paid. n5

In addition, if a shared-appreciation mortgage is on property used in business, or the lender acquires rights other than repayment at a specified time, the lender may be treated as holding an equity investment rather than debt, so the payments would not represent interest.

[3] Graduated Payment Mortgages

This method of home financing is designed primarily for the first-time buyer. Initial monthly payments are much lower than the payments of a conventional mortgage, but payments are scheduled to increase, presumably with the buyer's income. Generally, payments increase at the rate of about 5 to 8 percent annually for the first five years, at which time normal amortization may begin.

In some situations, the initial payments may not be sufficient to cover the interest accruing on the mortgage, let alone principal. The Service has ruled, in an instance involving an FHA mortgage, that the initial payments, in these circumstances, are treated as interest and are deductible to the extent otherwise allowable. Moreover, subsequent payments are considered to consist entirely of interest, until such time as the back interest is fully paid up. n6

[4] Participating Mortgages

Many lenders use participating mortgages to finance large real estate projects. Under such an arrangement, the financing has a stated interest rate (normally lower than the market rate) and a contingent interest feature. The feature may take the form of participation in appreciation when the property is sold, participation in gross income of the borrower, participation in net income of the borrower, participation in cash flow, or some combination of these features. In some instances, the participation is structured as additional interest to the lending institution, while in other cases it is structured as capital participation. n7

[5] "Balloon" Mortgages

In some situations, a lender may be unwilling to grant a long-term mortgage. A short mortgage term requires substantial debt amortization payments. This has a negative effect on the cash flow from a real estate investment. The solution, in these situations, is sometimes the "balloon" mortgage.

A balloon mortgage provides for a large ("balloon") principal payment at the end of the mortgage term. To accomplish this, the monthly payments are based on a longer amortization period than the period of the mortgage. For example, a ten-year mortgage may be given with monthly payments based upon a 25-year amortization schedule. At the end of the ten years, the balance of the principal that would have been payable over the last 15 years would be due and payable.

The use of a "balloon-type" mortgage may increase cash flow during the term of the mortgage, while not materially reducing the interest deduction. Of course, it tends to limit any equity build-up in the real estate.

[6] Price-Level Adjusted Mortgages

To encourage home ownership, the Department of Housing and Urban Development introduced price-level adjusted mortgages (PLAMs). PLAMs were primarily designed to make home buying more affordable in an inflationary economy. PLAMs achieve this goal by having the borrower pay interest at a rate that reflects the "real" cost of money. As the rate of inflation increases, so do the borrower's monthly payments and so does the outstanding debt balance. The increase in the mortgage debt is deemed to be accrued interest. The theory behind a PLAM is that a borrower will spend a fixed percentage of his annual income on mortgage payments throughout the term of the mortgage. This theory assumes that wages will rise at the same rate that mortgages do. However, if this basic premise is not true, the borrower may have difficulty making the monthly payments. Also, because of the lower initial interest rates, lenders are more likely to require a larger downpayment with a PLAM than with a conventional mortgage.

Because a portion of the amount of interest that accrues on a PLAM is not paid when it accrues, but is added to the outstanding balance, the original issue discount provisions apply to this type of mortgage. When the Treasury issued temporary regulations in 1990, it provided a special, generally favorable, rule allowing PLAMs to be treated as variable-rate debt instruments (VRDIs).ⁿ⁸ Final regulations issued in 1994 removed this special rule.ⁿ⁹ PLAMs issued after February 2, 1994, are now governed by general rules concerning original issue discount and qualified residence interest.

[7] Tax-Exempt Financing

[a] In General

At one time, tax-exempt financing was a common way for real estate investors to develop projects. Legislation which Congress passed in 1986 changed the name of these tax-exempt bonds (from industrial development bonds to private activity bonds) and severely curtailed their use. In addition, the 1986 legislation significantly increased the complexity in this area. For these reasons, the following discussion presents just a brief overview of tax-exempt financing.ⁿ¹⁰

A qualified private activity bond includes, but is not limited to, qualified mortgage bonds, qualified veterans' mortgage bonds, and bonds for qualified residential rental projects.^{n10.1} If a real estate investor uses tax-exempt financing, it is most likely for the development of a "qualified residential rental project." A private-activity bond may qualify as tax exempt when the proceeds are used for this kind of a development.^{n10.2}

A qualified residential rental project is a multifamily residential rental project where the issuer irrevocably elects to set aside units for rental to low- or moderate-income families as follows:

- (1) 40 percent or more units for families having incomes of 60 percent or less of the area median income (the 40 percent/60 percent test), or
- (2) 20 percent or more units for families having incomes of 50 percent or less of the area median income (the 20 percent/50 percent test).ⁿ¹¹

The IRS has issued the following guidance for complying with the set-aside requirements:^{n11.1}

- The general rule for set-aside requirements is that beginning on the first day of the qualified project period (i.e., the later of the first day on which at least 10 percent of all of the residential units in the project are occupied, or the issue date of the bonds),^{n11.2} the set-aside requirements apply to the total number of available units.
- A special rule applies for certain existing projects. It applies to the acquisition of an existing residential rental project unless more than 90 percent of the residential units in the project are not

available units (for example, because residential units are not available for occupancy due to renovations) at any time within 60 days after the later of (1) the date the project is acquired, or (2) the issue date of the first bonds. Under the special rule, for a period of 12 months beginning on the issue date of the first bonds (the "transition period"), the failure to satisfy the set-aside requirements under the general rule will not cause the project to lose its qualified residential rental project status. Failure to satisfy the set-aside requirements on the last date of the transition period, however, will cause the project to not be a qualified residential rental project as of the issue date(s) of the bonds issued to finance the project unless all bonds issued to finance the project are redeemed as soon as possible, but in no event later than 18 months after the issue date of the first bonds.

A qualified tenant is deemed to remain eligible as long as his family's income does not increase to a level that is more than 140 percent of the area-income limit. n12 Qualified students may reside in a residential unit without violating the income tests, n12.1 and a residential unit may be a single-room occupancy unit. n12.2 If the income of a qualified tenant in a unit rises above certain levels, then his or her income will still be treated as meeting the 140-percent test, provided that the next available unit in the project (of a size comparable or smaller than that unit) is rented to a new tenant who satisfies the income and rent-restriction requirements (the "next-available-unit rule"). n12.3 In the case of a low-income building that is tax-exempt bond financed and eligible for the low-income housing credit, n12.4 the bond restrictions will be satisfied if the next available unit in the *building* (rather than in the project) is rented to a new tenant who satisfies the income and rent-restriction requirements. n12.5 This conforms the tax-exempt bond rule to the low-income housing credit rule. n12.6 Tenant eligibility generally must be determined annually on the basis of current income, but annual recertification is waived for any project for a year as long as no residential unit in the project is occupied by tenants who fail to satisfy the otherwise applicable income limits. n13

The rental housing generally must remain a qualified project until the latest of these three periods:

- (1) 15 years from the date on which 50 percent of the project's residential units are occupied;
- (2) the date on which the bonds are no longer outstanding; or
- (3) the date on which assistance under Section 8 of the U.S. Housing Act of 1937 terminates. n14

The operator of a qualified residential-rental project must file an annual certification that low- and moderate-income occupancy requirements have been met. n14.1 Failure to file subjects the operator to a \$100 per day penalty. n14.2 In a private letter ruling the IRS has approved dual ownership of a multi-family housing project, with one partnership owning the market-rate units, and another owning the low-income units. The ruling held that the dual ownership would not cause the project to fail to qualify as a qualified residential rental project under *IRC Section 142(d)*. n14.2.1

Tax-exempt interest on exempt facility bonds issued as part of an issue 95 percent or more of the net proceeds of which are used to provide qualified residential rental projects, n14.2.2 qualified mortgage bonds, n14.2.3 and qualified veterans' mortgage bonds n14.2.4 is not an item of tax preference for purposes of the alternative minimum tax. The same is true for interest on any refunding bond, but only if interest on the refunded bond (or in the case of a series of refundings, the original bond) was not an item of tax preference. n14.2.5 Also, this interest is not included in the corporate AMT adjustment based on current earnings. n14.2.6

[b] Qualified Green Bonds

Legislation enacted in 2004 created a new category of exempt-facility bond-the qualified green building and sustainable design project bond ("qualified green bond"). n14.3 A qualified green bond is one issued as part of an issue that finances a project designated by the IRS as a green building and sustainable design project that meets the following eligibility requirements: (1) at least 75 percent of the square footage of the commercial buildings that are part of the

project is registered for the U.S. Green Building Council's LEED certification and is reasonably expected (at the time of designation) to meet that certification; n14.4 (2) the project includes a brownfield site; (3) the project receives at least \$5 million in specific state or local resources; and (4) the project includes at least one million square feet of building or at least 20 acres of land. n14.5

Qualified green bonds are not subject to the state bond volume limitations. n14.6 Rather, there is a national limit of \$2 billion of qualified green bonds that may be allocated, in the aggregate, to qualified green building and sustainable design projects. n14.7 Qualified green bonds may be currently refunded if certain conditions are met, but cannot be advance refunded. n14.8 The authority to issue qualified green bonds terminates after September 30, 2012. n14.9

A detailed statutory application and designation process must be followed, n14.10 and cumbersome energy use, employment, and location eligibility, and accountability requirements must be met. n14.11

[c] Tax-Exempt Bonds for Sub-Prime Loan Refinancings

Legislation enacted in 2008 in response to the sub-prime mortgage crisis made several modifications to the tax treatment of tax-exempt bonds:

- It increases the volume cap for 2008 by \$11 billion for the purpose of issuing qualified mortgage bonds or private activity bonds for qualified residential rental projects. n14.11.1
- Qualified mortgage bonds issued with respect to the additional volume cap may be used to finance either new mortgages or refinance qualified subprime loans. n14.11.2 A qualified subprime loan as an adjustable rate residential mortgage loan originated after December 31, 2001, and before January 1, 2008, that the bond issuer determines would be reasonably likely to cause financial hardship to the borrower if not refinanced. n14.11.3 Qualified subprime loans cannot be refinanced by bonds issued after December 31, 2010. n14.11.4
- All proceeds of qualified mortgage bonds issued with respect to the additional volume cap must be used within 12 months of the date of issuance of the bonds. n14.11.5
- Additional volume cap that remains unused at the end of 2008 may be carried forward to 2009 and 2010, but solely for the purpose of issuing qualified mortgage bonds or private activity bonds for a qualified residential rental projects. n14.11.6

The IRS has issued a detailed notice providing guidance on allocations, carryforwards, information reporting, and uses of the additional bond volume cap enacted by the 2008 legislation, and guidance on the use of qualified mortgage revenue bonds to refinance certain subprime mortgage loans. n14.11.7

FOOTNOTES:

(n1)Footnote 2. *Rev Rul 83-51, 1983-1 CB 48* . The wide variety in SAM terms has led the Service to refuse to issue advance rulings in this area, except when the facts are similar to those in *Rev Rul 83-51* . *Rev Proc 99-3, 1999-1 IRB 103* , § 3.01(9).

(n2)Footnote 3. See generally *IRC § 165(a)* and *(c)(1)*, providing that in the case of an individual, losses are limited to losses incurred in a trade or business. See also *Rev Rul 83-51* , N 2 above, for a discussion of interest deductions.

(n3)Footnote 4. *Id.*

(n4)Footnote 5. *Heyman v Commr, 70 TC 482 (1978)* , *aff'd 652 F2d 598* , 80-2 USTC P 9736 (6th Cir 1980); *Rev*

Rul 69-189, 1969-1 CB 55 . See also *Franklin v Commr*, 683 F2d 125 , 82-2 USTC P 9532 (5th Cir 1982); *Perry v Commr*, 28 BTA 497 (1933) .

(n5)Footnote 6. *Rev Rul 77-135, 1977-1 CB 133* . The government's payment of a subsidy to the lender to provide the loan is not treated as income to the mortgagor. *Rev Rul 75-271, 1975-2 CB 23* .

(n6)Footnote 7. For the impact which this kind of revenue has on the ability of an entity to qualify as a real estate investment trust (REIT), see *IRC § 856(f)(1)*.

(n7)Footnote 8. *Temp Treas Reg § 1.1275-6T*.

(n8)Footnote 9. *TD 8517, 1994-1 CB 38* (Feb 2, 1994) . For a discussion on VRDIs, see *Treas Reg § 1.1275-5*.

(n9)Footnote 10. For more extensive coverage, see Bates, "Changes Made In Tax-Exempt Bond Area By 1986 Act Usher In New Era In Public Finance," 66 *J Tax'n* 72 (1987).

(n10)Footnote 10.1. See *IRC §§ 141-147*.

(n11)Footnote 10.2. *IRC §§ 103, 141(e)(1)(A),(G), 142(a)(7)*.

(n12)Footnote 11. *IRC § 142(d)(1)*. Separate rules apply for deep-rent skewed projects (*IRC § 142(d)(4)*) and for military housing allowances (*IRC § 142(d)(2)(B)(ii)*). Special rules also apply after 2008 in determining the area median gross income for HUD hold harmless impacted projects (*IRC § 42(d)(2)(E)*).

(n13)Footnote 11.1. *Rev Proc 2004-39, 2004-2 CB 49* .

(n14)Footnote 11.2. See *IRC § 142(d)(2)(A)*.

(n15)Footnote 12. *IRC § 142(d)(3)(B)*.

(n16)Footnote 12.1. *IRC § 142(d)(2)(C)*; see *IRC § 42(i)(3)(D)*.

(n17)Footnote 12.2. *IRC § 142(d)(2)(D)*.

(n18)Footnote 12.3. *IRC § 142(d)(3)(B)*.

(n19)Footnote 12.4. *IRC § 42*.

(n20)Footnote 12.5. *IRC § 142(d)(3)(C)*.

(n21)Footnote 12.6. See *IRC §§ 42(g)(2)(D)(ii), 142(d)(3)(C)*.

(n22)Footnote 13. *IRC § 142(d)(3)(A)*.

(n23)Footnote 14. *IRC § 142(d)(2)(A)*.

(n24)Footnote 14.1. *IRC § 142(d)(7)*.

(n25)Footnote 14.2. *IRC § 6652(j)*.

(n26)Footnote 14.2.1. *Ltr Rul 200601021* .

(n27)Footnote 14.2.2. See *IRC § 142(d)*.

(n28)Footnote 14.2.3. See *143(a)*.

(n29)Footnote 14.2.4. See *IRC* § 143(b).

(n30)Footnote 14.2.5. *IRC* § 57(a)(5)(C)(iii), effective for bonds issued after July 30, 2008 [Pub Law 110-289, § 3022(d)(1)].

(n31)Footnote 14.2.6. *IRC* § 56(g)(4)(B)(iii), effective for bonds issued after July 30, 2008 [Pub Law 110-289, § 3022(d)(1)].

(n32)Footnote 14.3. *IRC* § 142(a)(14).

(n33)Footnote 14.4. The LEED ("Leadership in Energy and Environmental Design) Green Building Rating System is a voluntary, consensus-based national standard for developing high-performance sustainable buildings. Registration is the first step toward LEED certification. For purposes of the provision, a brownfield site is defined by Section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 USC § 9601).

(n34)Footnote 14.5. *IRC* § 142(l)(1), (4)(A)(i)-(iv).

(n35)Footnote 14.6. See *IRC* § 146(g)(3).

(n36)Footnote 14.7. *IRC* § 142(l)(7).

(n37)Footnote 14.8. *IRC* § 142(l)(9).

(n38)Footnote 14.9. *IRC* § 142(l)(8).

(n39)Footnote 14.10. *IRC* § 142(l)(4). See Notice 2005-28, 2005-1 CB 796 (extension of deadline for nominating qualified green building and sustainable design projects).

(n40)Footnote 14.11. *IRC* § 142(l); Pub L No 108-357, § 701(d).

(n41)Footnote 14.11.1. *IRC* § 146(d)(5), (6).

(n42)Footnote 14.11.2. *IRC* §§ 143(i)(1), (k)(12), 146(d)(5)(B)(ii).

(n43)Footnote 14.11.3. *IRC* § 143(k)(12)(C).

(n44)Footnote 14.11.4. *IRC* § 143(k)(12)(D).

(n45)Footnote 14.11.5. *IRC* §§ 143(a)(2)(D)(i), 146(d)(5)(B)(ii)(II).

(n46)Footnote 14.11.6. *IRC* § 146(f)(6).

(n47)Footnote 14.11.7. Notice 2008-79, 2008-40 IRB 815.



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.04

§ 12.04 "Wraparound" Mortgages

One financing arrangement which is most often used with installment sales is the "wraparound" or "all-inclusive" mortgage. A wraparound mortgage is similar to a purchase-money mortgage. The property remains encumbered by a previous first mortgage, and the wraparound becomes a form of second mortgage. The seller collects payments on the wraparound obligation and pays down the first mortgage remaining on his books. Normally, the wraparound mortgage bears a higher interest rate than the first mortgage, and the seller receives the economic advantage of this "spread" by preserving the underlying mortgage at its attractive low existing rate.

The following example shows how a wraparound mortgage can be used when selling property.

Example:

A seller owns property subject to a 7 percent, \$250,000 first mortgage on which he is personally liable. He offers to sell the property at its fair market value of \$500,000, with a \$50,000 cash down payment and a mortgage note for the balance. The purchaser wants to buy the property in a purchase money arrangement under which he has no personal liability. The seller does not want to pay off the existing mortgage debt with its attractive interest rate.

To accomplish these objectives, the seller transfers title to the purchaser, receives the \$50,000 initial payment, and takes a \$450,000 mortgage note (properly describing the existing indebtedness from the purchaser) bearing interest at 11 percent. The seller agrees to look only to the property in the event of default. The mortgage note of \$450,000 is then recorded by the seller as a lien against the property and "wraps around" the prior existing \$250,000 lien.

Typically, under this arrangement, the seller receives the monthly or other periodic payments called for under the \$450,000 mortgage and uses part of these proceeds to make his payments under his continuing obligation on the \$250,000 mortgage. He retains the financial advantage of the low 7 percent interest on the \$250,000 mortgage: In effect, funds which he has borrowed at 7 percent he has lent at 11 percent. The purchaser holds title subject both to the original debt of \$250,000 and the new lien of \$450,000. Therefore, he must be certain that the seller makes the mortgage payments due to the holder of the \$250,000 mortgage.

The use of a wraparound mortgage generally permits reporting of gain from a sale under the installment method. See Chapter 7 for a further discussion of this subject.



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.05

§ 12.05 Effect on Basis of Acquired Property

The tax basis of real property acquired by use of debt is not limited to a purchaser's cash investment. It is equal to the full consideration paid for the property, including the amount of any mortgage or other debt incurred incident to the purchase. Similarly, the tax basis of property acquired already encumbered by a mortgage includes the outstanding mortgage debt, whether the buyer assumes the mortgage or acquires the property subject to the debt. n15 In addition, to the extent the property is depreciable, the taxpayer's basis for depreciation will include the mortgage.

Example:

A buyer purchases real estate for \$2,500,000, paying \$500,000 in cash and giving a \$2,000,000 mortgage secured by the property. The buyer's tax basis in the property is \$2,500,000. Whether the buyer assumes personal liability for an already existing mortgage debt of \$2,000,000 or takes the property subject to it, his basis is still \$2,500,000. If the entire property is depreciable, the buyer's depreciation deductions will be based on \$2,500,000.

Simply incurring a liability by mortgaging the property (or paying off the mortgage) will not affect the basis of property securing the mortgage debt when the proceeds are used for a purpose other than the purchase or improvement of the property--e.g., a home equity loan used to finance a child's college education, purchase or start up a business, or pay for an expensive vacation. Mortgage proceeds or any other funds used to construct depreciable improvements will increase the taxpayer's basis for depreciation and the basis for determining gain or loss, but only to the extent of the cost of construction (see Chapter 5).

These general rules are subject to a number of exceptions and conditions. During the period when tax-shelters were prevalent, the courts typically found that inflated non-recourse debt--when coupled with an inflated purchase price--did not constitute valid indebtedness. This resulted in the denial of depreciation and interest expense deductions. n16

Even in cases where the nonrecourse debt is reasonable, the at-risk rules and passive activity loss rules may limit the taxpayer's deduction. (See Chapter 13.)

FOOTNOTES:

(n1)Footnote 15. *Crane v Commr*, 331 US 1 , 47-1 USTC P 9217, 35 AFTR 776 (1947) .

(n2)Footnote 16. See, eg, *Est of Franklin v Commr*, 544 F2d 1045 , 76-2 USTC P 9773 (9th Cir 1976); *Oden'hal v*

Commr, 748 F2d 908 , 84-2 USTC P 9963 (4th Cir 1984), cert den 105 S Ct 2688 (1985); *Narver v Commr*, 670 F2d 855 , 82-1 USTC P 9265 (9th Cir 1982); *Bergstrom v US*, 97-1 USTC P 50,143 (Ct Fed Cl 1997); *Corbin West Limited Partnership v Commr*, TC Memo 1999-7 . For a variation on this theme, see *Bromwell and Assoc, Inc v Commr*, TC Memo 1993-438, 66 TCM 799 (1993) . Although most courts take the *Franklin* approach, allowing none of the mortgage to be included in the "mortgagor's" basis, some courts have allowed the mortgage to be included in basis up to the fair market value of the property. See, eg, *Regents Park Partners v Commr*, 63 TCM 3131, TC Memo 1992-336 (1992) ; *Levy v Commr*, TC Memo 1991-646, 62 TCM 1636 (1991) ; *Pleasant Summit Land Corp v Commr*, 863 F2d 263 , 88-2 USTC P 9601 (1989). This subject is discussed in further detail in Cowan, "Is Any Part of a Nonrecourse Mortgage Greatly Exceeding FMV Includable in Basis?," 77 J Tax'n 260 (1992).



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.06

§ 12.06 Costs of Obtaining a Mortgage Loan

There are several types of costs that may be incurred when a mortgage loan is made. Some of these costs are borne by the mortgagor and some by the mortgagee. The net economic cost to the mortgagor and mortgagee depends on the tax treatment accorded to the various costs.

The mortgagor may incur costs incident to obtaining a loan, such as attorneys' and appraisers' fees, title and survey costs required to obtain the mortgage, and transfers and commissions. Loan origination fees, sometimes as a percentage of the loaned amount, may also be charged. If the loan is obtained for business purposes or for acquisition of investment property, the mortgagor ordinarily amortizes the costs on a straight-line basis over the term of the loan. n17 For purposes of determining the term of a loan with a call option, a lender's option to call the loan is presumed to be exercised if exercise of the call would produce a higher yield to maturity for the lender. n18

In addition to the above costs, it may be necessary to pay a commitment fee to obtain financing. A commitment fee is viewed as a charge for making funds available and not as interest. n19 The Service ruled, in 1981, that if a taxpayer exercises the taxpayer's right under the commitment agreement, the commitment fee becomes a cost of acquiring the loan and, if the acquired property is held for business or production of income purposes, the taxpayer may deduct the fee ratably over the term of the loan. n20

Example:

A cash-basis taxpayer pays commissions of \$7,500 to obtain a 15-year loan. The taxpayer uses the loan to purchase land and an existing building for investment purposes, and the property will secure the mortgage. The commissions are deductible only at the rate of \$500 per year (i.e., \$7,500/15 years).

If loan costs are incurred in connection with construction financing, the borrower must capitalize some or all of the costs and add them to the basis of the constructed property. n21

Other fees incurred incident to a taxpayer's acquisition of property may also be capitalized and added to the property's basis. These can include fees for the following: n21.1

- arranging for options to acquire property;

- evaluating zoning requirements and ensuring compliance;
- arranging and evaluating environmental reports relating to property; and
- establishing guidelines for compliance with low-income housing tax credit requirements.

Fees not associated with an acquisition of property, n21.2 or for which no authority permits capitalization or deduction, cannot be added to basis. Falling in this category have been so-called "tax credit guarantee fees" (fee for guaranteeing that a property will be operated to ensure entitlement to the low-income housing credit) and "no negative cash flow guarantee fees" (fee for agreement to make loans to cover operating deficits). n21.3

A borrower who incurs costs to renew or extend an existing mortgage should amortize the costs over the life of the new loan. n22 On the other hand, a borrower who terminates a mortgage before its original maturity date may deduct the entire unamortized mortgage costs remaining and any prepayment penalty in the year in which he entirely prepays the mortgage or sells the property. n23 This is true even if the mortgage is prepaid from the cash obtained from a new mortgage loan with a different mortgagee. n24 Assuming the mortgage relates to business or investment property, these unamortized costs and penalties are ordinary *IRC Section 162* or *212* deductions and not reductions of the gain upon sale. Prepayment penalties are treated as interest on the indebtedness. n25 If the property is sold on the installment method and the property is not sold subject to the mortgage, nor is the mortgage assumed, the mortgagor may not take a deduction for the unamortized mortgage costs. n26

[1] Interest Expense--When Deductible

[a] General Rules

The time when interest is deductible depends on the mortgagor's tax accounting method. An accrual-basis mortgagor's interest deduction does not depend on the time of payment but is spread over the term of the debt as such interest accrues. n27 A cash-basis mortgagor deducts interest only when he pays the interest in cash or its equivalent; giving a note does not constitute payment under the cash method. n28 And, except in the case of certain points, cash-basis taxpayers may only deduct interest payments in the period to which they relate under the accrual method of accounting (see *Section 12.06[2]*, below). Thus, a cash-basis taxpayer who prepays mortgage interest properly attributable to a subsequent year cannot deduct the interest in the current year. n29

What constitutes "payment" for a cash-basis taxpayer is not always clear. n30 The general rule is that the borrower cannot deduct an interest payment if the lender lends the money so the borrower can make the interest payment. n31 In *Burgess v Commissioner*, n32 however, the Tax Court allowed an interest deduction when the lender advanced funds so the borrower could make the required interest payment. In this case, though, there was a special consideration: The borrower commingled the advance with the borrower's own funds, and the interest check which the borrower gave the bank was from these commingled funds. The Court, in effect, allowed the commingled funds to be treated as if they were provided by a third party.

While not rejecting the commingling theory, several subsequent cases have limited its application to cases where the borrower has significant control over the advance before the borrower uses it to make the payment. Unless the taxpayer has this control, an interest deduction is unlikely to be allowed. n33

The Internal Revenue Code imposes a further limitation on the deductibility of interest on investment indebtedness. n34 See Chapter 4 for a more detailed discussion of this limitation. Additionally, the original issue discount (OID) rules sometimes override the general rules discussed above. See Chapter 7 for further discussion of the OID rules. n35

[b] Interest Overcharges on Adjustable Rate Mortgages

In the early 1990's, several lenders acknowledged that they had overcharged interest on some of their adjustable rate mortgages. This motivated the Service to adopt a policy concerning the tax treatment of the borrowers' interest overpayments, as well as the treatment of the refunds. n36 The policy is enunciated in a 1992 revenue ruling, which states that an interest overcharge on an adjustable mortgage that a homeowner has paid as a result of the mortgagee's miscalculation is deductible by the homeowner in the year paid. However, recovery of the overcharge in a subsequent year can lead to income to the homeowner. Income recognition is limited to the tax benefit received. n37

[2] "Points" and "Discounts" as Deductible Interest

[a] General Rules

At the time of making a loan, a lending institution may charge a borrower an amount that is termed "points." A point is equal to one percent of the loan. These points are in addition to the stated interest rate and are usually in addition to normal service fees. They may be paid from a borrower's separate funds or deducted from the loan proceeds. n38 For tax purposes, points are generally treated as prepaid interest. n39

IRC Section 461(g) provides a general rule under which points paid by a cash-basis taxpayer must be capitalized and deducted in the periods to which they are allocable, i.e., over the life of the loan. n40 The Code also provides an exception to this general rule for loan points paid to purchase or improve a principal residence. n41 These points are deductible when paid if:

- (1) they relate to indebtedness secured by this residence;
- (2) the payment of points is an "established business practice" where the debt is incurred; and
- (3) the amount of the points does not exceed "the amount generally charged in such area." n42

This special treatment is limited to points that constitute additional interest, as contrasted with a service charge, for the loan. n43 Homeowners cannot deduct loan service charges or amortize the charges over the term of the loan. Instead, service charges are a capital cost of acquiring the loan, which is a personal expense. n44

[b] "Fresh Funds" and Seller-Paid Points

For a number of years, the Service generally took the position that residential home points are deductible in the year of payment under *IRC § 461(g)(2)* only if the buyer paid the points with "fresh funds." n45 Fresh funds are funds which the buyer provides from a source other than the mortgage loan. If a lender disburses loan proceeds after first deducting the points, the points would, therefore, not be treated as paid with fresh funds.

This seemingly technical requirement prejudiced taxpayers who were stretched to the limit after their downpayment and could not find fresh funds to pay their points. In 1994, the Service issued a revenue procedure which permits most taxpayers to deduct points, even if not paid from fresh funds--and even if the points are paid by the seller of the residence. n46 To qualify for this treatment, these five requirements must be satisfied:

- (1) The Uniform Settlement Statement (i.e., Form HUD-1) clearly designates the amount as points (e.g., by describing the amount as "loan origination fees," "loan discount," "discount points," or "points"). For this purpose, amounts designated as loan origination fees on Veterans Affairs (VA) and Federal Housing Administration (FHA) loans are considered points. The amounts designated as points on the Form

HUD-1 may be shown as paid from either the borrower's or the seller's funds at settlement.

(2) The points are computed as a percentage of the mortgage loan.

(3) The amount paid is in keeping with an established business practice of charging points for residential mortgages in the area, and the amount does not exceed the amount generally charged in the area. Appraisal fees, inspection fees, title fees, attorney fees, property taxes, and mortgage insurance premiums do not satisfy this requirement.

(4) The amount is paid in connection with the acquisition of the taxpayer's principal residence, and the residence secures the loan.

(5) The taxpayer pays the amount "directly." An amount is considered as paid directly if: "the taxpayer provides, from funds that have not been borrowed for this purpose as part of the overall transaction, an amount at least equal to the amount required to be applied as points at the closing. The amount provided may include down payments, escrow deposits, earnest money applied at the closing, and other funds actually paid over at closing. In addition, for purposes of [determining whether the taxpayer directly paid the points], points paid by the seller (including points charged to the seller) in connection with the loan to the taxpayer will be treated as paid directly by the taxpayer from funds that have not been borrowed for this purpose, provided the taxpayer subtracts the amount of any seller-paid points from the purchase price of the residence in computing the basis of the residence."

Because of the test in Paragraph (5), a taxpayer can avoid the "fresh funds" requirement if he can show that the cash he contributed to purchase the residence equals or exceeds the points charged.

Example:

National Bank agrees to provide John with a \$300,000 mortgage so he can buy a \$350,000 principal residence. The bank charges 3 points (i.e., \$9,000) for the mortgage and disburses the mortgage after subtracting the points (i.e., \$291,000). John's downpayment is \$59,000, which is the amount which the bank does not finance (i.e., \$350,000 - \$291,000). While John has not given fresh funds to cover the points, he is treated as having paid the points and may deduct them in the year paid. This is so because he has provided "from funds that have not been borrowed for this purpose as part of the overall transaction, an amount at least equal to the amount required to be applied as points at the closing." ⁿ⁴⁷ Here, John's downpayment more than meets this requirement, because the \$59,000 downpayment exceeds the \$9,000 of points.

The Revenue Procedure 94-27 states that it is not applicable:

(1) if the points are attributable to principal exceeding the amount that can be acquisition indebtedness under *IRC Section 163(h)(3)(B)(ii)* (usually \$1 million);

(2) if the points are paid for a loan to improve, instead of acquire, a principal residence;

(3) if the points are paid for a loan to purchase or improve a residence other than the taxpayer's principal residence; or

(4) if the points are paid for a refinancing or home equity loan, even though the indebtedness is secured by a principal residence.

Three of the four restrictions (Items 1, 3 and 4) make sense because they track the requirements of *IRC Section 163(h)(3)* (regarding qualified residence interest) or *IRC Section 461(g)(2)*. In these cases, the taxpayer would either be denied an interest deduction or, at least, prohibited from fully deducting the interest in the year paid.

The other restriction (in Item 2) does not seem to make sense, since *IRC Section 461(g)(2)* allows points to be deducted if they are for a loan which the taxpayer uses to improve a principal residence. Despite this, taxpayers who pay points for home improvement loans must demonstrate that the points were paid from fresh funds, because of this restriction.

[c] Points Paid in Connection with a Refinancing

IRC Section 461(g)(2) permits a current deduction for loan points paid "in connection with the purchase or improvement of" a principal residence. The Service has interpreted this as denying a current deduction for points paid to refinance an existing home mortgage.ⁿ⁴⁸ The Service's rationale is that the points are connected with refinancing an existing debt rather than connected with the purchase or improvement of the home.

A somewhat limited inroad has been made in this rule. In *Huntsman v Commissioner*,ⁿ⁴⁹ the Eighth Circuit permitted a current deduction for points the taxpayers paid to refinance two short-term loans. The taxpayers used one of the loans, a three-year balloon mortgage for \$122,000, to purchase their home. About one and one-half years later, they took out a second mortgage for \$22,000 to improve their home. Slightly less than three years after the purchase of the home, they refinanced both mortgages with a 30-year variable rate mortgage. The refinancing required the taxpayers to pay \$4,440 in points, which they wanted to deduct in the year of payment under Section 461(g)(2).

The Service denied the deduction on the ground that the Section does not apply to refinancing. The Court, however, concluded that *IRC Section 461(g)(2)* did not require the new debt to be "directly related" to the actual acquisition or improvement of the principal residence. The new debt merely had to be incurred "in connection with" the acquisition or improvement, which the Court treated as requiring a slightly more attenuated relationship.

In finding for the taxpayers, the Eighth Circuit stated:

"Thus, where taxpayers purchase a principal residence with a short-term three-year loan secured by a mortgage on the residence, and replace the loan with permanent financing within the time period involved, the permanent mortgage obtained is sufficiently in connection with the purchase of the home to fall within the exception provided for by section 461(g)(2)."

The amount of solace which *Huntsman* provides is somewhat limited. First, the Service has announced that it will not follow the decision outside of the Eighth Circuit.ⁿ⁵⁰ Second, it applies only to the somewhat unusual situation where the taxpayer purchases a home using short-term, temporary financing (here, a three-year balloon mortgage). In the more typical situation--for example, taxpayers with a 30-year mortgage who refinance after five years to take advantage of lower interest rates--*Huntsman* provides no assistance. These taxpayers must amortize their points over the term the loan.

FOOTNOTES:

(n1)Footnote 17. *Lieber v Commr*, TC Memo 1993-391, 66 TCM 529 (1993) (mortgage guaranty fees); *Enoch v Commr*, 57 TC 781 (1972) ; *Anover Realty Corp v Commr*, 33 TC 671 (1960). See *Lange v Commr*, TC Memo 2005-176 (loan origination fee related to refinanced loan could not be amortized because there was no evidence of the loan's term or proof that the loan proceeds were used for business or investment purposes).

(n2)Footnote 18. *Treas Reg* § 1.1272-1(c)(5).

(n3)Footnote 19. Consider Rev Rul 70-540, 1970-2 CB 101 (see situation 3). See also *Rev Rul* 83-84, 1983-1 CB 97 . *Rev Proc* 94-29, 1994-1 CB 616 , declared *Rev Rul* 74-607, 1974-2 CB 149 , obsolete. *Rev Rul* 74-607 had

previously amplified *Rev Rul 70-540* . The Service's decision to declare the 1974 ruling obsolete had no impact on the part of *Rev Rul 70-540* dealing with commitment fees.

(n4)Footnote 20. *Rev Rul 81-160, 1981-1 CB 312* .

(n5)Footnote 21. *IRC § 263A* (requiring that costs must be capitalized). This subject is discussed further in Chapter 3.

(n6)Footnote 21.1. *Corbin West Limited Partnership v Commr, TC Memo 1999-7* .

(n7)Footnote 21.2. See *Treas Reg § 1.263(a)-2*.

(n8)Footnote 21.3. *Corbin West Limited Partnership v Commr, TC Memo 1999-7* .

(n9)Footnote 22. *Lovejoy v Commr, 18 BTA 1179 (1930)* .

(n10)Footnote 23. *Rev Rul 86-67, 1986-1 CB 238* .

(n11)Footnote 24. *12701 Shaker Blvd Co v Commr, 36 TC 255 (1961)* , *aff'd 312 F2d 749, 11 AFTR2d 63-455 (6th Cir 1963)* .

(n12)Footnote 25. *Lieber v Commr, TC Memo 1993-391, 66 TCM 529 (1993)* .

(n13)Footnote 26. *Stonecrest Corp v Commr, 24 TC 659 (1955)* .

(n14)Footnote 27. An accrual basis mortgagee generally accrues interest in a similar fashion. Sometimes, though, a mortgagor will be in trouble and the lender's prospects for collection are bleak. An accrual basis mortgagee may be able to stop accruing interest in these circumstances. See Calvin & Farias, "When Can Holders of Defaulted Debt Cease Accruing Interest Income?" *73 J Tax'n 378 (1990)*.

(n15)Footnote 28. *Rev Rul 77-135, 1977-1 CB 133* ; *Rev Rul 70-647, 1970-2 CB 38* ; *England v Commr, 34 TC 617 (1970)* ; *Helvering v Price, 309 US 409 , 40-1 USTC P 9336 (1940)*. The mortgagor, however, will get a deduction if he borrows from another lender and uses the cash to make the interest payment due to the first lender. *Franklin v Commr, 683 F2d 125 , 82-2 USTC P 9532 (5th Cir 1982)*; *Perry v Commr, 28 BTA 497 (1933)* . See also *Heyman v Commr, 70 TC 482 (1978)* , *aff'd 652 F2d 598 , 1980-2 USTC P 9736 (6th Cir 1980)*; *Rev Rul 69-189, 1969-1 CB 55* .

(n16)Footnote 29. *IRC § 461(g)*; *Kadunc v Commr, TC Memo 1997-92* .

(n17)Footnote 30. A related issue is what constitutes interest payments in the case of qualified residence interest. *IRC § 163(h)(3)*. See *Washington-Oglesby v Commr, 66 TCM 365, TC Memo 1993-357 (1993)* ; *Tseng v Commr, TC Memo 1994-126, 67 TCM 2501 (1994)* . Compare *Dively v Commr, TC Memo 1993-395, 66 TCM 557 (1993)* (the Service disallowed deductions for mortgage interest payments because taxpayers did not prove they purchased the house for which the deductions were claimed) with *Nelson v Commr, TC Memo 1993-419, 66 TCM 691 (1993)* (Tax Court allowed deductions for interest payments because taxpayers assumed a prior purchase contract on the property and were thus obligated to make the payments). See also *Induni v Commr, 990 F2d 53, 1993-1 USTC P 50,200 (2d Cir 1993)* (mortgage interest deductions denied to extent payments were allocable to allowance for tax-exempt living quarters); *TAM 9418001* (deduction for interest payments denied where indebtedness was not secured by residential real property); *Garrison v Commr, TC Memo 1994-200, 67 TCM 2896 (1994)* (paid interest was disallowed as a deduction because the mortgage was not for a principal or second residence); *Mulholland v US, 93-1 USTC P 50,286 (Cl Ct 1993)* (Commissioner was allowed to change the taxpayer's interest deduction). For further discussion, see Ch 9.

(n18)Footnote 31. See N 28, above.

(n19)Footnote 32. *Burgess v Commr*, 8 TC 47 (1947) . See also *Burck v Commr*, 63 TC 556 (1975) .

(n20)Footnote 33. See, eg, *Franklin v Commr*, 77 TC 173 (1981) , *rev'd on other issue* 683 F2d 125 , 82-2 USTC P 9532 (5th Cir 1982); *Wilkerson v Commr*, 655 F2d 980, 81-2 USTC P 9657 (9th Cir 1981); *Battelstein v IRS*, 80-2 USTC 9840, 631 F2d 1182 (5th Cir 1980) , *cert den* 451 US 938 (1981) .

(n21)Footnote 34. *IRC § 163(d)*.

(n22)Footnote 35. *IRC §§ 1271 through 1275*.

(n23)Footnote 36. For a discussion of information reporting when the lender refunds this excess interest, see § 12.11[3], below.

(n24)Footnote 37. *Rev Rul 92-91*, 1992-2 CB 49 . See also Shimabuku, "Overpaid Mortgage Interest Refunds Are Usually Taxable," 50 *Tax'n for Accts* 293 (1993); Hume, Englebrecht & Iyer, "The Service Expands Interest Deduction Opportunities for ARMs," 21 *J Real Est Tax'n* 79 (1993).

(n25)Footnote 38. See § 12.11[2], below, for a discussion of the reporting requirements for points paid on mortgages.

(n26)Footnote 39. *Rev Rul 69-188*, 1969-1 CB 54 .

(n27)Footnote 40. *Jackson v Commr*, TC Memo 2005-159 ; *Rubnitz v Commr*, 67 TC 621 (1977) ; *Novoa v Commr*, TC Memo 1998-192 . For a formula showing the proper amortization method, see *Rev Proc 87-15*, 1987-1 CB 624 .

(n28)Footnote 41. See also *Russell v Commr*, TC Memo 1994-96, 67 TCM 2347 (1994) , *aff'd* 96-1 USTC P 50,096 (9th Cir 1995).

(n29)Footnote 42. *IRC § 461(g)(2)*.

(n30)Footnote 43. S Rep No 938, 94th Cong, 2d Sess 103-05 (1976).

(n31)Footnote 44. See generally *IRC § 262* (disallowing personal, living or family expenses). In some instances, it may be unclear whether an amount is points or, instead, a fee. If the amount is determined using factors taken into account in setting an interest rate, the amount will typically be treated as points. See, eg, *Rev Rul 70-540*, 1970-2 CB 101 , *amplified by Rev Rul 74-607*, 1974-2 CB 149 , *and clarified by Rev Rul 83-84*, 1983-2 CB 97 . (The first two of the rulings were declared obsolete in *Rev Rul 94-29*, 1994-1 CB 616 , but only with respect to a lender's tax treatment of points). See also *Pacific First Fed Sav & Loan v Commr*, 79 TC 512 (1982) ; *Blitzer v US*, 684 F2d 874 , 82-2 USTC P 9465 (Ct Cl 1982); *Ltr Rul 8712001* .

(n32)Footnote 45. See, eg, *Rev Rul 87-22*, 1987-1 CB 146 , *Ltr Ruls 8710001*, 8706001, 8516009, 8516003; and *Schubel v Commr*, 77 TC 701 (1981) . If points are not deductible in full in the year of payment under *IRC § 461(g)(2)*, the taxpayer may amortize them over the term of the loan, assuming they represent qualified residence interest.

(n33)Footnote 46. *Rev Proc 94-27*, 1994-1 CB 613 . This pronouncement is discussed in Hebble & Fernandez, "Residential Mortgage Points Are Now Easier to Deduct," 54 *Tax'n for Accts* 137 (1995) (this article also appears at 23 *Tax'n for Lawyers* 350 (1995); Klopsch, "What Are the Real Requirements for Interest Deductibility? An Analysis of Revenue Procedure 94-27 ," 21 *U Dayton L Rev* 145 (1995); "Seller-Paid Points Break May Go Beyond the 'Burbs'," *Tax Notes*, April 11, 1994, at 143.

(n34)Footnote 47. *Rev Proc 94-27* , N 43, above.

(n35)Footnote 48. See Rev Rul 87-22, 1987-1 CB 146 ; IR 86-88 (May 13, 1986). See also Eule and Richman, "Refinancing a Home Mortgage May Have Adverse Tax Costs," 49 *Tax'n for Accts* 102 (1992) (the same article also appears at 21 *Tax'n for Lawyers* 100 (1992)).

(n36)Footnote 49. 905 F2d 1182 , 90-2 USTC P 50,340 (8th Cir 1990). See *Cao v Commr*, TC Memo 1994-60, 67 TCM 2171 (1994) , *affd* 96-1 USTC P 50,167 (9th Cir 1996), distinguishing *Huntsman*, for further clarification in this area.

(n37)Footnote 50. AOD 1991-02 (Feb 11, 1991) .



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.07

§ 12.07 Effect of Mortgages on Transfer of Property

Mortgages also must be considered when determining the taxable gain or loss upon the disposition of real estate. The general rule is that the seller treats the principal amount of the mortgage indebtedness which the purchaser assumes or takes subject to as an amount received. Therefore, if mortgage debt is transferred, it becomes part of the proceeds of sale. The result is the same whether the seller is personally liable on the mortgage or whether the purchaser becomes personally liable on the mortgage. n51

Example:

X buys land for \$500,000 cash and assumes a mortgage debt of \$2,000,000. His tax basis is \$2,500,000. He later sells the land for \$1,500,000 cash subject to the then-outstanding mortgage debt of \$1,500,000. The proceeds of sale are \$3,000,000, represented by cash of \$1,500,000 and the mortgage of \$1,500,000 taken on by the purchaser. X's gain is \$500,000, computed by taking the proceeds of \$3,000,000 and subtracting the \$2,500,000 basis of the property.

A seller interested in using the installment method of reporting gain should be aware of the effect of a mortgage on the selling price and the payments received in the year of sale. When property is sold subject to a mortgage or where a buyer assumes the mortgage, the amount by which the debt exceeds the seller's basis is treated as a payment received in the year of sale. n52 As discussed in Chapter 7, a wraparound mortgage can often be used to solve this problem.

As pointed out in Chapter 8, the owner of real property held for investment or for use in a trade or business may exchange such property for property of a like kind without incurring a tax. However, the amount of the mortgages, if any, involved in such a transaction could affect the computation of the basis of the property received, the basis of the property transferred, and the amount of gain recognized on the exchange. There can be partial recognition of taxable gain to the extent that "boot" (defined as cash or other property) is involved. A mortgage which the transferee assumes in connection with the exchange is treated, for these purposes, as cash boot. n53

Example:

An investor owns real estate that has a fair market value of \$4,000,000, and is encumbered with a \$1 million nonrecourse mortgage. The investor's adjusted basis in the property is \$2,000,000. She exchanges this real estate for \$500,000 cash and unencumbered like-kind property worth \$2,500,000, which she will

hold for investment. There is no express agreement as to whether the exchanging party will assume the mortgage on the property she transfers in the exchange. The exchanging party is treated as having assumed the nonrecourse liability on the property received in the exchange. [See *IRC §§ 357(d)(1)(B); 1031(d).*] The investor realizes a \$2,000,000 gain, of which \$1,500,000 will be recognized (i.e., be taxable), computed as follows:

Value of land received	\$.....2,500,000
Cash received	\$.....500,000
Mortgage treated as assumed by other party	\$.....1,000,000
Amount realized	\$.....4,000,000
Less--Basis of property exchanged	\$.....2,000,000
Gain realized	\$.....2,000,000
Gain recognized (i.e., boot is cash and mortgage treated as assumed by other party)	\$.....1,500,000

The basis of the property received is equal to the basis of the property transferred, decreased by any money received and by the mortgages assumed on the property transferred, and increased by the gain recognized in the exchange. n54 In the above example, the investor's basis in the property received is \$2,000,000. This is computed by subtracting the \$500,000 cash received and the \$1,000,000 mortgage assumed by the other party in the exchange from the \$2,000,000 tax basis and adding the \$1,500,000 gain recognized.

As previously discussed in Chapter 8, mortgage indebtedness assumed on property received offsets a mortgage assumed on property that is transferred so that a net decrease in mortgage liability is treated as cash for the purpose of computing gain and the basis of the property received in the transfer. However, in the converse situation, where the acquired property is more heavily mortgaged than the property transferred, the excess of liability which the transferor assumes over the liability transferred is not considered "boot." n55

FOOTNOTES:

(n1)Footnote 51. *Crane v Commr*, N 15, above; *Blackstone Theater Co v Commr*, 12 TC 801 (1949) , acq 1949-2 CB 1 . See also *Mayerson v Commr*, 47 TC 340 (1966) .

(n2)Footnote 52. *Treas Reg § 15A.453-1(b)(3)(i)*.

(n3)Footnote 53. *IRC § 1031(d)*.

(n4)Footnote 54. *Id.*

(n5)Footnote 55. *Treas Reg § 1.1031(d)-2*. See also Chapter 8 for additional coverage of this subject.



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.08

§ 12.08 Consequences of Mortgages in Excess of Tax Basis

At times, property may be mortgaged in excess of the mortgagor's tax basis in the property. Mortgaging in excess of tax basis does not result in any gain or loss. A situation such as this may result if debt is refinanced at a time when there is substantial appreciation in the value of the property or when depreciation has reduced the mortgagor's basis.

There are several situations in which the existence of mortgage indebtedness in excess of the tax basis of the mortgaged property may give rise to taxable gain. One is the transfer of mortgaged property. The transfer of mortgaged property to the mortgagee and release from liability (i.e., a foreclosure and repossession) will, in certain circumstances, produce a gain, as discussed in *Section 12.09*, below. Another situation involves the mortgagor's transfer of encumbered property to a corporation he controls. Usually, no tax is incurred when property is transferred to a corporation solely in exchange for such corporation's stock if, immediately after the exchange, the transferors are in control of the corporation (i.e., own at least 80 percent of the voting power of the voting stock and 80 percent of all other stock).ⁿ⁵⁶ Sometimes, however, the transferred property is subject to a mortgage which the corporation assumes and the mortgage exceeds the transferor's adjusted basis in the transferred property. This excess is taxed as gain at the time of the exchange; the gain may be ordinary or capital, depending on the nature of the property and its status in the mortgagor's hands.ⁿ⁵⁷

One case has indicated that gain recognition may be avoided by transferring a note in addition to the encumbered real property. In the case, a taxpayer transferred to a corporation real property on which the mortgage exceeded his adjusted basis. To avoid the trap of *IRC Section 357(c)(1)*, he also transferred an unsecured promissory note to the corporation along with the real property. The Ninth Circuit held that the note had a basis equal to its face amount, thereby making the taxpayer's total basis in the property contributed (including the note) greater than the total liabilities. Therefore, there was no gain recognized on the transfer of the real property.^{n57.1} Another case reached a similar result for the same reason when a loan receivable owed by the taxpayer equal in amount of the excess of liabilities transferred over assets was recorded on the corporate books of the transferee corporation.^{n57.2}

The transfer of mortgaged property by gift results in recognition of gain to the donor if the property is encumbered by a mortgage which exceeds the donor's adjusted basis. The gain recognized equals the amount by which the mortgage exceeds the donor's adjusted basis.ⁿ⁵⁸ Moreover, this result applies regardless of whether the mortgage is recourse or nonrecourse.ⁿ⁵⁹

Taxable gain can be recognized if property subject to a mortgage is transferred by a partner to his partnership in

exchange for a partnership interest or as a contribution to capital. This transfer subjects the partner to a taxable gain when the portion of the mortgage allocable to the other partners after the transfer exceeds the tax basis of the transferor-partner in the partnership after the transfer. n60

FOOTNOTES:

(n1)Footnote 56. *IRC* §§ 351 and 368(c).

(n2)Footnote 57. *IRC* § 357(c). See also Chapter 15.

(n3)Footnote 57.1. *Peracchi v Commr*, 143 F3d 487 (9th Cir 1998) .

(n4)Footnote 57.2. *Lessinger v Commr*, 872 F2d 519 (2nd Cir 1989) .

(n5)Footnote 58. See, eg, *Est of Juden v Commr*, 865 F2d 960 , 89-1 USTC P 9142 (8th Cir 1989); *Ebben v US*, 783 F2d 906 , 86-1 USTC P 9250 (9th Cir 1986); *Est of Levine v Commr*, 634 F2d 12 , 80-2 USTC P 9549 (2nd Cir 1980).

(n6)Footnote 59. See *Commr v Tufts*, 461 US 300 , 83-1 USTC P 9328 (1983).

(n7)Footnote 60. *IRC* § 752(b); *Treas Reg* § 1.752-1(c).



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.09

§ 12.09 Foreclosure and Repossession of Mortgaged Property

If a mortgagor defaults on the payment of the mortgage debt, the mortgagee may either foreclose or mitigate the debt. Many factors, not the least of which are the tax consequences of foreclosure versus mitigation, should be considered by the mortgagee before a final decision is made as to what action is appropriate when faced with a defaulting mortgagor. The tax consequences of a mitigation to the mortgagor are discussed in *Section 12.09[1]*, below. The tax consequences for the mortgagee are discussed in *Section 12.09[4]*, below.

A foreclosure generally takes one of four forms:

- (1) involuntary sale to the mortgagee;
- (2) voluntary conveyance to the mortgagee;
- (3) sale to a third party; and
- (4) sale to the mortgagee.

All foreclosure transactions have important tax consequences to both the mortgagor and the mortgagee. These consequences, such as determining taxable gain or loss, tax basis of the property, amount and timing of any bad debt deductions, etc., are discussed later in this chapter. In reviewing the tax consequences of a foreclosure, it is important to remember that all foreclosures result in two separate events for tax purposes: (1) sale of the property; and (2) satisfaction of the mortgage.

Because the mortgagor's tax treatment on foreclosure depends, in part, on whether the mortgagor is personally liable on the debt (i.e., a recourse mortgage) or not personally liable (i.e., a nonrecourse mortgage), these two situations are discussed separately below in *Section 12.09[2]* (recourse mortgages) and *Section 12.09[3]* (nonrecourse mortgages), below. n61

[1] Tax Consequences to the Mortgagor on Mitigation of the Debt

In lieu of foreclosing on a defaulted mortgage, the mortgagee may agree to reduce the amount outstanding. This is not

treated as a sale or exchange of the mortgaged property. It will, however, result in cancellation of indebtedness income (COD income) for the mortgagor n62 unless the taxpayer qualifies for one of the exemptions described in *IRC Section 108*. n63 These exemptions may affect the taxpayer's "tax attributes" or may require a reduction in the basis of depreciable real property. n63.1

Even if *IRC § 108* does not apply, the timing of the discharge may be in issue. In one case, the taxpayers received a discharge of an outstanding FmHA mortgage on their farm. In exchange they agreed to pay the FmHA a lower net recovery buyout amount, and also agreed to pay to the FmHA the amount discharged if they disposed of the farm within a 10-year period. The taxpayers conceded they had received discharge of indebtedness income, but insisted that it was not includable in income until they conveyed the land or upon the passing of 10 years. They claimed that their potential obligation to repay some part or all of the amount discharged precluded a finding that the debt had been forgiven. The Tax Court disagreed and found that the taxpayers received discharge of indebtedness income at the time the net buyout agreement was entered into, because at that time, the taxpayers controlled whether they would ever be required to make any further payments to FmHA. The taxpayers' potential obligation to repay the amounts discharged was too contingent to be considered a substitute for the original obligation. n63.2

[2] Tax Consequences to the Mortgagor on Foreclosure of Recourse Mortgage

[a] Transaction Viewed as Sale of the Property

The mortgagee's foreclosure of property used to secure a debt is treated as the taxable sale of the property to the mortgagee. n64 If the mortgagor voluntarily issues his deed in favor of the mortgagee in satisfaction of the debt (a transfer in lieu of foreclosure), the transaction is also viewed as a sale or exchange. n65

[b] Computation of Gain or Loss

The general rule for determining gain or loss in each type of foreclosure transaction is the same as the rule for a voluntary sale: Gain or loss is the difference between the adjusted tax basis of the property and the amount realized (gross proceeds less expenses) from the foreclosure transaction. n66

If the property is sold at a foreclosure sale, the amount realized is generally the sale price, and this is used to determine the mortgagor's gain or loss. This is so even if the mortgage exceeds the sale price. n67 If the mortgagor pays that excess (the "deficiency"), the payment will have no independent tax significance. If the mortgagee releases the mortgagor from this obligation, the mortgagor may have COD income, as discussed in *Section 12.10*, below.

The amount realized on a foreclosure sale or other transfer of property in consideration of the discharge or reduction of indebtedness depends on whether the debt is recourse or nonrecourse in nature. If the debt is nonrecourse, the amount realized includes the full amount of debt canceled. n67.1 If the debt is recourse debt, the amount realized generally cannot exceed the fair market value of the mortgaged property. n68 This limitation applies even if the amount bid at the foreclosure sale exceeds the property's fair market value. n68.1

PRACTICE TIP:

It should be noted that, absent clear and convincing proof to the contrary, the sale price of property at a foreclosure sale is presumed to be its fair market value. n68.2 Unless a taxpayer rebuts this presumption, the amount bid will be deemed to be the property's fair market value. Lenders not uncommonly bid an amount higher than the property's fair market value. A taxpayer in an appropriate case should obtain appraisal evidence at the time of sale if the value of property is less than the amount bid at foreclosure. Doing so will reduce the amount realized, and hence the gain from the sale. n68.3

If the amount realized is less than the mortgagor's adjusted basis in the property, the loss incurred is deductible only if

the mortgage indebtedness was incurred in connection with property either held for investment or used in the mortgagor's trade or business. ⁿ⁶⁹ For this reason, a foreclosure on a personal residence will typically produce a nondeductible capital loss. This result may be particularly unappealing if, as discussed in *Section 12.10*, below, the mortgage is recourse and the transaction results in COD income for the mortgagor.

Example:

Assume that individual A purchases a small rental property for \$200,000, consisting of \$10,000 cash and \$190,000 borrowed from Bank X on a recourse note. Later, when the fair market value of the property has decreased to \$160,000, A walks away from the property, and Bank X releases A from any liability remaining after the foreclosure sale. The foreclosure sale produces proceeds of \$160,000. A realizes a \$40,000 capital loss (\$200,000 basis less \$160,000 proceeds), but also must recognize \$30,000 COD income (\$190,000 debt less \$160,000 FMV). The recognition of the COD income may be avoided if A qualifies for one of the exclusions from recognition of income from the discharge of indebtedness. ^{n69.1} See § 12.10, below, for a discussion of these rules.

[c] Timing of the Mortgagor's Loss

If a mortgagor has a statutory right of redemption from a purchaser (i.e., a right to reacquire the property following the foreclosure), the mortgagor's ability to deduct a loss is postponed until the right of redemption expires. ⁿ⁷⁰ If the mortgagor exercises his right to redeem and recovers possession of the property, no gain or loss is realized. ⁿ⁷¹ When state law provides for redemption rights, a mortgagor may avoid postponement of any foreclosure gain or loss by quitclaiming his redemption rights. ⁿ⁷²

Regardless of whether the mortgagor is an accrual-basis or cash basis taxpayer, the sale or exchange loss resulting from the foreclosure is treated as occurring when the foreclosure (or transfer in lieu of foreclosure) takes place, ⁿ⁷³ or, if later, when the right of redemption expires. If the fair market value of the foreclosed property is less than the outstanding mortgage and the mortgagee releases the mortgagor from his obligation to pay the deficiency, any COD income which the mortgagor realizes is reported in the year the mortgagee provides the release.

[3] Tax Consequences to the Mortgagor on Foreclosure of Nonrecourse Mortgage

[a] Transaction Viewed as Sale of the Property

As with a recourse mortgage, the mortgagee's foreclosure of property used to secure a debt is treated as the taxable sale of the property to the mortgagee. ⁿ⁷⁴ If the mortgagor voluntarily issues his deed in favor of the mortgagee in satisfaction of the debt (a transfer in lieu of foreclosure), the transaction is also viewed as a sale or exchange, even if the market value of the property is less than the outstanding mortgage balance. ⁿ⁷⁵

[b] Computation of Gain or Loss

The general rule for determining gain or loss in each type of foreclosure transaction is the same as the rule for a voluntary sale: Gain or loss is the difference between the adjusted tax basis of the property and the amount realized (gross proceeds less expenses) from the foreclosure transaction. ⁿ⁷⁶ The amount realized, however, cannot be less than the nonrecourse debt. ⁿ⁷⁷

If the mortgagor simply transfers the property to the mortgagee, the amount which the mortgagor has realized is not obvious. The rule is that the amount realized is the amount of the debt canceled, even if this exceeds the fair market value of the mortgaged property. ⁿ⁷⁸

One significant difference between nonrecourse and recourse mortgages is that, with a nonrecourse mortgage, the

amount realized on foreclosure, or a transfer in lieu of foreclosure, is never less than the outstanding debt. ⁿ⁷⁹ Thus, the debt is not treated as "canceled" and the mortgagor does not have to worry about COD income. This is, however, not necessarily unmitigated good news for the nonrecourse mortgagor. Unlike the recourse mortgagor--who only includes in the amount realized the fair market value of the property--the nonrecourse mortgagor includes the full amount of the debt in the amount realized. ^{n79.1} This typically reduces the mortgagor's loss (or increases his gain) when the mortgage exceeds the fair market value of the property. The amount realized may also include interest that had accrued as of the date of the foreclosure. ^{n79.2}

Planning Note:

The inclusion of interest in the amount realized may result in the taxpayer being deemed to have paid the interest in the foreclosure. Therefore, the taxpayer may be entitled to deduct the portion of mortgage interest deemed to be paid in the foreclosure. ^{n79.3}

If the amount realized is less than the mortgagor's adjusted basis in the property, the loss incurred is deductible only if the mortgage indebtedness was incurred in connection with property either held for investment or used in the mortgagor's trade or business. ⁿ⁸⁰

Example:

Assume that individual A purchases his personal residence for \$100,000, consisting of \$5,000 cash and a \$95,000 nonrecourse note payable to the seller (i.e., a purchase-money mortgage). Subsequently, when the fair market value (FMV) of the residence decreases to \$80,000, A walks away from the home. Because A is not personally liable on the note, the mortgagee has no further recourse against A. The foreclosure proceeds would be treated as equal to the nonrecourse debt, i.e., \$95,000, and A would realize a \$5,000 nondeductible capital loss (\$100,000 purchase price minus \$95,000 "proceeds"). A would not have any COD income as a result of this transaction.

[c] Timing of the Mortgagor's Loss

With a nonrecourse mortgage, the primary factor affecting the period in which a foreclosure loss is reported for tax purposes is the mortgagor's right of redemption. If a mortgagor has a statutory right of redemption from a purchaser (i.e., a right to reacquire the property following the foreclosure), the mortgagor's ability to deduct a loss is postponed until the right of redemption expires. ⁿ⁸¹ If the mortgagor exercises his right to redeem and recovers possession of the property, no gain or loss is realized. ⁿ⁸² When state law provides for redemption rights, a mortgagor may avoid postponement of any foreclosure gain or loss by quitclaiming his redemption rights. ⁿ⁸³

Additionally, it should be noted that under the laws of some states or under the terms of some debt instruments, accrued interest may be recourse even though the obligation to repay the principal is nonrecourse. In that situation, different results may be obtained.

[4] Tax Consequences to the Mortgagee on Foreclosure and Mitigation

There generally are two possible taxable transactions affecting the mortgagee that can occur when property is foreclosed. First, on a foreclosure, the mortgagee may have a bad debt deduction in the year of foreclosure on the outstanding portion of the mortgage. ⁿ⁸⁴ Second, the mortgagee may recognize gain or loss on the final disposition of the property, as explained below. ⁿ⁸⁵

To the extent that amounts received from a foreclosure sale of mortgaged property to a third party exceed the total claim of the mortgagee (including all costs associated with the foreclosure), the excess is normally paid to the mortgagor. Therefore, it is unusual for a mortgagee to realize a gain from a foreclosure sale. However, if a mortgagee originally

purchased a mortgage debt at a discount or if the mortgagee had previously taken a partial bad debt deduction (generally available only with respect to business loans) which reduced the mortgagee's basis in the loan, gain could occur.

In the case of a nonrecourse mortgage where the mortgagee purchases the mortgaged property in a foreclosure sale, the mortgagee has a taxable gain or loss to the extent of the difference between the bid price and the mortgagee's basis in the mortgage. n86 The result is the same with a recourse mortgage, if the bid price equals or exceeds the outstanding debt.

If, however, there is a deficiency and the mortgage is recourse, the mortgagee has the right to try to recover the deficiency from the mortgagor. Since recovery on a deficiency judgment would make the mortgagee whole, any loss which the mortgagee might have can only be taken in the foreclosure year if it can be shown in that year that the deficiency is uncollectible. n87 Otherwise, the mortgagee subtracts the foreclosure recovery from its original debt basis to determine its basis in the deficiency. It then defers reporting gain or loss until the collectibility (or uncollectibility) of the deficiency is determined. n87.1 Accrued interest may be included as part of the deduction allowable with respect to a mortgage foreclosure, but only if the interest has been reported as income on a federal tax return. n87.2

A loss may be recognized for tax purposes in the year of foreclosure, even though the mortgagor has a right of redemption. n88

The bid price usually is presumed to be the fair market value of the property. This presumption was upheld in a case in which the Service contended that the bid price was less than the fair market value. n89 If the bid price is not the fair market value of the property, the difference will result in a separately reported gain or loss. Supporting a fair market value which is different from the bid price can be a difficult task because the Treasury regulations on the sale of mortgaged property define fair market value as follows:

"The fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid by the taxpayer." n90

If the Service asserts an additional gain due to a fair market value in excess of the bid price, the Service has the burden of overcoming the presumption. n91

The foregoing rules do not apply when the mortgagee is the seller and is also the one foreclosing on the property. *IRC Section 1038* provides that, when the seller-mortgagee repossesses property in satisfaction of the indebtedness, no loss is recognized, and, under certain circumstances, gain may be recognized. See Chapter 7 for further discussion of this topic. n92

[5] Expenses of Foreclosures and Repossessions

Court costs, legal fees and other foreclosure costs related to property acquired by a third party reduce the proceeds received by the mortgagee in a foreclosure sale. When the mortgagee acquires the property, expenses and liens paid by the mortgagee to protect the mortgaged property will be added either to the mortgagee's basis for the loan or to its basis for the acquired property, depending upon when they are paid. Outlays by the mortgagee prior to foreclosure are added to its loan basis, while outlays during the foreclosure proceedings are added to its property basis or to its deficiency judgment if it does not acquire the property. n93

[6] Foreclosure by Prior Lien Holder

A foreclosure by a prior lien holder generally eliminates a mortgagee as a secured creditor. A bad debt loss is not deductible by the mortgagee, however, until the junior note (previously secured by the foreclosed property) is proven to be worthless. n94

[7] Alternatives to Foreclosure

In an effort to circumvent the potentially adverse tax effects arising out of a foreclosure, mortgagors have attempted to use various alternatives to avoid or defer the adverse tax consequences that can arise from "phantom gain" that can attend a foreclosure. n95

[a] Restructuring the Debt

Mortgagees may be willing to cooperate with mortgagors in restructuring the debt to accomplish mutual business and tax objectives. The actual substitution of a new debt instrument in satisfaction of outstanding indebtedness, however, is treated as satisfaction of the outstanding indebtedness for an amount equal to the issue price of the new debt instrument. n96 As a result, a borrower may recognize COD income equal to the difference between the new debt instrument's issue price and the adjusted issue price of the old debt instrument. If there is an actual cancellation of indebtedness--rather than replacement with a new debt instrument--the debtor may realize ordinary income to the extent of the discharge. n97 Taxpayers who have discharge of indebtedness income from the reacquisition of certain debt instruments, however, may elect to defer that gain to future years. n97.1 See § 12.09[8], *below*, for a discussion.

Adjustments such as extending the mortgage term, waiver of current debt service payments, addition of unpaid interest to the principal balance of the mortgage, etc., are other alternatives to foreclosure. If the modification is not material, these types of adjustments have historically been treated as nonrecognition events, and no current tax liabilities have resulted. n98

The tax treatment of these modifications, however, was complicated by a Supreme Court decision, *Cottage Savings Association v Commissioner*. n99 In that case, the Court ruled that thrift institutions can deduct losses claimed from exchanges of groups of residential mortgage loan receivables (or participation interests in two portfolios) with other thrifts or with the Federal National Mortgage Association, even though the mortgages, viewed individually and in groups, possessed many identical financial terms. The tax issue arose in *Cottage Savings* and other thrift "loan swaps" because no nonrecognition provisions of the Code apply specifically to exchanges of debt obligations of different individual obligors. (The like-kind nonrecognition rule of *IRC Section 1031*, relating to exchanges of property held for productive use in a trade or business or for investment, specifically does not apply to exchanges of bonds, notes, other securities, or evidences of indebtedness or interest.) Since the Service could find no statute providing nonrecognition of the losses claimed in *Cottage Savings*, it retreated to realization concepts and claimed that the losses were not "realized."

The Supreme Court held that the losses were realized and deductible because the different obligors and real estate collateral underlying each and every loan involved on both sides of the exchanges made the groups of mortgages materially different from each other within the meaning of the "material difference" test of *Regulations Section 1.1001-1(a)*. The Court also held that the wash sale rule of *IRC Section 1091* did not disallow the loss because the different obligors and collateral on each mortgage made each loan not "substantially identical" to any other loan in the trade. The Court then held broadly that properties are materially different as long as each party to the exchange owns afterward "legally distinct entitlements," apparently meaning property rights and powers that are "not identical" to those held before the exchange. The Court rejected any notion that the mortgages were not materially different merely because the regulatory accounting rule permitted thrifts not to report a loss for financial statement purposes.

The decision had potentially broader application to tax questions across diverse types of transactions, particularly regarding debt restructurings and workouts. The Supreme Court seemed to create a very low threshold in determining whether a modification of terms of an outstanding debt obligation is material enough to be treated as a deemed exchange of old debt for new debt with tax consequences for the lender and borrower following such an exchange.

To clarify the rulings in *Cottage Savings* as well as other debt modification transactions, the IRS issued regulations.

n100 The general approach of the regulations is that there is a realization event if there is a "modification" in the debt instrument which is a "significant modification." For these purposes, a modification is:

"any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise." n101

Most temporary forbearances of a mortgagor's failure to perform are not considered modifications and, therefore, do not result in a realization event. n102

The regulations provide, generally, that a modification is significant only if:

"based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." n103

The regulations then provide specific rules for some common situations. In particular, a yield change is not considered a significant modification unless it varies from the annual yield on the original mortgage by more than the greater of--(1) 1/4 of one percent (25 basis points); or (2) 5 percent of the annual yield of the original mortgage (.05 x annual yield). n104

The regulations provide a general rule that a modification that changes the timing of payments is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. n105 The regulations then provide a safe-harbor, which treats a deferral as not significant if the deferred payments are unconditionally payable no later than five years after the original due date (or, if sooner, 50 percent of the original term of the instrument). n106

A change which releases, substitutes, adds or otherwise alters the collateral for a recourse mortgage is a significant modification if the modification results in a change in payment expectations. n107 In the case of a nonrecourse mortgage, a modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for a mortgage is a significant modification. A substitution of collateral is not, however, a significant modification if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and rating). n108

As the foregoing discussion indicates, the restructuring of an existing loan by entering into a loan modification agreement may cause the lender to be treated as having disposed of the original mortgage, and the borrower may have COD income if the principal amount of the old loan exceeds the principal amount of the new one. The modification may also trigger the original issue discount rules that would treat a portion of the new debt principal as imputed interest. If the principal of the old debt is greater than the imputed principal of the new debt, a solvent borrower generally realizes COD income. n109

Example:

B issues a ten-year note to A for \$3 million. The note provides for 12 percent annual interest. Three years later, when B is solvent, A and B agree to reduce the interest rate to 3 percent. This is a significant modification under *Regulation Section 1.1001-3*. Assuming the 3 percent interest rate is below the applicable federal rate, the original issue discount rules would apply and a portion of the \$3 million principal of the note would be treated as interest. As a result, B could have forgiveness of indebtedness income equal to the amount of principal recharacterized as interest.

[b] Installment Sales

Installment sale reporting has been used to defer recognition of a part of the gain until the installment payments are collected in the future. As previously discussed in *Section 12.04*, above, the major limitation is that any excess of the mortgage balance over the adjusted basis of the property is treated as payment received in the year of sale.

[c] Like-kind Exchanges

Like-kind exchanges have been employed as viable alternatives to contemplated foreclosures. A problem that frequently arises is the difficulty of finding a property suitable for exchange. This problem is aggravated by the fact that the taxpayer's property typically has a relatively high outstanding mortgage balance, along with a low equity value. A solution for this problem is for the taxpayer, if possible, to include some cash along with his property in the trade and to trade up to a higher-value property. This can defer recognition of any phantom gain.

[d] Constructive Receipt Issues in Debt Restructurings

Constructive receipt of income may occur when a mortgage or other debt is extended or restructured. Constructive receipt of income occurs when the taxpayer has an unrestricted right to receive the income, is able to collect it, and the failure to do so results from the exercise of the taxpayer's own choice. n110 If the debtor is unable to pay a mortgage note when due, no constructive receipt will occur. If, however, a note is extended or restructured as an accommodation to an obligor who is otherwise able to pay, constructive receipt of the entire principal due may occur on the due date of the note. This type of situation is likely to occur when real property is sold to related parties, to controlled entities, or to parties who are well-known to the seller. To avoid constructive receipt in this situation, any extension or superseding agreement with respect to the loan must be agreed to before the existing mortgage note or loan becomes due. n111

[8] Election to Defer Cancellation of Indebtedness Income from Reacquisition of a Debt Instrument

[a] In General

A taxpayer may elect to defer cancellation of indebtedness income arising from a "reacquisition" of "an applicable debt instrument" after December 31, 2008, and before January 1, 2011. n111.1 Income deferred pursuant to the election must be included in the gross income of the taxpayer ratably in the five taxable years beginning with (1) for repurchases in 2009, the fifth taxable year following the taxable year in which the repurchase occurs or (2) for repurchases in 2010, the fourth taxable year following the taxable year in which the repurchase occurs. n111.2

An "applicable debt instrument" is any debt instrument issued by (1) a C corporation or (2) any other person in connection with the conduct of a trade or business by that person. n111.3 For purposes of the provision, a "debt instrument" is broadly defined to include any bond, debenture, note, certificate or any other instrument or contractual arrangement constituting indebtedness. n111.4

A "reacquisition" is any "acquisition" of an applicable debt instrument by (1) the debtor that issued (or is otherwise the obligor under) that debt instrument or (2) any person related to the debtor. n111.5 An "acquisition" includes, without limitation, any of the following: n111.6

- An acquisition of a debt instrument for cash;
- The exchange of a debt instrument for another debt instrument (including an exchange resulting from a modification of a debt instrument);
- The exchange of the debt instrument for corporate stock or a partnership interest;
- The contribution of a debt instrument to the capital of the issuer; or

- The complete forgiveness of a debt instrument by a holder of the instrument.

NOTE:

Conspicuously absent from the above list are exchanges of a debt instrument for property, including transfers of real estate in mortgage foreclosures. The IRS, however, has clarified that the term "acquisition" includes an acquisition of a debt instrument for cash or other property, so these exchanges do fall within the ambit of *IRC Section 108(i)*. n111.6.1 In addition, the IRS has clarified that the term "acquisition" also includes an indirect acquisition n111.6.2 if a direct acquisition of the debt instrument would qualify for an election under *IRC Section 108(i)*. For example, if a corporation acquires debt of a partnership that the partnership issued in connection with its trade or business, and the partnership and corporation become related within six months of the corporation's acquisition of the debt, the indirect acquisition is an acquisition for which an election under *IRC Section 108(i)* may be made. n111.6.3

[b] Deferral of Deduction for Original Issue Discount in Debt-for-Debt Exchanges

If a taxpayer makes the election for a debt-for-debt exchange in which the newly issued debt instrument that is issued (or deemed issued, under regulations) n111.7 in satisfaction of an outstanding debt instrument of the debtor has original issue discount (OID), then the deduction for OID must be deferred. Any otherwise allowable deduction for OID with respect to the newly issued debt instrument that (1) accrues before the first year of the five-taxable-year period in which the related, deferred discharge of indebtedness income is included in the gross income of the taxpayer and (2) does not exceed that related, deferred discharge of indebtedness income, must be deferred. n111.8 Instead of an immediate deduction, the OID is allowed as a deduction ratably over the same five-taxable-year period in which the deferred discharge of indebtedness income is included in gross income. If the amount of the OID accruing before the first year exceeds the income from the discharge of indebtedness with respect to the reacquired debt instrument, the deductions must be disallowed in the order in which the OID is accrued. n111.9

NOTE:

The above rule can also apply in certain cases when a debtor reacquires its debt for cash. If the taxpayer issues a debt instrument and uses the proceeds to reacquire one of its existing debt instruments, the newly issued debt instrument is treated as if it were issued in satisfaction of the retired debt instrument. If the newly issued debt instrument has OID, the rule described above applies. Thus, all or a portion of the interest deductions with respect to OID on the newly issued debt instrument is deferred into the five-taxable-year period in which the discharge of indebtedness income is recognized. Where only a portion of the proceeds of a new issuance is used by a taxpayer to satisfy outstanding debt, then the deferral rule applies to the portion of the OID on the newly issued debt instrument that is equal to the portion of the proceeds of the newly issued instrument that is used to retire outstanding debt of the taxpayer. n111.10

[c] Acceleration of Deferred Items

Cancellation of indebtedness income and any related deduction for OID that is deferred by an electing taxpayer (and which has not previously been taken into account) generally are accelerated and taken into income in the taxable year in which the taxpayer: (1) dies, (2) liquidates or sells substantially all of its assets (including in a Title 11 or similar case), (3) ceases to do business, or (4) or is in similar circumstances. In a case under Title 11 or a similar case, any deferred items are taken into income as of the day before the petition is filed. n111.11 In the case of a partnership, LLC or other pass-thru entity, this acceleration rule also applies to the sale, exchange, or redemption of an interest in the entity by a holder of an ownership interest in the entity. n111.12 The Secretary may adopt regulations extending the acceleration provisions to other circumstances. n111.13

NOTE:

Deferred items are accelerated in a case under Title 11 where the taxpayer liquidates, sells substantially all of its assets, or ceases to do business, but not where a taxpayer reorganizes and emerges from the Title 11 case.

[d] Special Rule for Partnerships

In the case of partnership, any income deferred as a result of the election is allocated to the partners in the partnership immediately before the discharge of indebtedness in the manner those amounts would have been included in the distributive shares of the partners under *IRC Section 704* if that income were recognized at the time of the discharge. Any decrease in a partner's share of liabilities as a result of the discharge is not taken into account for purposes of *IRC Section 752* at the time of the discharge to the extent the deemed distribution under *IRC Section 752* would cause the partner to recognize gain under 38-45Q. Thus, the deemed distribution under *IRC Section 752* is deferred with respect to a partner to the extent it exceeds that partner's basis. Amounts so deferred are taken into account at the same time, and to the extent remaining in the same amount, as income deferred as a result of the election is recognized by the partner. n111.14

[e] Coordination with the Statutory Exclusions from COD Income

Where a taxpayer makes the election to defer income under *IRC Section 108(i)*, the statutory exclusions for Title 11 cases, insolvency, qualified farm indebtedness, and qualified real property business indebtedness n111.15 do not apply to the income from the discharge of indebtedness for the year in which the taxpayer makes the election or any subsequent year. n111.16

PLANNING GUIDE:

The inapplicability of the cancellation of indebtedness exclusions when the deferral election is made provides a planning opportunity. For example, an insolvent taxpayer may elect under *IRC Section 108(i)* to defer income from the discharge of indebtedness, rather than exclude that income under *IRC Section 108(a)(1)(B)*. By making this election and not taking advantage of the exclusion, the taxpayer will thereby avoid having to reduce its tax attributes by a corresponding amount. This can be a good decision if the taxpayer expects to be in a more profitable position in later years when larger carryovers of NOLs, the general business credit, and capital losses will provide a larger tax benefit. n111.17

[f] Procedures for Making the Election

The election is made on an instrument-by-instrument basis. A taxpayer makes an election with respect to a debt instrument by including with its return for the taxable year in which the reacquisition of the debt instrument occurs a statement that (1) clearly identifies the debt instrument and (2) includes the amount of deferred income to which the provision applies and such other information as may be prescribed by the Secretary. n111.18 Once made, the election is irrevocable. n111.19 In the case of a partnership, LLC, S corporation or other pass-thru entity, the election is made by the entity. n111.20 The Secretary is authorized to require reporting of the election (and other information with respect to the reacquisition) for years subsequent to the year of the reacquisition. n111.21

Guidance in making the election and information that must be provided is set forth in *Revenue Procedure 2009-37*. n111.22 Partial elections may be made with respect to any portion of COD income realized from the reacquisition of any applicable debt instrument. n111.23

PLANNING GUIDE:

The ability to make partial elections is especially valuable for partnerships because of the different treatment that can be afforded to different partners. A partnership that elects to defer less than all of the COD income realized from the reacquisition of an applicable debt instrument may determine, in any

manner, the portion, if any, of a partner's COD income amount that is the partner's deferred amount. Some partners may have no deferred amount, while others may have a deferred amount that equals their entire COD income amount. A partner with no deferred amount may use the exclusions for COD income under *IRC Section 108(a)(1)(A), (B), (C), or (D)*. n111.24 The situation is different for S corporations. An S corporation's COD income deferred under *IRC Section 108(i)* must be shared pro rata among those shareholders that are shareholders of the S corporation immediately before the reacquisition transaction. n111.25

Protective elections are also permitted--this could be valuable for taxpayers who take a position that the reacquisition of a debt instrument does not result in the realization of COD income, but who have concerns that the IRS may challenge that position. n111.26 In addition, a taxpayer may specify for each applicable debt instrument an amount greater than the identified amount the taxpayer is electing to defer, in the event the IRS subsequently concludes that the taxpayer understated the amount of COD income that could be deferred. This additional amount of COD income the taxpayer elects to defer may be described as the entire additional COD income, or as a percentage of any additional COD income. If the taxpayer is a partnership, the partnership must specify each partner's share of the partnership's additional COD income that would be deferred (the partner's additional deferred amount), which the partnership may describe for each partner as the partner's entire share of the partnership's additional COD income or as a percentage of the partner's share of the partnership's additional COD income. If the taxpayer is an S corporation, the S corporation must specify each shareholder's share of the S corporation's additional COD income that would be deferred. The S corporation may describe this amount for each shareholder as the shareholder's entire share of the S corporation's additional COD income or as a percentage of the shareholder's share of the S corporation's additional COD income. n111.27

Under its authorization to do so, n111.28 the IRS requires reporting of specified information with respect to the reacquisition for years subsequent to the year of the reacquisition. n111.29

FOOTNOTES:

(n1)Footnote 61. See generally *Wicker v Commr*, *TC Memo 1993-431*, 66 *TCM* 757 (1993) , *aff'd* 95-1 *USTC* P 50,182 (8th Cir 1995) (when the Service is asserting mortgagor had gain on foreclosure sale, the Service has burden of proof as to whether discharged liability was recourse or nonrecourse).

(n2)Footnote 62. See *IRC § 61(a)(12)*. See also *Rev Rul 82-202*, 1982-2 *CB* 35 , relating to the recognition of COD income on the mitigation of a home mortgage. For purposes of computing gain under *Treas Reg § 1.1034-1(b)(4)*, any discount which a taxpayer gets as a result of prepaying a recourse mortgage is not considered in determining the "amount realized." *Michaels v Commr*, 87 *TC* 1412 (1986) . See also Culp and Marsh, "Avoiding Cancellation of Debt Income Where the Liability is Disputed," 74 *J Tax'n* 288 (1991).

(n3)Footnote 63. The Service's position is that this result applies, even if the mortgage is nonrecourse. *Rev Rul 91-31*, 1991-1 *CB* 19 . This ruling has been criticized. See Schmalz, Brumbaugh, Crnkovich & Jones, "IRS Insists That Reduction or Cancellation of Nonrecourse Debt Always Results in Income," 75 *J Tax'n* 68 (1991).

(n4)Footnote 63.1. *IRC §§ 108(b), 1017*.

(n5)Footnote 63.2. *Jelle v Commr*, 116 *TC* 63 (2001) .

(n6)Footnote 64. *Helvering v Hammel*, 311 *US* 504 , 41-1 *USTC* P 9169, 24 *AFTR* 1082 (1941) ; *Parker v Delaney*, 186 *F2d* 455 , 51-1 *USTC* P 9112, 40 *AFTR* 89 (1st Cir 1950) , *cert den* 341 *US* 926 ; *Woodsam Associates v Commr*, 16 *TC* 649 , *aff'd* 198 *F2d* 357 , 52-2 *USTC* P 9396 , 42 *AFTR* 505 (2d Cir 1952) . See also *Rev Rul 73-36*, 1973-1 *CB* 372 .

(n7)Footnote 65. *Treas Reg* § 1.1001-2; *Rev Rul* 90-16, 1990-1 CB 12 ; *Chilingirian v Commr*, 918 F2d 1251 , 1990-2 USTC P 50,569 (6th Cir 1990); *Freeland v Commr*, 74 TC 970 (1980) ; *Commr v Green*, 126 F2d 70 , 42-1 USTC P 9277, 28 AFTR 1286 (3d Cir 1942) ; *Commr v Hoffman*, 117 F2d 987 , 41-1 USTC P 9280, 42 AFTR 486 (2d Cir 1941).

(n8)Footnote 66. See *Emmons v Commr*, TC Memo 1998-173 ; *Cox v Commr*, TC Memo 1994-189, 67 TCM 2809 (1994) . The mortgagor is also deemed to have received consideration on foreclosure if the purchaser assumes any of the mortgagor's accrued liabilities, such as unpaid property taxes. *Allan v Commr*, 86 TC 655 (1986) , aff'd 856 F2d 1169 , 1988-2 USTC P 9510, 62 AFTR2d 88-5715 (8th Cir 1988) .

(n9)Footnote 67. *Treas Reg* § 1.1001-2(a)(2). See also *Emmons v Commr*, TC Memo 1998-173 ; *Webb v Commr*, TC Memo 1995-486 (1995) ; *Aizawa v Commr*, 99 TC 197 (1992) , aff'd without publ opinion 29 F3d 630, 74 AFTR2d P 94-5493 (9th Cir 1994); *Hintenberger v Commr*, 36 TCM 1683, TC Memo 1977-414 (1979) .

(n10)Footnote 67.1. *Commr v Tufts*, 461 US 300 (1983) ; *Gershowitz v Commr*, 88 TC 984 (1987) ; *Estate of Delman v Commr*, 73 TC 15 (1979) ; *Frazier v Commr*, 111 TC No 11 (1998) .

(n11)Footnote 68. *Rev Rul* 90-16, 1990-1 CB 12 ; *Treas Reg* § 1.1001-2(c), Ex 8. See also *Rev Rul* 82-202, 1982-2 CB 35 .

(n12)Footnote 68.1. *Frazier v Commr*, 111 TC 243 (1998) .

(n13)Footnote 68.2. *Community Bank v Commr*, 79 TC 789 (1982) , aff'd 819 F2d 940 (9th Cir 1987) ; *Frazier v Commr*, 111 TC 243 (1998) ; *Maracaccio v Commr*, TC Memo 1995-174 .

(n14)Footnote 68.3. See *Frazier v Commr*, 111 TC No 11 (1998) .

(n15)Footnote 69. If the foreclosure proceeds are used to pay outstanding interest or property tax obligations, they will typically be deductible. See *Malmstead v Commr*, 578 F2d 520 , 78-2 USTC P 9479 (4th Cir 1978); *Rev Rul* 72-237, 1972-1 CB 51 . If the loss results from a sale to a related party, it will be disallowed. *IRC* § 267(a)(1), (b).

(n16)Footnote 69.1. See *IRC* § 108(a)(1).

(n17)Footnote 70. *Rev Rul* 70-63, 1970-1 CB 36 ; *Shelden Land Co v Commr*, 42 BTA 498 (1940) ; *Nickoll v Commr*, 103 F2d 619 , 39-1 USTC P 9446 (7th Cir 1939); *Derby Realty Corp v Commr*, 35 BTA 335 , *Commr's app dismissed* 92 F2d 999 , 39-1 USTC P 9446, 20 AFTR 370 (6th Cir 1937) , acq 1938-1 CB 9 ; *Hawkins v Commr*, 34 BTA 918 , aff'd 91 F2d 354 , 37-2 USTC P 9412 , 19 AFTR 1116 (5th Cir 1937) .

(n18)Footnote 71. *Hotz v Commr*, 42 BTA 432 (1940) .

(n19)Footnote 72. *Atmore Realty Co v Commr*, BTA Memo 1942-248 (1948); *Hill v Commr*, 40 BTA 376 (1939) , *nonacq* 1939-2 CB 53 , *rev'd and remanded on another issue* 119 F2d 421 , 41-1 USTC P 9415 (6th Cir 1941).

(n20)Footnote 73. *Lamm v Commr*, 873 F2d 194 , 89-1 USTC P 9282 (8th Cir 1989); *George v US*, 97-2 USTC P 50,644 (10th Cir 1997); *Commr v Green*, 126 F2d 70 (3rd Cir 1942) ; *Helvering v Hammel*, 311 US 504 (1941) .

(n21)Footnote 74. See authorities cited in N 61, above; see also *Tufts*, N 56, above.

(n22)Footnote 75. See N 62, above.

(n23)Footnote 76. See *Cox v Commr*, TC Memo 1994-189, 67 TCM 2809 (1994) .

(n24)Footnote 77. *Commr v Tufts*, 461 US 300 , 83-1 USTC P 9328 (1983).

(n25)Footnote 78. *Id.* The mortgagor is also deemed to have received consideration on foreclosure if the purchaser assumes any of the mortgagor's accrued liabilities, such as unpaid property taxes. *Allan v Commr*, 86 TC 655 (1986), *aff'd* 856 F2d 1169, 1988-2 USTC P 9510, 62 AFTR2d 88-5715 (8th Cir 1988).

(n26)Footnote 79. IRC § 7701(g) provides that, in the case of nonrecourse debt, the fair market value of the encumbered property cannot be less than the outstanding principal balance of the debt. Therefore, in the case of nonrecourse debt, the amount realized will never be less than the principal balance.

(n27)Footnote 79.1. *Commr v Tufts*, 461 US 300 (1983); see *Treas Reg* § 1.1001-2(c)(2), Ex 7.

(n28)Footnote 79.2. *Catalano v Commr*, TC Memo 2000-82, *rev'd on other grounds* 279 F3d 682 (9th Cir 2002); *Allan v Commr*, 856 F2d 1169 (8th Cir 1988).

(n29)Footnote 79.3. *Catalano v Commr*, TC Memo 2000-82, *rev'd on other grounds* 2002-1 USTC P 50,203 (9th Cir 2002); *Harris v Commr*, TC Memo 1976-125, *aff'd without publ opin* 554 F2d 1068 (9th Cir 1977).

(n30)Footnote 80. If the foreclosure proceeds are used to pay outstanding interest or property tax obligations, they will typically be deductible. If the loss results from a sale to a related party, it will be disallowed. IRC § 267(a)(1), (b).

(n31)Footnote 81. *Rev Rul* 70-63, 1970-1 CB 36; *Shelden Land Co v Commr*, 42 BTA 498 (1940); *Nickoll v Commr*, 103 F2d 619, 39-1 USTC P 9446 (7th Cir 1939); *Derby Realty Corp v Commr*, 35 BTA 335, *Commr's app dismissed* 92 F2d 999, 37-2 USTC P 9412, 20 AFTR 370 (6th Cir 1937), *acq* 1938-1 CB 9; *Hawkins v Commr*, 34 BTA 918, *aff'd* 91 F2d 354, 19 AFTR 1116 (5th Cir 1937).

(n32)Footnote 82. *Hotz v Commr*, 42 BTA 432 (1940).

(n33)Footnote 83. *Atmore Realty Co v Commr*, BTA Memo 1942-248 (1948); *Hill v Commr*, 40 BTA 376 (1939), *nonacq* 1939-2 CB 53, *rev'd and remanded on another issue* 119 F2d 421 (6th Cir 1941).

(n34)Footnote 84. *Commr v Spreckels*, 120 F2d 517, 41-1 USTC P 9471 (9th Cir 1941). This assumes that the mortgage is a bad debt subject to IRC § 166(a) (i.e., either a mortgage held by a corporation or a mortgage that is a business bad debt). If it is a nonbusiness bad debt, subject to IRC § 166(d), the loss will be a short-term capital loss. Note that, if the mortgage is held by a corporation or is a business bad debt, the mortgagee will generally be allowed to take a partial bad debt deduction if the mortgage is partially worthless and the mortgagee charges off the worthless portion. See generally IRC § 166(a)(2) and *Treas Reg* § 1.166-3. (Special rules apply to banks and other regulated corporations with respect to proof of worthlessness. See *Treas Reg* § 1.166-2(d).)

(n35)Footnote 85. See also Grajewski and Nartker, "Uniform Capitalization Rules Can Defer Deductions on a Bank's Foreclosed Property," 9 *J Bank Tax'n* 111 (1996), which discusses the implications of the UNICAP rules when a bank must complete work on a foreclosed construction project.

(n36)Footnote 86. The mortgagee's basis is determined by subtracting principal paid from the loan's face amount. IRC § 166(b); *Treas Reg* § 1.166-1(d).

(n37)Footnote 87. *Treas Reg* §§ 1.166-6(a); 1.165-5(e). See also *Est of Jewett v Commr*, 1949 Tax Ct Memo LEXIS 143 (1949); *Havemeyer v Commr*, 45 BTA 329 (1941), *acq* 1942-1 CB 8.

(n38)Footnote 87.1. See *Treas Reg* § 1.166-6(a)(1).

(n39)Footnote 87.2. *Treas Reg* § 1.166-6(a)(2); *Federal Home Loan Mortgage Corporation v Commr*, 121 TC 279 (2003) (Tax Court held that in computing gain or loss from the mortgage foreclosures, the taxpayer could not increase its adjusted cost basis in the mortgages by interest that accrued on them when the taxpayer was tax-exempt).

(n40)Footnote 88. *Securities Mortgage Co v Commr*, 58 TC 667 (1972) ; *William C Heinemann & Co v Commr*, 40 BTA 1090 (1939) .

(n41)Footnote 89. *Community Bank v Commr*, 62 TC 503 (1974) , *acq* 1975-2 CB 1 .

(n42)Footnote 90. *Treas Reg* § 1.166-6(b)(2).

(n43)Footnote 91. *Community Bank*, see N 86, above.

(n44)Footnote 92. See also Frankel, "When and How to Avoid Sec. 1038 Relief When Reacquiring Real Property," 27 *Tax Adv* 34 (1996) (noting that it is sometimes advantageous for a mortgagee to avoid the application of *IRC* § 1038, particularly with loss property).

(n45)Footnote 93. *Cf Heger v Commr*, *TC Memo* 1993-408, 66 *TCM* 610 (1993) , where payments made to avoid foreclosure were not allowed to be added to basis.

(n46)Footnote 94. *Berenson v Commr*, 39 BTA 77 (1939) , *aff'd* 113 F2d 113 , 40-2 *USTC* P 9572, 25 *AFTR* 343 (2d Cir 1940) .

(n47)Footnote 95. In addition to the methods discussed here, there are other means that may be used to avoid the negative impact of a foreclosure, such as transfers to corporations and partnerships, or expansion of a partnership. These approaches are complex and are beyond the purview of this discussion. For reasons why a seller-mortgagee might want to avoid foreclosure and the application of *IRC* § 1038, see Frankel, N 89, above.

(n48)Footnote 96. *IRC* § 108(e)(10).

(n49)Footnote 97. *IRC* § 61(a)(12). See § 12.10, below.

(n50)Footnote 97.1. *IRC* § 108(i).

(n51)Footnote 98. *Rev Rul* 73-160, 1973-1 CB 415 ; *Soter v Commr*, *TC Memo* 1968-43, 27 *TCM* 194 (1968) ; *Rev Rul* 68-419, 1968-2 CB 196 ; *Rev Rul* 55-429, 1955-2 CB 252 .

(n52)Footnote 99. 499 *US* 554 , 1991-1 *USTC* P 50,187 (1991). This case is discussed in Sax, "Supreme Court Decides Fundamental Debt Discharge, Loss Realization Issues," 75 *J Tax'n* 54 (1991).

(n53)Footnote 100. *Treas Reg* § 1.1001-3. These regulations were originally published in proposed form as FI-31-92 (Dec 2, 1992), and the proposed version is discussed in Wolf and Malvey, "IRS Proposes Debt Modification Rules in Response to *Cottage Savings*," 78 *J Tax'n* 140 (1993). The regulations were put into final form with some changes in *TD* 8675 (June 26, 1996) .

(n54)Footnote 101. *Treas Reg* § 1.1001-3(c)(1).

(n55)Footnote 102. See *Treas Reg* § 1.1001-3(c)(4)(ii), providing that a forbearance of under two years (and sometimes longer) is temporary for these purposes.

(n56)Footnote 103. *Treas Reg* § 1.1001-3(e)(1).

(n57)Footnote 104. *Treas Reg* §§ 1.1001-3(e)(2); 1.1001-3(g), Ex 2.

(n58)Footnote 105. *Treas Reg* § 1.1001-3(e)(3)(i).

(n59)Footnote 106. *Treas Reg* §§ 1.1001-3(e)(3)(ii); 1.1001-3(g), Ex 4.

(n60)Footnote 107. *Treas Reg § 1.1001-3(e)(4)(iv)(A)*. The term "payment expectations" is defined in *Treas Reg § 1.1001-3(e)(4)(vi)*.

(n61)Footnote 108. *Treas Reg § 1.1001-3(e)(4)(iv)(B)*.

(n62)Footnote 109. *IRC § 108(e)(11)*.

(n63)Footnote 110. *Treas Reg § 1.451-2(a)*; *Saint Claire Corp v Commr, TC Memo 1997-171* .

(n64)Footnote 111. *Martin v Commr, 85 TC 814 (1991)* ; *Oates v Commr, 18 TC 570 (1952)* , *affd 207 F2d 711 (7th Cir 1953)* ; *Saint Claire Corp v Commr, TC Memo 1997-171* (constructive receipt of entire remaining principal occurred when mortgage note was extended on the date it became due and obligor was otherwise able to pay).

(n65)Footnote 111.1. *IRC § 108(i)(1)*, effective for discharges in taxable years ending after Dec 31, 2008 [Pub Law No 111-5, § 1231(b)].

(n66)Footnote 111.2. *IRC § 108(i)(1)*.

(n67)Footnote 111.3. *IRC § 108(i)(3)(A)*.

(n68)Footnote 111.4. *IRC § 108(i)(3)(B)*; see *IRC § 1275(a)(1)*.

(n69)Footnote 111.5. *IRC § 108(i)(4)(A)*; whether a person is related is determined under *IRC § 108(e)(4)*; in general a 50-percent common entity ownership is required [see *IRC §§ 267(b), 707(b)(1)*].

(n70)Footnote 111.6. *IRC § 108(i)(4)(B)*.

(n71)Footnote 111.6.1. *Rev Proc 2009-37* , § 2.03, *2009-36 IRB 309* .

(n72)Footnote 111.6.2. See *Treas Reg § 1.108-2(c)*.

(n73)Footnote 111.6.3. *Rev Proc 2009-37* , § 2.03, *2009-36 IRB 309* .

(n74)Footnote 111.7. See *Treas Reg § 1.108-2(g)*.

(n75)Footnote 111.8. *IRC § 108(i)(2)(A)(i)*.

(n76)Footnote 111.9. *IRC § 108(i)(2)(A)(ii)*.

(n77)Footnote 111.10. See *IRC § 108(i)(2)(B)*.

(n78)Footnote 111.11. *IRC § 108(i)(5)(D)(i)*.

(n79)Footnote 111.12. *IRC § 108(i)(5)(D)(ii)*.

(n80)Footnote 111.13. *IRC § 108(i)(7)(A)*.

(n81)Footnote 111.14. *IRC § 108(i)(6)*.

(n82)Footnote 111.15. See *IRC § 108(a)(1)(A), (B), (C), (D)*. See § 12.10, below, for a discussion of these exclusions.

(n83)Footnote 111.16. *IRC § 108(i)(5)(C)*.

(n84)Footnote 111.17. See *IRC § 108(b)*.

(n85)Footnote 111.18. *IRC § 108(i)(5)(B)(i)*.

(n86)Footnote 111.19. *IRC § 108(i)(5)(B)(ii)*.

(n87)Footnote 111.20. *IRC § 108(i)(5)(iii)*.

(n88)Footnote 111.21. *IRC § 108(i)(7)(B)*.

(n89)Footnote 111.22. *Rev Proc 2009-37, 2009-36 IRB 309* . The procedure generally applies for re-acquisitions of applicable debt instruments in tax years ending after Dec 31, 2008 [*Rev Proc 2009-37* , § 6, *2009-36 IRB 309* . A transition rule allows non-complying elections made before Sept 17, 2009 to be treated as effective if the taxpayer by Nov 16, 2009 filed an amended return for the taxable year of the election and complied with the requirements *Rev Proc 2009-37* [*Rev Proc 2009-37* , § 7, *2009-36 IRB 309*].

(n90)Footnote 111.23. *Rev Proc 2009-37* , § 4.04, *2009-36 IRB 309* .

(n91)Footnote 111.24. *Rev Proc 2009-37* , § 4.04(3), *2009-36 IRB 309* .

(n92)Footnote 111.25. *Rev Proc 2009-37* , § 2.10, *2009-36 IRB 309* .

(n93)Footnote 111.26. *Rev Proc 2009-37* , § 4.11, *2009-36 IRB 309* .

(n94)Footnote 111.27. *Rev Proc 2009-37* , § 4.06, *2009-36 IRB 309* .

(n95)Footnote 111.28. *IRC § 108(i)(7)(B)*.

(n96)Footnote 111.29. *Rev Proc 2009-37* , § 5, *2009-36 IRB 309* .



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Federal Taxes Affecting Real Estate

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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.10

§ 12.10 Income from the Discharge of Indebtedness

[1] General Rules

Generally, income from discharge of indebtedness is currently included in gross income n112 unless it is excludable under *IRC Section 108*. Under *IRC Section 108*, five exclusions are provided: n113

- (1) a debt discharge in a Title 11 bankruptcy case, if the discharge is granted or approved by the court;
- (2) a discharge when the taxpayer is insolvent outside of bankruptcy; n114
- (3) a discharge of qualified farm indebtedness;
- (4) a discharge of qualified real property business indebtedness for taxpayers other than C corporations;
or
- (5) a discharge of indebtedness that is qualified principal residence indebtedness. n115

NOTE:

The exclusions for insolvency discharges, qualified farm indebtedness discharges, qualified real property business indebtedness discharges, and discharges of qualified principal residence indebtedness do not apply to a taxpayer in a Title 11 case. n116 In the case of an insolvent taxpayer not in a Title 11 case, statutory ordering rules apply under which (1) the insolvency exclusion takes precedence over the qualified farm indebtedness and qualified real property business exclusions, n117 and (2) the principal residence exclusion takes precedence over the insolvency exclusion unless the taxpayer elects otherwise. n118

The insolvency exclusion n119 is limited to the amount by which the taxpayer is insolvent. n120 Insolvency is measured by the amount by which liabilities exceed the fair market value of assets immediately before the debt discharge. n121 The IRS takes the position that assets which are exempt from creditors' claims under state law, including real property held as tenants by the entirety, or a taxpayer's personal residence, must be counted in the taxpayer's assets for purposes of determining if the taxpayer is insolvent. Courts, however, have ruled that property

exempt from the claims of creditors is not included in determining the fair market value of the taxpayer's assets in determining insolvency because the cancellation of indebtedness does not release them from the creditors' claims. n122

The amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent under *IRC Section 108(d)(3)* of the Code, but only to the extent that the excess nonrecourse debt is discharged. If the nonrecourse debt is not discharged, it is not treated as a liability. n123

For bankrupt taxpayers, any amount of debt discharge that is left after the reduction of tax attributes is disregarded and does not result in income or have other tax consequences.

In a partnership, the eligibility for discharge of indebtedness exclusions is determined at the partner level. n124 Any partner guarantees made in connection with partnership activities may also be entitled to the above exclusions. n125

[2] Discharge of Qualified Farm Indebtedness

Gross income does not include income from the discharge of qualified farm indebtedness. n126 The amount excluded from gross income, however, cannot exceed the sum of the taxpayer's adjusted tax attributes and the aggregate adjusted bases of qualified property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. n127 The "adjusted tax attributes" n128 are determined by (1) first adding the sum of the basis adjustments under *IRC Section 108(b)(2)* other than the basis reduction adjustment; n129 (2) taking \$3 for each \$1 of the general business credit, minimum tax credit, and foreign tax credit carryover attributes; and (3) taking the passive activity carryover attribute only to the extent attributable to any passive activity credit carryover. n130 "Qualified property" includes any property used in a trade or business, or held for the production of income. n131

The qualified farm indebtedness exclusion is available only to discharges made by qualified persons. n132 "Qualified persons" include persons actively and regularly engaged in the lending business who are not any of the following: n133

- related to the taxpayer;
- a person from which the taxpayer acquired the property (or a person related to that person); or
- a person who receives a fee with respect to the taxpayer's investment in the property (or a person related to that person).

Qualified persons also include federal, state, or local governments and their agencies and instrumentalities. n134

For purposes of the exclusion, indebtedness is "qualified farm indebtedness" only if it meets the following requirements: n135

- it was incurred direction in connection with the operation by the taxpayer of a farming business; and
- at least 50 percent of the taxpayer's aggregate gross receipts for the three taxable years before the year the indebtedness is discharged is attributable to the trade or business of farming.

[3] Income from Discharge of Qualified Real Property Business Indebtedness

Taxpayers (other than C corporations) may *elect* to exclude income attributable to the discharge of "qualified real property business indebtedness" from gross income. n136 The election must be made on a timely filed (including extensions) federal income tax return for the taxable year in which the taxpayer has discharge of indebtedness income

that is excludable under *IRC Section 108(a)*. The election is made on completed Form 982. n137 A taxpayer that fails to make the election on that return must request the Commissioner's consent to file a late election under *Regulation 301.9100-3*.

Qualified real property business indebtedness is indebtedness incurred or assumed in connection with real property used in a trade or business and secured by that real property. (Qualified farm indebtedness is not included in the above definition.) n138 The IRS has privately ruled that indebtedness collateralized by an ownership interest in an entity owning real property is secured by that property, and can therefore be treated as qualified real property business indebtedness if other statutory requirements are satisfied. n138.1

NOTE:

In a private letter ruling, the IRS has ruled that if a loan is incurred "in connection with" a taxpayer's business real property because it is secured by that real property at the time the debt was incurred, it is unnecessary to trace the use of the loan proceeds to determine if the "in connection with" requirement is met. Thus, a loan the proceeds of which are used for non-real estate-related purposes should be able to qualify as qualified real property business indebtedness and therefore be eligible for the exclusion. n139

In addition, the indebtedness must either have been incurred or assumed before 1993 or be "qualified acquisition indebtedness." Qualified acquisition indebtedness is debt that is used to acquire, construct or substantially improve real property used in a trade or business and secured by that real property. n140 It also includes debt incurred to refinance qualified real property business debt incurred before 1993; but on refinancing, any debt incurred in excess of the debt being refinanced does not qualify. n141

The exclusion from income may not exceed the aggregate bases of all the taxpayer's depreciable real property. n142 A reduction in the basis of the taxpayer's depreciable real property under *IRC Section 1017* is required, but this basis reduction is limited to the income excluded. n143

In addition to this overall basis limitation, the amount of income excluded because of the discharge of any qualified real property business indebtedness may not exceed the excess of: (1) the outstanding principal amount of the debt (immediately before the discharge), over (2) the fair market value (immediately before the discharge) of the business real property which is security for the debt. n144

PRACTICE TIP:

The statutory provision limiting relief to the amount by which the debt exceeds the value of the security n144.1 reflects the legislative intent for the exclusion to apply when debt secured by real property becomes undersecured due to a decline in the property's value. Under these circumstances, rather than requiring a taxpayer to report discharge of indebtedness income when the debt is modified, the taxpayer may reduce the basis of depreciable property (and take smaller depreciation deductions). n144.2

For this purpose only, the outstanding principal amount means the principal amount of an indebtedness and all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on those amounts would accrue and compound in the future. Amounts subject to *IRC Section 108(e)(2)* (dealing with income not realized to the extent of lost deductions) are excluded from the definition of principal amount. In addition, principal amount must be adjusted to account for unamortized premium and discount consistent with *IRC Section 108(e)(3)*. n145 For this purpose, the fair market value of the property is reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by the property immediately before the discharge.

Example:

Jack (who is not insolvent) owns a building now valued at \$150,000 which he uses in his insurance business. The building is subject to two third-party mortgages: the first secures a debt of \$110,000 and the second secures a debt of \$90,000. Jack agrees with the second mortgagee to reduce that debt to \$30,000, resulting in discharge of indebtedness income of \$60,000. Jack can elect to exclude \$50,000 of that amount from gross income, provided he has enough basis in business real property to absorb it. The \$50,000 equals the excess of the discharged debt immediately before its discharge (\$90,000) over the net fair market value of the property that secures it (this equals \$40,000, i.e., \$150,000 less the \$110,000 of other qualified business real property debt). The remaining \$10,000 of income attributable to the debt discharge is included in gross income unless some other exception applied.

Special rules apply when applying the exclusion to partnerships and S corporations. For partnerships that have a discharge of indebtedness, the determination of whether debt is qualified real property business indebtedness (and the application of the fair market value limitation) is made at the partnership level. However, the election to apply this provision is made at the partner level on a partner-by-partner basis. n146 An interest of a partner in a partnership that owns depreciable real property is treated as depreciable real property to the extent of the partner's proportionate interest in the depreciable real property held by the partnership. The partnership's basis in depreciable real property with respect to such partner is correspondingly reduced.

For S corporations, the election to apply this provision to income from the discharge of indebtedness is made by the S corporation, and the exclusion and basis reduction are both made at the S corporation level. n147

When depreciable real property, the basis of which was reduced under this provision, is disposed of, the amount of depreciation recapture under *IRC Section 1250* is increased as follows: (1) any basis reduction attributable to this rule is treated as a deduction allowed for depreciation, and (2) the determination of what would have been the depreciation adjustment under the straight line method is made as if there had been no such reduction. Thus, the amount of the basis reduction that is recaptured as ordinary income is reduced over the time the taxpayer continues to hold the property, as the taxpayer forgoes depreciation deductions due to the basis reduction. n148

[4] Discharge of Qualified Principal Residence Indebtedness Excluded from Gross Income

In response in part to the sub-prime mortgage crisis in 2007, Congress enacted a new provision excluding from gross income any discharge of indebtedness income resulting from a discharge (in whole or in part) of qualified principal residence indebtedness. n149 The provision is effective for discharges of indebtedness on or after January 1, 2007 and before January 1, 2013. n150 The main reason for the legislation was a sense that where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure, it is inappropriate to treat discharges of acquisition indebtedness as income.

For purposes of the exclusion, "qualified principal residence indebtedness" means acquisition indebtedness with respect to the taxpayer's principal residence. n151 The term "principal residence" has the same meaning as under *IRC Section 121*. n152

Acquisition indebtedness with respect to a principal residence generally means indebtedness that is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by that residence. It also includes refinancing of that indebtedness to the extent the amount of the refinancing does not exceed the amount of the refinanced indebtedness. n153

NOTE:

The exclusion for qualified principal residence indebtedness generally incorporates the definition of

"acquisition indebtedness" that is used for purposes of the interest deduction. n154 One important difference, however, is that the \$1 million limit that applies with respect to acquisition indebtedness for purposes of deducting interest n155 does not apply for purposes of the discharge of indebtedness exclusion. Therefore, debt forgiveness in excess of \$1 million is eligible for the exclusion. n156

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt that is not qualified principal residence indebtedness. n157

Example:

Jim's principal residence is secured by an indebtedness of \$1 million, of which \$800,000 is qualified principal residence indebtedness. If the residence is sold for \$700,000 and \$300,000 debt is discharged, then only \$100,000 of the amount discharged may be excluded from gross income. n158

The basis of the individual's principal residence is reduced (but not below zero) by the amount excluded from income. n159

The exclusion for discharges of qualified principal residence indebtedness does not apply to a taxpayer in a Title 11 case; the Title 11 exclusion takes precedence in that case. n160 In the case of an insolvent taxpayer who is not in a Title 11 case, the exclusion for discharges of qualified principal residence indebtedness applies unless the taxpayer elects to have the insolvency exception apply. n161

The exclusion for discharges of qualified principal residence indebtedness does not apply to the discharge of a loan if the discharge is on account of services performed for the lender. n162

[5] Reduction of Purchase Money Debt of an Insolvent Debtor

IRC Section 108 treats any reduction of purchase-money debt of a solvent debtor as a purchase price adjustment, rather than a discharge of indebtedness. n163 Thus, when a seller of property reduces the purchase money obligation of a solvent buyer, the reduction is treated as an adjustment to the cost of the property. n164

Example:

B purchases raw land from S for \$100,000, paying \$20,000 in cash and taking a purchase money mortgage for the balance. B is delinquent on payments, but S does not wish to foreclose. Further, B is solvent and does not file a petition in bankruptcy.

If S agrees to reduce the amount of debt to \$65,000, B will not recognize income from the discharge of indebtedness. Instead, he must adjust his basis in the property to \$85,000 (\$100,000 original basis less \$15,000 of debt discharged).

[6] Impact on Tax Attributes

[a] In General

Whenever a taxpayer is able to exclude income from a discharge in indebtedness from gross income under *IRC Section 108(a)*, a corresponding reduction must be made to one or more of the taxpayer's tax attributes. The particular attributes affected and the manner in which the reductions are applied to them depend upon the particular type of exclusion from gross income that was involved.

In the case of excluded income resulting from discharges of indebtedness in Title 11 or insolvency cases, or discharges of qualified farm indebtedness, the amount excluded from gross income must be applied to reduce several of the taxpayer's tax attributes. n165 Unless a taxpayer makes an election discussed below, n166 the attributes must be reduced in the following order: n167

- (1) net operating losses and carryovers;
- (2) general business credit;
- (3) minimum tax credit;
- (4) capital loss carryovers;
- (5) basis of the taxpayer's depreciable and nondepreciable assets;
- (6) passive activity loss and credit carryovers; and
- (7) foreign tax credit carryovers.

[b] Election to Apply Reductions First Against Depreciable Property

A taxpayer with amounts excluded from gross income in Title 11 bankruptcy or insolvency cases, or in discharges of qualified farm indebtedness may elect to alter the above default statutory ordering of the reduction of tax attributes. If the election is made, a taxpayer may apply all or a portion of the debt discharge amount to first reduce basis (but not below zero) in depreciable property or real property held primarily for sale to customers in the ordinary course of a trade or business. n168 The election is limited to the aggregate adjusted bases of depreciable property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. n169

The election must be made on a timely-filed (including extensions) federal income tax return for the taxable year in which the taxpayer has COD income that is excluded under *IRC Section 108(a)*. The appropriate information must be entered on Form 982, and the form attached to the tax return. An election may be revoked only with the consent of the Commissioner. n170

A taxpayer who makes an election under *IRC Section 108(b)(5)* may pick and choose the depreciable property for which bases will be reduced and avoid the general ordering rules on basis reduction. n171

If the election is made, a taxpayer first reduces the adjusted bases of depreciable property (real and personal) to the extent of the excluded discharge of indebtedness income. n172 If the adjusted bases of depreciable property are insufficient to offset the entire amount of excluded income, the taxpayer must reduce any remaining tax attributes in the order specified in *IRC Section 108(b)(2)*. n173

PLANNING GUIDE:

The election to first reduce basis in depreciable property, rather than reduce tax attributes under the default ordering rule, provides a taxpayer with the opportunity to account for the discharge of indebtedness in a manner most favorable to the taxpayer's tax situation. A bankrupt or insolvent taxpayer who wishes to retain net operating losses or any of the other carryovers n174 should often make the basis-reduction election. In contrast, a taxpayer having an expiring net operating loss would want to reduce the carryovers rather than make the election. n175

[c] Rules for Discharges of Qualified Real Property Business Indebtedness

Only one tax attribute is affected when a taxpayer excludes gross income from discharges of qualified real property indebtedness--the basis of the taxpayer's depreciable property. n176 In this case, the basis of a taxpayer's depreciable real property must be reduced by the amount excluded from gross income. The reduction is done in accordance with *IRC Section 1017* and accompanying regulations n177 and is applied to the basis of depreciable real property held by the taxpayer at the beginning of the tax year following the tax year in which the discharge occurs. n178 There are no other reductions of tax attributes applied for this type of indebtedness discharge. n179 See § 12.10[7][c], below, for a discussion of *IRC Section 1017* basis reduction rules that apply to discharges of qualified real property indebtedness.

[d] Rules for Discharges of Qualified Principal Residence Indebtedness

Only one tax attribute must be reduced when a taxpayer excludes income from the discharge of qualified principal residence indebtedness. n180 In these cases, the basis of the individual's principal residence must be reduced (but not below zero) by the amount excluded from gross income. n181 There are no other reductions of tax attributes applied for this type of indebtedness discharge. n182 See § 12.10[4], above, for a detailed discussion of this exclusion.

[7] Reductions of Basis under *IRC Section 1017***[a] In General**

IRC Section 1017 is used to apply the required basis reduction in property when a taxpayer has discharge of indebtedness income in a Title 11 bankruptcy case, an insolvency case, or has discharge of qualified farm indebtedness or (for taxpayers other than C corporations) discharge of qualified real property indebtedness. n183

When a taxpayer has discharge of indebtedness income and a basis reduction under *IRC Section 1017* is required, the amount is applied to reduce the basis of property held by the taxpayer at the beginning of the tax year following the tax year in which the discharge of indebtedness occurs. n184 Final regulations detail the manner of making the reductions. n185

[b] General Basis Reduction Ordering Rules

If the discharge of indebtedness involves a Title 11 bankruptcy case, an insolvency case, or is a discharge of qualified farm indebtedness, the general ordering rules on basis reduction will apply unless the taxpayer has made a *IRC Section 108(b)(5)* election. n186

These rules require a taxpayer to reduce the adjusted basis of the property that secured the discharged indebtedness before reducing the adjusted bases of other property. The adjusted bases of properties must be reduced in the following order: n187

- (1) real property used in the taxpayer's trade or business or held for the production of income that secured the discharged indebtedness immediately before discharge, other than real property that is inventory or held primarily for sale to customers in the ordinary course of business;
- (2) personal property used in the taxpayer's trade or business or held for investment that secured the discharged indebtedness immediately before discharge, other than inventory, accounts receivable and notes receivable;
- (3) remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable and real property held as inventory or primarily for sale to customers in the ordinary course of business;

(4) inventory, accounts receivable, notes receivable and real property held as inventory or primarily for sale to customers in the ordinary course of business;

(5) property not used in a trade or business nor held for investment.

The basis reductions within each of the above categories are made in proportion to the adjusted bases of all properties within each category. n188 The amount of excluded income used to reduce basis does not include any income that has already reduced other tax attributes of the taxpayer or which has been used to reduce the basis of depreciable property pursuant to an *IRC Section 108(b)(5)* election. n189

[c] Ordering Rules for Basis Reductions Relating to Discharges Qualified Real Property Business Indebtedness or When *IRC Section 108(b)(5)* Election is Made

The general basis reduction ordering rules n190 are modified when the reduction is made under *IRC Section 108(c)(1)* (i.e., when there has been a discharge of qualified real property business indebtedness for a taxpayer other than a C corporation) or when the taxpayer has made an election under *IRC Section 108(b)(5)* to apply the reduction of tax attributes first against depreciable property. In either of these situations, the basis reduction is applied only to reduce the basis of the taxpayer's depreciable property in the various ordering categories. n192

If basis reductions made to depreciable property under a *IRC Section 108(b)(5)* election are less than the amount of excluded income, the remaining amounts must be applied to reduce tax attributes following the general ordering rules. n193

Basis reductions made under *IRC Section 108(c)(1)* can be applied only to depreciable real property. n194 In addition, the taxpayer must first reduce the adjusted basis of the qualifying real property to the extent of the discharged qualified real property business indebtedness before reducing the adjusted bases of other depreciable real property. n195

For these basis reduction purposes, "depreciable property" includes any property that is subject to depreciation, but only if a basis reduction will reduce the amount of depreciation or amortization that otherwise would be allowable for the period immediately following the reduction. n196

When an election has been made under *IRC Section 108(b)(5)*, and for basis reductions relating to qualified farm indebtedness, a taxpayer may also elect to treat any real property that is inventory as depreciable property. n197 This election is not available for basis reductions with respect to discharged qualified real property business indebtedness. n198 The election is made on Form 982, and the form must be attached to a timely-filed (including extensions) federal income tax return for the tax year in which the taxpayer has discharge of indebtedness income that is excluded from gross income under *IRC Section 108*. Once made, the election can be revoked only with the consent of the Commissioner. n199 If an election is not timely filed, a taxpayer may nevertheless request Commissioner's consent to file a late election under Treasury Regulation Section 301.9100.

[d] Limitation in Title 11 Bankruptcy or Insolvency Cases

In the case of a Title 11 bankruptcy or the taxpayer's insolvency, basis reductions are limited to: (1) the excess of the aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge; over (2) the aggregate of the liabilities of the taxpayer immediately after the discharge. n200 This limitation does not apply to reductions in basis to depreciable property by reason of an election under *IRC Section 108(b)(5)*. n201

[e] Special Rules for Qualified Farm Indebtedness

Any basis reductions attributable to qualified farm indebtedness n202 may be applied only to reduce the basis of "qualified property" held by the taxpayer. Furthermore, they must be applied to reduce the basis of that property in the following order: n203

- (1) first, the basis of depreciable property;
- (2) second, the basis of land that is used or held for use in a farming trade or business; and
- (3) third, the basis of other qualified property.

"Qualified property" is any property used or held for use in a trade or business or for the production of income. n204 Partnership interests, affiliated corporation stock, and real property that is inventory may also be "qualified property." n205

[f] Partnership Interests as Depreciable Property

For purpose of the basis reduction rules, any interest of a partner in a partnership is treated as depreciable property to the extent of the partner's interest in the depreciable property held by the partnership. This characterization applies, however, only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to that partner. n206

A partner may (but does not have to) request the partnership to reduce that partner's share of the inside basis of the partnership's depreciable property (or depreciable real property) with respect to that partner; doing so will permit that partner to treat the partnership interest as depreciable property (or depreciable real property). The partnership may grant or deny the request, in its sole discretion. n207

To prevent avoidance of the general ordering rules through the use of partnerships, however, a partner must request the above consent in either of the following circumstances: n208

- the partner owns more than 50 percent of the capital and profits interest of the partnership; or
- reductions to the basis of the partner's depreciable property (or depreciable real property) are being made with respect to the partner's distributive share of cancellation of indebtedness income of the partnership.

A partnership must grant its consent to reduce its partners' shares of the partnership's depreciable basis in depreciable property (or depreciable real property) if consent is requested with respect to that indebtedness by either of the following: n209

- partners owning an aggregate of more than 80 percent of the capital and profits interests of the partnership; or
- five or fewer partners owning an aggregate of more than 50 percent of the capital and profits interest of the partnership.

A partner making the request must do so before the due date (including extensions) of the partner's federal income tax return for the tax year in which the partner as cancellation of indebtedness income that is excluded from gross income under *IRC Section 108(a)*. n210

A partnership that consents to a basis reduction must file a consent statement containing specified information with its

partnership information return for the tax year following the year that ends with or within the tax year the partner excludes cancellation of indebtedness income from gross income under *IRC Section 108(a)*. The partnership must also provide a copy of that statement to the affected partner before the due date (including extensions) of the partner's return for the tax year in which the partner excludes cancellation of indebtedness income from gross income under *IRC Section 108(a)*. n211

[g] Affiliated Group Stock as Depreciable Property

For purposes of the *IRC Section 1017* basis reduction rules, a corporation that holds stock of a subsidiary must treat that stock as depreciable property to the extent that the subsidiary consents to a corresponding reduction in the basis of its depreciable property. This rule applies only if both corporations are members of the same affiliated group, and if the group files a consolidated return for the tax year in which the discharge occurs. n212

FOOTNOTES:

(n1)Footnote 112. *IRC § 61(a)(12)*. See Ltr Rul 9245023 for IRS rulings on various transactions involving mortgage-encumbered real property in which a Title 11 bankruptcy petitioner had an interest. See also *Salva v Commr*, *TC Memo 1993-90*, 65 *TCM 2080 (1993)* .

(n2)Footnote 113. *IRC § 108(a)(1)*.

(n3)Footnote 114. See *Babin v Commr*, *TC Memo 1992-673*, 64 *TCM 1357 (1992)* , *affd 23 F3d 1032 (10th Cir 1994)* , *cert denied Oct 31, 1994*.

(n4)Footnote 115. See *IRC § 108(a)(1)(E)*, *108(h)*. See § 12.10[4], below, for a discussion.

(n5)Footnote 116. *IRC § 108(a)(2)(A)*.

(n6)Footnote 117. *IRC § 108(a)(2)(B)*.

(n7)Footnote 118. *IRC § 108(a)(2)(C)*.

(n8)Footnote 119. *IRC § 108(a)(1)(B)*.

(n9)Footnote 120. *IRC § 108(a)(3)*.

(n10)Footnote 121. *IRC § 108(d)(3)*.

(n11)Footnote 122. *Ltr Rul 199932013* ; *FSAI 199932019* ; see *Cole v Commissioner*, 42 *BTA 1110 (1940)* , *nonacq 1941-1 CB 13* ; *Marcus Estate v Commissioner*, *TC Memo 1975-9* ; *Babin v Commissioner*, *TC Memo 1992-673* , *affd 23 F3d 1032 (10th Cir 1994)* , *cert denied 10/31/94*; *Hunt v Commissioner*, *TC Memo 1989-335* .

(n12)Footnote 123. *Rev Rul 92-53*, 1992-2 *CB 48* ; this ruling is discussed in Lipton, "IRS Adopts Inconsistent Positions on Nonrecourse Debt in Loan Workout," 77 *J Tax'n* 196 (1992).

(n13)Footnote 124. *IRC § 108(d)(6)*.

(n14)Footnote 125. *Gracia v Commr*, *TC Memo 2004-147* .

(n15)Footnote 126. *IRC § 108(a)(1)(C)*, (g).

(n16)Footnote 127. *IRC § 108(g)(3)(A)*.

(n17)Footnote 128. See *IRC § 108(b)(2)(A)*, (B), (C), (D), (F), (G).

- (n18)Footnote 129. See *IRC § 108(b)(2)(A), (B), (C), (D), (F), (G)*.
- (n19)Footnote 130. *IRC § 108(g)(3)(B)*.
- (n20)Footnote 131. *IRC § 108(g)(3)(C)*.
- (n21)Footnote 132. *IRC § 108(g)(1)(A)*.
- (n22)Footnote 133. *IRC §§ 49(a)(1)(D)(iv), 108(g)(2)(B)*.
- (n23)Footnote 134. *IRC § 108(g)(2)(B)*.
- (n24)Footnote 135. *IRC § 108(g)(2)*.
- (n25)Footnote 136. *IRC § 108(a)(1)(D), (c)(3)(C)*.
- (n26)Footnote 137. *Treas Reg § 1.108-5(b)*.
- (n27)Footnote 138. *IRC § 108(c)(3)*.
- (n28)Footnote 138.1. *Ltr Rul 200953005* .
- (n29)Footnote 139. *TAM 200014007* .
- (n30)Footnote 140. *IRC § 108(c)(4)*.
- (n31)Footnote 141. *IRC § 108(c)(3)*.
- (n32)Footnote 142. *IRC § 108(c)(2)(B)*.
- (n33)Footnote 143. *IRC § 108(c)(1)(B)*.
- (n34)Footnote 144. *IRC § 108(c)(2)(A); Treas Reg § 1.108-6(a)*.
- (n35)Footnote 144.1. *IRC § 108(c)(2)(A)*.
- (n36)Footnote 144.2. See *IRC § 108(c)(2)(A)*; see *Ltr Rul 200953005* .
- (n37)Footnote 145. *Treas Reg § 1.108-6(a)*.
- (n38)Footnote 146. *IRC § 108(d)(6)*.
- (n39)Footnote 147. *IRC § 108(d)(7)*.
- (n40)Footnote 148. *IRC §§ 108, 703 and 1017*.
- (n41)Footnote 149. *IRC § 108(a)(1)(E), (h)*.
- (n42)Footnote 150. *IRC § 108(a)(1)(E)*. Pub Law No 110-142, § 2(d).
- (n43)Footnote 151. *IRC § 108(h)(2)*.
- (n44)Footnote 152. *IRC § 108(h)(5)*.
- (n45)Footnote 153. *IRC §§ 108(h)(2), 163(h)(3)(B)*.

(n46)Footnote 154. See *IRC § 163(h)(3)(B)(ii)*.

(n47)Footnote 155. See *IRC § 163(h)(3)(B)(ii)*.

(n48)Footnote 156. *IRC § 108(a)(1)(E), (h)(2)*.

(n49)Footnote 157. *IRC § 108(h)(4)*.

(n50)Footnote 158. See *IRC § 108(h)(4)*.

(n51)Footnote 159. *IRC § 108(h)(1)*.

(n52)Footnote 160. *IRC § 108(a)(2)(A)*.

(n53)Footnote 161. *IRC § 108(a)(2)(C)*.

(n54)Footnote 162. *IRC § 108(h)(3)*.

(n55)Footnote 163. *IRC § 108(e)(5)*. This provision is discussed in Weindruch and Brown, "Scope of Purchase Price Exception to COD Income Questioned in New Ruling," 74 *J Tax'n* 302 (1991).

(n56)Footnote 164. See Rev Proc 92-92, 1992-2 *CB* 505 (applying *IRC § 108(e)(5)* to an insolvent or bankrupt partnership).

(n57)Footnote 165. *IRC § 108(b)(1)*.

(n58)Footnote 166. See *IRC § 108(b)(5)*.

(n59)Footnote 167. *IRC § 108(b)(2)*.

(n60)Footnote 168. *IRC § 108(b)(5)*.

(n61)Footnote 169. *Id.*

(n62)Footnote 170. *Treas Reg § 1.108-4(b)*.

(n63)Footnote 171. See *IRC § 108(b)(5)*.

(n64)Footnote 172. *IRC § 108(b)(5)*.

(n65)Footnote 173. *IRC § 108(c)(5)(C)*.

(n66)Footnote 174. See *IRC § 108(b)(2)*.

(n67)Footnote 175. See *IRC § 108(b)(2), (5)*.

(n68)Footnote 176. See *IRC § 108(a)(1)(D)*.

(n69)Footnote 177. *IRC § 108(c)(1); Treas Reg § 1.1017-1(c)*.

(n70)Footnote 178. *IRC § 1017(a), (b)(3)(F)*.

(n71)Footnote 179. See *IRC § 108(b)(1), (c)*.

(n72)Footnote 180. See *IRC § 108(a)(1)(E)*.

- (n73)Footnote 181. *IRC § 108(h)(1)*.
- (n74)Footnote 182. See *IRC § 108(b)(1), (h)*.
- (n75)Footnote 183. *IRC § 1017(a)(2)*; see *IRC § 108(b)(2)(E), (b)(5), (c)(1)*.
- (n76)Footnote 184. *IRC § 1017(a)*.
- (n77)Footnote 185. *Treas Reg § 1.1017-1*.
- (n78)Footnote 186. *Treas Reg § 1.1017-1(a)*.
- (n79)Footnote 187. *Treas Reg § 1.1017-1(a)*.
- (n80)Footnote 188. *Treas Reg § 1.1017-1(a)*.
- (n81)Footnote 189. *Treas Reg § 1.1017-1(b)(1)*.
- (n82)Footnote 190. See *Treas Reg § 1.1017-1(a)*; see [b], above.
- (n83)Footnote 192. *IRC § 1017(b)(3)(A)*; *Treas Reg § 1.1017-1(c)(1)*.
- (n84)Footnote 193. *Treas Reg § 1.1017-1(c)(2)*; see *IRC § 108(b)(2)*, discussed in § 12.10[6][a], above.
- (n85)Footnote 194. *IRC § 1017(b)(3)(A), (F)(i)*.
- (n86)Footnote 195. *Treas Reg § 1.1017-1(c)(1)*.
- (n87)Footnote 196. *IRC § 1017(b)(3)(B)*; *Treas Reg § 1.1017-1(e)*.
- (n88)Footnote 197. *IRC § 1017(b)(3)(E)(1)*; *Treas Reg § 1.1017-1(f)(1)*.
- (n89)Footnote 198. *IRC § 1017(b)(3)(F)(ii)*; *Treas Reg § 1.1017-1(f)(1)*.
- (n90)Footnote 199. *IRC § 1017(b)(3)(E)(ii)*; *Treas Reg § 1.1017-1(f)(2)*.
- (n91)Footnote 200. *IRC § 1017(b)(2)*; *Treas Reg § 1.1017-1(b)(3)*.
- (n92)Footnote 201. *IRC § 1017(b)(2)*.
- (n93)Footnote 202. See *IRC § 1017(a)(1)(C)*.
- (n94)Footnote 203. *IRC § 1017(b)(4)(A)*.
- (n95)Footnote 204. *IRC §§ 108(g)(3)(C), 1017(b)(4)(B)*.
- (n96)Footnote 205. *IRC § 1017(b)(4)(C)*.
- (n97)Footnote 206. *IRC § 1017(b)(3)(C)*.
- (n98)Footnote 207. *Treas Reg § 1.1017-1(g)(2)(ii)(A)*.
- (n99)Footnote 208. *Treas Reg § 1.1017-1(g)(2)(ii)(B)*.
- (n100)Footnote 209. *Treas Reg § 1.1017-1(g)(2)(ii)(C)*.

(n101)Footnote 210. *Treas Reg § 1.1017-1(g)(2)(ii)(A)*.

(n102)Footnote 211. *Treas Reg § 1.1017-1(g)(2)(iii)(A)*.

(n103)Footnote 212. *IRC § 1017(b)(3)(D)*.



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CHAPTER 12 Mortgages in Real Estate Transactions

1-12 Federal Taxes Affecting Real Estate § 12.11

§ 12.11 Reporting Mortgage Interest Received

[1] General Rules

Any person who, in the course of a trade or business, receives interest from an individual in excess of \$600 per year on any mortgage must report it to the IRS. n213 For this purpose, a mortgage is "any obligation secured by real property." n214 The lender reports the interest on IRS Form 1098 (Mortgage Interest Statement). n215

This requirement is applied to each mortgage obligation, and not to the particular payor. For example, if interest is received on two different mortgages from the same payor, the recipient does not have to report the interest from each obligation if the interest on each individual obligation does not exceed \$600, even though the total interest from both obligations may exceed \$600. Moreover, only interest received from individuals must be reported, not interest received from trusts, estates, partnerships, or corporations. n216

The Secretary is also authorized to prescribe return filing requirements for businesses that receive mortgage insurance premiums of at least \$600 in a calendar year from any individual. A return may be required for each such individual. n217 Any person required to file a return must also furnish to each individual with respect to whom a return is made a written statement showing information as the Secretary may prescribe. That statement must be furnished on or before January 31 of the year following the calendar year for which the return was required to be made. n218

[2] Treatment of Points

For information reporting purposes, points are treated as interest. Thus, when "regular" interest plus points come to \$600 or more, income reporting is required. n219 For this purpose, "points" are an amount that:

- (1) is clearly designated on the Uniform Settlement Statement prescribed under the Real Estate Settlement Procedures Act of 1974 n220 as points incurred in connection with the indebtedness, for example as loan origination fees, n221 loan discount, discount points, or points;
- (2) is computed as a percentage of the indebtedness' stated principal amount incurred by the payor of record;
- (3) conforms to an established practice of charging points in the area in which the loan is issued and does

not exceed the amount generally charged in the area;

(4) is paid in connection with the acquisition by the payor of record of his principal residence and that secures the loan. For this purpose, the lender of record may rely on the payer's signed written statement stating whether the loan proceeds are for the purchase of his principal residence; and

(5) is paid directly by the payor of record. n222

The regulations n223 indicate that for information reporting purposes, the term "points" does not include points:

- Paid on indebtedness incurred to *improve* a principal residence; n224
- Paid on indebtedness incurred to purchase or improve a second home, vacation property, investment property, or trade or business property;
- Paid on a home equity loan;
- Paid in connection with a refinancing loan (except for certain construction loans);
- Paid instead of amounts that are usually separately stated on Form HUD-1, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes; or
- Paid in connection with the acquisition of a principal residence, to the extent that the amount is allocable to indebtedness exceeding the total amount that is treated as acquisition indebtedness under Section 163(h)(3)(B)(ii).
- The purchaser of a principal residence can deduct points that the seller pays on his behalf (i.e., seller-paid points). n225 Thus, the regulations require information reporting for these points, which are treated as paid by the seller to the payor of record and then paid directly by the payor of record to the lender. n226

[3] Information Reporting for Refunds of Interest Erroneously Collected

In the early 1990's, several lenders acknowledged that they had overcharged interest on some of their adjustable rate mortgages. This motivated the Service to adopt a policy concerning information reporting when the lender refunds this excess interest. n227

Generally, the lender must report the amount of the refund on Form 1098, if (1) the refund is \$600 or more; or (2) the refund is less than \$600, but the lender receives \$600 or more of interest on the mortgage in the refund year. n228 The lender does not have to indicate the year the refund relates to. n229

FOOTNOTES:

(n1)Footnote 213. *IRC § 6050H(a)*.

(n2)Footnote 214. *IRC § 6050H(e)*.

(n3)Footnote 215. But see *West v Commr, TC Memo 1991-18, 61 TCM 1694 (1991)* (because late payment charges on a home mortgage are not interest, the borrower cannot deduct them and they, therefore, are not reportable on Form 1098).

(n4)Footnote 216. *IRC § 6050H(a)(2)*.

(n5)Footnote 217. *IRC § 6050H(h)(1)*.

(n6)Footnote 218. *IRC § 6050H(h)(2)*.

(n7)Footnote 219. *Treas Reg § 1.6050H-1(e)(1)*. The rules discussed here apply to points received after 1994. For prior-law rules, see *Notice 90-70, 1990-2 CB 351* .

(n8)Footnote 220. *12 USC P 2601 et seq*. The Form HUD-1 is an example of the Uniform Settlement Statement.

(n9)Footnote 221. This includes amounts designated as loan origination fees on Veterans Affairs (VA) and Federal Housing Administration (FHA) loans.

(n10)Footnote 222. *Treas Reg § 1.6050H-1(f)(1)*.

(n11)Footnote 223. *Treas Reg § 1.6050H-1(f)(1)*.

(n12)Footnote 224. The rationale for excluding these points is that lenders would generally find it difficult to determine whether the taxpayer actually uses the loan funds to improve his residence.

(n13)Footnote 225. *IRC § 461(g)(2)* and *Rev Proc 94-27, 1994-1 CB 613* .

(n14)Footnote 226. *Treas Reg § 1.6050H-1(f)(3)(i)(B)*.

(n15)Footnote 227. The borrower's tax treatment of the refund is discussed at § 12.06[1][b], above.

(n16)Footnote 228. *Treas Reg § 1.6050H-2(a)(2)(iv)*.

(n17)Footnote 229. *Treas Reg § 1.6050H-2(a)(3)*. Note that the lender may also have to file a Form 1099-INT for the borrower if the lender pays interest on the amount it refunds.



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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate 13.syn

§ 13.syn Synopsis to Chapter 13: Limitations on Losses From Real Estate *

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- [2] Passive Activity Losses and Credits under the Alternative Minimum Tax
- [3] Coordination of Passive Activity Limitations with Other Statutory Limitations
 - [a] Interaction of *IRC Section 469* With Other Code Provisions
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 - [c] At-Risk Limitations
 - [d] Capital Loss Limitations
 - [e] Limitation on Investment Interest
 - [f] Qualified Residence Interest Deduction Limitations
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 - [h] Corporate Interest Deductions on Excess Indebtedness
 - [i] Casualty Loss Deductions
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[1] Subchapter J (*IRC Sections 641-692*)

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[2] Closely Held C Corporations Are Subject to Passive Activity Limitations

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- [a] In General

- [b] Lessee Cannot Monetize Its Lease Obligations

- [c] Requirement of Substantial Equity Investment in Leased Property

- [d] Tax-Exempt Lessee Can Bear No More than Minimal Risk of Loss

- [e] Restriction on Tax-Exempt Lessee's Purchase Option Price

- [f] Coordination with Like-Kind Exchange and Involuntary Conversion Rules

[g] Other Rules



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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.01

§ 13.01 Overview of Passive Activity Limitations

[1] Excess Passive Deductions and Credits Cannot Be Used to Offset Non-Passive Income

Losses and certain tax credits n1 arising from passive activities are subject to the passive activity limitations. n2 The purpose of the passive activity limitations is to prevent certain taxpayers from artificially reducing taxable income or tax liability. Under the passive activity loss limitations, deductions from a passive activity may not be claimed in excess of the income from that activity for the taxable year. n3 Income and loss within each passive activity can be netted, but any aggregate net loss from passive activities cannot be used to offset net income from other sources. n4

Under passive activity credit limitations, specified credits arising from a passive activity may not be taken in excess of the regular tax liability attributable to that activity for the taxable year. n5 Furthermore, tax credits arising from passive activities can be used only to reduce the regular tax (not alternative minimum tax) attributable to passive activity income. n6

Note:

The passive activity limitations were initially enacted to prevent individuals and certain corporations from using tax shelters to reduce their tax liabilities, but they go far beyond any traditional tax shelter limitation. When they apply, the passive activity limits not only deny deductions for noncash items such as depreciation and accrued expenses, but also limit deductions for out-of-pocket cash expenses. Thus, they prevent recognition real cash losses, and not just "paper" losses. n7

Disallowed passive losses and credits may be carried forward indefinitely to later years, n8 and are allowed in their entirety in the year the taxpayer disposes of the interest in the passive activity. n9 The passive activity limitations are not applied to a passive activity unless current and carried-over passive deductions exceed current income (that is, there would be a cumulative net loss), or currently available and carried-over passive credits exceed current tax liability from that activity. n10

Note:

Notwithstanding their conceptual simplicity, the implementation of the passive activity rules is highly subjective and quite complex. The record keeping required to track disallowed losses and credits, and the

relationship of the passive activity provisions to other tax provisions create a mechanical complexity that may be impossible for many taxpayers to manage. Finally, the adjustments to the regular tax limitations necessary to determine alternative minimum tax liability create an overlay of difficult calculations. n11

[2] Passive Activity Losses and Credits under the Alternative Minimum Tax

The passive activity limitations, with certain adjustments, also apply to the calculation of alternative minimum tax (AMT). Therefore, passive activity losses and credits are disallowed for AMT purposes. n12 The usual AMT adjustments and items of tax preference n13 apply in computing the passive losses and credits for AMT purposes. n14

Note:

The difference in the tax treatment of particular items for regular tax and AMT purposes (such as depreciation n15) can result in different passive activity losses or credits for each in a given year. There may even be a passive gain for AMT purposes and a passive loss for regular tax purposes, or a passive loss for AMT purposes and a passive gain for regular tax purposes. n16 As a result, suspended losses and credits that are carried over to later years may differ for regular tax and AMT purposes. It is imperative to track carried forward items separately for both AMT and regular tax purposes. n17

A special rule applies for insolvent taxpayers subject to the AMT. Any AMT passive activity losses are reduced by the amount (if any) by which the taxpayer is insolvent as of the close of the year. n18 For this purpose, the term "insolvent" refers to the excess of liabilities over the fair market value of assets. n19

Two other differences for the passive activity limitations should be noted for the AMT. First, for AMT purposes, a taxpayer's passive activity loss is computed without regard to "qualified housing interest." n20 For regular tax purposes, in contrast, a taxpayer's passive activity loss is computed without regard to "qualified residence interest." n21 While similar, the definition of these terms differs slightly, and this can cause the amount of interest deductible under each to be different. This difference, in turn, can affect the amount of the passive activity loss. The main difference is that interest paid for certain mobile homes used on a transient basis and for boats may be deductible for regular tax purposes as qualified residence interest, but cannot qualify as "qualified housing interest" for AMT purposes. n22 The amount of interest deductible for AMT and regular tax purposes may also differ as a result of grandfather provisions in 1986 legislation regarding pre-July 30, 1982 loans. n23

A final difference, now only of historical interest, deals with transition rules related to 1986 legislation. For AMT purposes, the passive activity limitations became fully effective for years beginning after 1986; the phase-in rules of the passive activity limitations in 1986-1990 for regular tax purposes did not apply. n24

[3] Coordination of Passive Activity Limitations with Other Statutory Limitations

[a] Interaction of IRC Section 469 With Other Code Provisions

IRC Section 469, dealing with passive activity losses, is only one of several provisions that limit losses and deductions. Even if a taxpayer has sufficient passive income to offset the losses, or has disposed of an entire interest in an activity so as to trigger the losses under *IRC Section 469(g)*, other Code section limitations must be considered. An understanding of the interaction among different statutory provisions and the timing of their application is necessary in order to properly apply the passive activity provisions.

[b] Basis Rules

Passive activity losses are subject to basis rules before application of the passive loss rules. n25 A taxpayer must have adequate basis in order to support any distributive loss from an entity n26 or a loss from a disposition. n27

These basis requirements often arise in partnerships and S corporations. A partner's distributive share of partnership loss cannot exceed the partner's adjusted basis in the partner's interest in the partnership at the end of the partnership year in which the loss occurs. n28 Similarly, a partner's loss on a sale or exchange of a partnership interest cannot exceed his or her adjusted basis of the partnership interest. n29

An S corporation shareholder's distributive loss cannot exceed the shareholder's basis in stock and loans to the corporation. n30 Loans in the corporate name but guaranteed by the shareholder are not basis until the taxpayer must actually pay the amounts. n31

Even passive losses that are triggered by a disposition of a taxpayer's entire interest in a passive activity, n32 are subject to basis requirements, and a taxpayer must have a basis in the activity order to claim a loss. If the taxpayer has inadequate basis, losses are not deductible under any circumstances, and the passive loss limitations do not come into play. n33

[c] At-Risk Limitations

Passive activity losses are subject to the at-risk limitations n34 before application of the passive activity limitations. n35 If a taxpayer does not have sufficient amounts at risk with respect to an activity, losses from that activity are not deductible under any circumstance. n36 If a loss is disallowed under the at-risk limitation with respect to an activity, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. n37

Taxpayers are at-risk for amounts they contributed to a passive activity. n38 They are also at risk with respect to borrowed amounts used in a passive activity if they are personally liable for repayment of those amounts or if they pledge property (other than property used in the activity) as security for the loan. n39 See Part II of this chapter for a discussion of the at-risk limitations.

[d] Capital Loss Limitations

Capital losses that are otherwise allowable under the passive activity limitations may be limited under *IRC Section 1211*. n40 *IRC Section 1211* is applied after the passive activity loss rules. n41 That provision limits corporate losses from sales and exchanges of capital assets to the extent of gains from those sales and exchanges during the year. n42 It also limits annual losses from sales or exchanges of capital assets from other taxpayers to the extent of capital gains, plus up to \$3,000 (or \$1,500 for married individuals who file a separate return). n43

Example (1):

Paul derives \$10,000 of ordinary income from a catering business, which for Paul is a passive activity. In the same year, he has \$12,000 in capital losses from an investment in an apartment building, which is a separate passive activity. He has no other income, gain, deductions or losses from any other passive activities, and no gains from the sale or exchange of capital assets or assets used in a trade or business. Paul's capital loss from the apartment passive activity is a passive activity deduction. Under the passive activity loss rules, Paul may deduct only \$10,000 of the \$12,000 passive activity deduction, and has a passive activity loss of \$2,000 for the tax year. n44 Because the \$10,000 passive activity deduction allowed under *IRC Section 469* is a capital loss, however, Paul may deduct the loss only to the extent provided by *IRC Section 1211*. Therefore, Paul is allowed only \$3,000 of the \$10,000 passive loss, and has a \$7,000 capital loss carryover to the next taxable year. n45

Example (2):

Ed's only income and loss from passive activities for the year are a \$10,000 capital gain from an investment in an apartment building (a passive activity) and a \$12,000 ordinary loss from a restaurant business (a separate passive activity). Ed also has a \$7,000 capital loss for the year from the sale of

stocks held in his investment portfolio. The capital loss from the sale of stocks is not derived from a passive activity. The only effect of the passive loss rules is that Ed cannot deduct the \$2,000 (\$12,000-\$10,000) passive activity loss for the year, but must carry the loss over to the succeeding taxable year. Ed may deduct his \$7,000 capital loss from his sale of stocks in full because the \$10,000 capital gain from the apartment building investment may be used to offset the loss on the sale of stocks. This rule applies even though the capital gain occurs in a passive activity. n46

[e] Limitation on Investment Interest

Noncorporate taxpayers who borrow money for investment can deduct interest on a loan only up to the amount of net investment income. n47 Disallowed interest deductions may be carried forward to the succeeding taxable year. n48

"Investment interest," however, does not include any interest expense from a passive activity. n49 As a result, interest expense related to passive activities from a limited partnership, rental real estate, and any other activity in which the taxpayer does not materially participate are not taken into account in applying the statutory limitation on investment interest. n50 Investment income for purposes of the *IRC Section 163(d)* limitation generally does not include passive income. n51

[f] Qualified Residence Interest Deduction Limitations

Passive activity losses are computed without regard to qualified residence interest. n52 A "qualified residence" is either a principal residence or a second residence chosen by the taxpayer. n53 Deductions for qualified residence interest are subject to detailed restrictions, including a \$1 million maximum acquisition indebtedness limitation and a \$100,000 limit for home equity loans. n54 Note that qualified residence interest deductions can only be taken as an itemized deduction; therefore, taxpayers who claim a standard deduction cannot claim the deduction. n55 See Chapter 9 for a detailed discussion of qualified residence interest.

[g] Rental of Taxpayer's Personal Residence

The rental of a dwelling unit that the taxpayer uses as a residence during the year is not a passive activity, and gains and losses from that rental are not taken into account in determining passive activity gains and losses. n56 For a dwelling to qualify as the taxpayer's "residence" for this purpose, the taxpayer must personally use the residence for more than the greater of 14 days or 10 percent of the number of days during the year that the home was rented for fair market value. n57

Although losses from these rentals are not subject to the passive activity limitations, *IRC Section 280A* applies to limit losses from the rental to net income reported. Disallowed amounts may be carried forward to the succeeding taxable year. n58 See Chapter 9 for a discussion of *IRC Section 280A*.

[h] Corporate Interest Deductions on Excess Indebtedness

Corporations are subject to *IRC Section 163(j)*, which limits deductions for excess interest paid on certain corporate indebtedness. *IRC Section 163(j)* comes into play before the passive activity limitations. A deduction or loss that is allowable is still subject to the passive loss limitations. n59

[i] Casualty Loss Deductions

A deduction from a casualty loss (losses from fire, storm, shipwreck, theft, or other casualty) is generally not a passive activity deduction. n60 Casualty loss deductions are governed by limitations in *IRC Section 165*. Subject to the limits of that provision, a casualty loss deduction is allowed in the year sustained (or in a prior year, if an appropriate election is made). n61

There is an exception. Casualty losses that are similar in cause and severity, and which occur regularly in the conduct of a passive activity are subject to the passive activity loss limitations. n62 For example, a loss resulting from a natural disaster is not limited by the passive activity loss rules. On the other hand, shoplifting losses at a retail store or accident losses sustained by an automobile rental activity--if those activities were passive for the taxpayer--would be passive because they occur regularly in the conduct of those activities. n63

There are special rules for insurance reimbursements. If the casualty loss was not a passive activity deduction, n64 any insurance reimbursement received in a subsequent year (and includible in income in that year), n65 will be considered non-passive. In contrast, if the casualty loss did not meet the exception to the passive loss rules, and was a passive activity deduction, any gross income from insurance reimbursements would be passive income in the year the reimbursement is received. n66

[j] Net Operating Loss Deduction

A regular net operating loss (NOL) generally can be carried back 2 years and forward 20 years. n67 Most taxpayers n67.1 may elect a 3-, 4-, or 5-year carryback for NOLs incurred in 2008 or 2009 (but not both). n67.2 For elections made after November 5, 2009, any loss carryback to the 5th taxable year preceding the taxable year of the loss cannot exceed 50 percent of the taxpayer's taxable income for that preceding taxable year. n67.3

Passive losses that are allowed in excess of passive income due to the special \$25,000 rental real estate allowance n68 or due to a disposition of the taxpayer's entire interest in a passive activity n69 can become part of the taxpayer's NOL for the year. As part of the taxpayer's NOL, those losses can then be carried back and forward under *IRC Section 172*, without regard to the passive activity loss restrictions.

A loss from a passive activity which cannot be used due to the passive activity loss limitations cannot be part of a taxpayer's NOL, and therefore cannot be carried back to a prior year. Rather, it must be carried forward indefinitely until there is passive income or a full disposition of the passive activity in a fully taxable transaction. n70 In the event that both a regular NOL and a suspended loss from a passive activity are carried forward into the same succeeding year, the IRS takes the position that the passive activity carryforward must be applied first against passive income before the regular NOL is applied.

[k] Limitation on Percentage Depletion Deductions for Oil and Gas Wells

Percentage depletion deductions for oil and gas wells that are allowable under the passive loss rules may be limited under a separate statutory provision. n71 The percentage depletion restrictions are applied after the passive activity loss rules. n72 Under *IRC Section 613A(d)*, the percentage depletion deduction cannot exceed 65 percent of the taxpayer's taxable income for the year, as determined under that section.

[l] Subchapter J (*IRC Sections 641-692*)

The interaction between *IRC Section 469* and Subchapter J of the Code, which deals with taxation of estates, trusts, beneficiaries, and decedents, n73 is unclear. There are no regulations or other IRS guidance explaining how the passive activity rules interact with the Subchapter J provisions. n74

For trusts (other than grantor trusts), the IRS takes the position that material participation must be determined by looking to the activities performed by the trustee or fiduciary in that capacity. n75 The only court addressing this issue, however, has n76 rejected this position and has held that the proper focus is on the activities of the entire trust, taking into account all activities of the trust fiduciaries, agents, and trustees. For estates, the IRS also takes the position that material participation by the executor or administrator determines the character of the income and deductions of the

estate for purposes of computing the estate's taxable income. n77 The application of other aspects of *IRC Section 469* within the context of Subchapter J is not clarified by any authoritative guidance, other than a rather obvious private IRS position that for grantor trusts, losses and credits attributable to the trust assets are subject to the passive activity loss and credit limitations on the individual level of the person treated as the owner, rather than to the trust itself. n78

FOOTNOTES:

(n1)Footnote 1. See *IRC §§ 27-30D, 38-45Q*.

(n2)Footnote 2. *IRC § 469(d)(1), (2)(A)*.

(n3)Footnote 3. *IRC § 469(a)(1)*.

(n4)Footnote 4. *IRC § 469(d)(1)*.

(n5)Footnote 5. *IRC § 469(a)(1)*.

(n6)Footnote 6. *IRC § 469(d)(2)*.

(n7)Footnote 7. See *IRC § 469(a)(1), (d)*.

(n8)Footnote 8. *IRC § 469(b)*; see §§ 13.08[4] and 13.09[3], *below*, for a discussion.

(n9)Footnote 9. *IRC § 469(g)*; see § 13.10[1], *below*, for a discussion.

(n10)Footnote 10. See *IRC § 469(a)(1)*.

(n11)Footnote 11. See *IRC §§ 58(b), 469*; see [2], *below*, for a discussion of the application of the passive activity limitations to the alternative minimum tax.

(n12)Footnote 12. *IRC § 58(b)*.

(n13)Footnote 13. See *IRC §§ 56, 57*.

(n14)Footnote 14. *IRC § 58(b)(1)*.

(n15)Footnote 15. See *IRC §§ 56(a)(1), 168*.

(n16)Footnote 16. See *IRC §§ 55-59*.

(n17)Footnote 17. See Announcement 88-45, 1988-12 *IRB* 54 ; see *IRC § 469(b)*.

(n18)Footnote 18. *IRC § 58(c)(1)(A)*.

(n19)Footnote 19. *IRC § 58(c)(1)(B)*.

(n20)Footnote 20. *IRC § 58(b)(3)*; see *IRC § 56(e)* (definition of qualified housing interest).

(n21)Footnote 21. *IRC § 469(j)(7)*; see *IRC § 163(h)(3)* (definition of qualified residence interest).

(n22)Footnote 22. See *IRC §§ 56(e), 163(h)(3), (4)*; *Temp Treas Reg § 1.163-10T(p)(3)(ii)*.

(n23)Footnote 23. See *IRC § 56(e)(3)*.

(n24)Footnote 24. *IRC §§ 58(b)(2), 469(m)*.

(n25)Footnote 25. *Temp Treas Reg* § 1.469-2T(d)(6)(i).

(n26)Footnote 26. *IRC* §§ 704(d), 1366(d).

(n27)Footnote 27. See *IRC* §§ 1001(a), 1011.

(n28)Footnote 28. *IRC* § 704(d).

(n29)Footnote 29. *IRC* §§ 743, 1001(a).

(n30)Footnote 30. *IRC* § 1366(d)(1); *Treas Reg* § 1.1366-2(a)(1), (3).

(n31)Footnote 31. *Estate of Leavitt v Commr*, 875 F2d 420 (4th Cir 1989) ; *Uri v Commr*, 949 F2d 371 (10th Cir 1991) ; *Harris v US*, 902 F2d 439 (5th Cir 1990) ; *Brown v Commr*, 706 F2d 755 (6th Cir 1983) ; *Jackson III v Commr*, TC Memo 2001-61 ; *Spencer v Commr*, 110 TC 62 (1998) , *affd in unpub opin per curiam* 194 F3d 1324 (11th Cir 1999) ; *Estate of Bean v Commr*, TC Memo 2000-355 , *affd* 268 F3d 553 (8th Cir 2001); but see *Selfe v US*, 778 F2d 769 (11th Cir 1985) (shareholders who guaranteed a loan to an S corporation could increase their basis where the substance of the transaction was that the shareholder borrowed funds and later made advances to the corporation).

(n32)Footnote 32. See *IRC* § 469(g); see § 13.10[1], below, for a discussion.

(n33)Footnote 33. See *IRC* §§ 1001(a), 1011.

(n34)Footnote 34. See *IRC* § 465.

(n35)Footnote 35. *Temp Treas Reg* § 1.469-2T(d)(6)(i).

(n36)Footnote 36. *IRC* § 465(a).

(n37)Footnote 37. *Temp Treas Reg* § 1.469-2T(d)(6)(iii).

(n38)Footnote 38. *IRC* § 465(b)(1).

(n39)Footnote 39. *IRC* § 465(b)(2).

(n40)Footnote 40. See *Treas Reg* § 1.469-1(d)(2).

(n41)Footnote 41. See *Treas Reg* § 1.469-1(d)(2).

(n42)Footnote 42. *IRC* § 1211(a).

(n43)Footnote 43. *IRC* § 1211(b).

(n44)Footnote 44. *IRC* § 469(a)(1), (d)(1).

(n45)Footnote 45. *IRC* § 1211(b)(1), 1212(b); *Treas Reg* § 1.469-1(d)(2).

(n46)Footnote 46. *IRC* §§ 469(a)(1), 1211(b); *Temp Treas Reg* § 1.469-1T(d)(1).

(n47)Footnote 47. *IRC* § 163(d)(1).

(n48)Footnote 48. *IRC* § 163(d)(2).

(n49)Footnote 49. *IRC* § 163(d)(3)(B)(ii).

(n50)Footnote 50. See *IRC § 163(d)(1)*; interest expense that is properly allocable to portfolio income from a passthrough entity that also conducts a passive activity is deductible as investment interest.

(n51)Footnote 51. *IRC § 163(d)(4)(D)*; see *Treas Reg § 1.469-2(f)(10)* (minor exceptions).

(n52)Footnote 52. *IRC § 469(j)(7)*; see *IRC § 163(h)(3)*.

(n53)Footnote 53. *IRC § 163(h)(4)(A)(I)*.

(n54)Footnote 54. *IRC § 163(h)(3)(B), (C)*.

(n55)Footnote 55. See *IRC § 63(b), (d)*.

(n56)Footnote 56. *IRC § 469(j)(10)*; see *IRC § 280A(c)(5)*.

(n57)Footnote 57. *IRC § 280A(d)(1)*.

(n58)Footnote 58. *IRC § 280A(c)(5)(C)*.

(n59)Footnote 59. See *IRC §§ 163(j), 469*.

(n60)Footnote 60. *Treas Reg § 1.469-2(d)(2)(xi)*.

(n61)Footnote 61. *IRC § 165(a), (c)(3), (i)*.

(n62)Footnote 62. *Treas Reg § 1.469-2(d)(2)(xi)*.

(n63)Footnote 63. See *Treas Reg § 1.469-2(d)(2)(xi)*.

(n64)Footnote 64. See *Treas Reg § 1.469-2(d)(2)(xi)*.

(n65)Footnote 65. See *Treas Reg § 1.165-1(d)(2)(iii)*.

(n66)Footnote 66. *Treas Reg § 1.469-2(c)(7)(vi)*.

(n67)Footnote 67. *IRC § 172(b)(1)(A)*.

(n68)Footnote 67.1. Taxpayers who received federal financial assistance under the federal Troubled Assets Relief Program (TARP program) under 2008 legislation, taxpayers who are members of the same affiliated group as those recipients, and The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation cannot make the election [Pub Law No 111-92, § 13(f)(1), (2), (3)].

(n69)Footnote 67.2. *IRC § 172(b)(1)(H)*. See Rev Proc 2009-52, 2009-49 IRB 744 for details of making the election. The provision allowing most taxpayers to claim a 3-, 4-, or 5-year carryback and extending it to 2009 losses expands an earlier provision--which allowed the carryback election only for 2008 NOLs of eligible small businesses [*IRC § 172(b)(1)(H)*, before amendment by Pub Law No 111-92]. Eligible small businesses that elected before November 6, 2009 to carry back 2008 NOLs under the originally enacted provision may also elect to carry back 2009 NOLs, but no other taxpayers may make the election for both 2008 and 2009 NOLs [*IRC § 172(b)(1)(H)(v)(I)*]. An eligible small business is generally one with \$15 million or less average annual gross receipts for the 3-taxable-year period before the taxable year of the NOL being carried back [*IRC §§ 172(b)(1)(F)(iii), (H)(v)(II), 448(c)*].

(n70)Footnote 67.3. *IRC § 172(b)(1)(H)(iv)(I)*.

(n71)Footnote 68. See *IRC § 469(i)*.

(n72)Footnote 69. See *IRC* § 469(g).

(n73)Footnote 70. *IRC* § 469(b), (g); see § 13.10[1], below, for a discussion.

(n74)Footnote 71. See *IRC* § 613A(d).

(n75)Footnote 72. See *Treas Reg* § 1.469-1(d)(2).

(n76)Footnote 73. See *IRC* §§ 641-692.

(n77)Footnote 74. See Schmolka, "Passive Activity Losses of Trusts and Estates: The Regulations (If I Were King)," *111 Tax Notes* 1367 (June 17, 2006).

(n78)Footnote 75. See S Rep No 313, 99th Cong, 2nd Sess 735, reprinted at 1986-3 *CB* 735 .

(n79)Footnote 76. *Mattie K. Carter Trust v US*, 256 *F Supp* 2d 536 (ND Tex 2003) .

(n80)Footnote 77. See S Rep No 313, 99th Cong, 2nd Sess 735.

(n81)Footnote 78. See FSA 200035006 ; *Temp Treas Reg* § 1.469-1T(b)(2).

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.02

§ 13.02 Taxpayers Subject to the Passive Activity Limitations

[1] Individuals, Estates, Trusts, and Certain Small Corporations Are Subject to the Passive Activity Limitations

Only the following taxpayers are subject to the passive activity limitations: n79

- individuals, estates, and non-grantor trusts (including pooled income funds); n80
- closely held C corporations; n81 and
- personal service corporations. n82

Partnerships, LLCs treated as partnerships, and S corporations are not subject to the passive activity limitations because they are passthrough entities. The passive activity limitations come into play with respect to allocations and distributions from them, however, and apply at the individual partner, LLC member, or S corporation shareholder level. n83

[2] Closely Held C Corporations Are Subject to Passive Activity Limitations

Closely held C corporations are subject to the passive activity limitations. n84 A C corporation is closely held if, at any time during the last half of the taxable year, more than 50 percent in value of its outstanding stock is owned (directly or indirectly) by five or fewer individuals. n85

Note:

Closely held C corporations that are not also personal service corporations n86 are subject to a less restrictive version of the passive activity limitations in that their passive losses and credits can offset active income. n87 A closely held C corporation that is also a personal service corporation will be treated as a personal service corporation for purposes of the passive activity limitations. n88

[3] Personal Service Corporations

[a] Certain Personal Service Corporations Are Subject to Passive Activity Limitations

Personal service corporations are subject to the passive activity limitations. n89 The definition of personal service corporation for purposes of the passive activity limitations modifies the definition of the term as defined in *IRC Section 269A*. A corporation is a personal service corporation under *IRC Section 469* only if the following three conditions are met: n90

- its principal activity is the performance of "personal services";
- those personal services are "substantially" performed by "employee-owners"; n91 and
- "employee-owners," in the aggregate, own more than 10 percent of the stock of the corporation.

"Personal services" include only the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. n92 A corporation's principal activity is the performance of personal services if the cost of compensation for those services during the testing period exceeds 50 percent of the corporation's total compensation cost for that testing period. n93 These services are "substantially" performed by employee-owners if the corporation's compensation cost for personal services performed by employee-owners is more than 20 percent of the corporation's total compensation cost for personal services. n94

NOTE:

Regulations under *IRC Section 469* incorporate the definition of "personal service corporation" that is used in regulations under *IRC Section 441*. n95 Under the *IRC Section 441* regulations, the requirements that the corporation's principal activity be personal services and that those services be substantially performed by employee-owners must be met during the "testing period." The stock ownership requirement for employee-owners must be met on the last day of the "testing period." n96 The "testing period" is generally the immediately preceding taxable year. n97 For a new corporation, the testing period begins on the first day of the corporation's taxable year and ends on the earlier of the last day of that taxable year or the last day of the calendar year in which that taxable year begins. n98

[b] "Employee-Owner" of a Personal Service Corporation for Passive Activity Purposes Includes Any Employee Who Owns Any Stock During the Year

For purposes of the passive activity limitations, the definition of an "employee-owner" is quite broad. An employee who owns any stock on any day during the taxable year is an employee-owner for that year. n99 In contrast, for purposes of *IRC Section 269A*, an employee must own at least 10 percent of the outstanding stock to be an employee-owner. n100

NOTE:

Regulations under *IRC Section 469* incorporate the definition of "personal service corporation" that is used in regulations under *IRC Section 441*. n101 Under the *IRC Section 441* regulations, whether an employee is an employee-owner is determined for the "testing period," which is generally the immediately preceding taxable year. n102 A person is an employee-owner for a "testing period" if (1) the person is an employee of the corporation on any day of the testing period, and (2) the person owns any outstanding stock of the corporation on any day of the testing period. These two days need not be the same days. n103 Persons who would otherwise be treated as independent contractors can be treated as employee-owners if they own any stock of the personal service corporation during the testing period. n104

Broad attribution rules apply in determining stock ownership in a personal service corporation for purposes of the passive activity limitations. n105 Generally *IRC Section 318* applies to impose constructive ownership of stock. For

purposes of the passive activity limitations, however, ownership is attributed from a corporation if any of the stock is owned, directly or indirectly, by or for any person. Therefore, if an employee owns any stock in a corporation that also owns stock in another corporation, the employee is treated as owning stock in that other corporation. n106 Employees are also treated as owning the following stock: n106.1

- stock owned by their spouses, children, grandchildren, or parents; and
- stock owned by partnerships in which they are partners or S corporations in which they are shareholders; and
- stock owned by trusts or estates in which they are beneficiaries.

An employee who has an option to acquire stock (or an option to acquire an option) is treated as owning the stock subject to the option. n106.2

[4] Members of Affiliated Groups Filing a Consolidated Return Are Treated as One Corporation for Passive Activity Limitations

For purposes of the passive activity limitations, all members of an affiliated group that files a consolidated return are generally treated as one corporation. n107 This rule applies for purposes of determining whether a consolidated group is a closely held corporation or a personal service corporation for purposes of the passive activity limitations, and in determining whether the consolidated group materially or significantly participates in an activity conducted by member(s) of the group. n108 The following rules also apply in determining status and participation of a consolidated group: n109

- the members of the consolidated group are treated as one corporation;
- only the outstanding stock of the common parent is treated as outstanding stock of the corporation;
- an employee of any member of the group is treated as an employee of the corporation; and
- an activity is treated as the principal activity of the corporation only if it is the principal activity of the consolidated group.

A member of a consolidated group is treated as a closely held corporation or personal service corporation only if the consolidated group is treated as a closely held corporation or personal service corporation. The determination of whether an activity conducted by members of the consolidated group is passive is made by reference to the consolidated group's participation in the activity. n110

[5] Partners, LLC Members, Beneficiaries of Grantor Trusts, and S Corporation Shareholders Are Subject to Passive Activity Limitations on Passed-Through Items

Passthrough entities, such as partnerships, LLCs treated as partnerships, grantor trusts, and S corporations, are not subject to the passive activity limitations at the entity level. n111 Passive losses and credits from those entities that are allocated to partners, LLC members, and S corporation shareholders who are otherwise subject to the passive activity limitations, however, are subject to the passive activity limitations at the partner, member, or shareholder level. Any passive activity computations with respect to passed-through items are determined separately with respect to each partner, member, or shareholder. n112

[6] Passive Activity Limitations are Applied Separately to Items from Each Publicly Traded Partnership

The passive activity limitations generally are applied separately with respect to items attributable to each publicly traded partnership. Therefore, a taxpayer's net passive income from a publicly traded partnership generally cannot be offset by losses from other passive activities, including losses from passive activities in other publicly traded partnerships in which the taxpayer is a partner. Losses from passive activities of a publicly traded partnership may be offset only by income or gain from passive activities of the same publicly traded partnership. n113

Similarly, credits arising from a passive activity of a publicly traded partnership may not be taken in excess of the regular tax liability attributable to that activity for the taxable year. Credits from passive activities of a publicly traded partnership may be offset only against the tax on the net passive income of the same publicly traded partnership. n114 In addition, the \$25,000 offset for rental real estate activities n115 does not generally apply with respect to items attributable to a publicly traded partnership. n116

The above rules do not apply, however, with respect to any low-income housing credit or rehabilitation credit n117 attributable to a publicly traded partnership, to the extent that the amount of those credits exceeds the regular tax liability attributable to any income from the partnership. n118

For purposes of the above rules, a publicly traded partnership is one whose interests are traded on an established securities market or are readily tradable on a secondary market or the substantial equivalent of one. n119

The separate treatment required for passive losses and credits of a publicly traded partnership also applies to regulated investment companies holding an interest in a "qualified publicly traded partnership" with respect to items attributable to that interest. n120 A "qualified publicly traded partnership" generally is the same as a "publicly traded partnership" as defined in *IRC Section 469(k)(2)*, except that it does not include a publicly traded partnership if 90 percent of its gross income consists of dividends, interest, payments with respect to securities loans, and gains from the sale or disposition of stock or securities, foreign currencies, or other income derived with respect to its business of investing in stock, securities, or currencies. n121

[7] Effect of Change in Corporate Status

The passive loss limitations do not apply to C corporations that are not closely held or not personal service corporations. Changes in ownership may cause a corporation to lose its closely held status or its status as a personal service corporation. Similarly, a personal service corporation may change its activities so that it no longer qualifies as a personal service corporation. n122 When a change in corporate status occurs, the passive activity loss and credit carryover rules will continue to apply as if the corporation were still a closely held C corporation or a personal service corporation. Therefore, any suspended losses of a former closely-held corporation may offset only net active income of that entity, not portfolio income, and any suspended losses of a former personal service corporation may offset only passive income in future years. n123 Passive activity limitations will no longer apply to future activity losses of the entity. n124

NOTE:

A change in corporate status does not constitute a disposition that will trigger suspended losses. n125

One private letter ruling involved a closely held corporation that was subject to the passive activity loss rules in Years 1 through 3, but then underwent a change of ownership and ceased to be closely held C corporation thereafter. The IRS ruled that the passive loss rules did not prevent the taxpayer from carrying back net operating losses that accrued in years after Year 3 to offset portfolio income earned in prior years in which it was a closely held C corporation. n125.1

FOOTNOTES:

(n1)Footnote 79. *IRC § 469(a)(2)*.

(n2)Footnote 80. See Ltr Rul 8806065 .

(n3)Footnote 81. See [2], below, for a discussion.

(n4)Footnote 82. See [3], below, for a discussion.

(n5)Footnote 83. See *IRC* § 469(a)(2); see [5], below, for a discussion.

(n6)Footnote 84. *IRC* § 469(a)(2)(B).

(n7)Footnote 85. *IRC* §§ 469(j)(1), 465(a)(1)(B), 542(a)(2); detailed attribution rules apply in determining stock ownership, and several types of trusts and foundations are treated as "individuals" (see *IRC* §§ 469(j)(1), 465(a)(1)(B), (3), 542(a)(2), 544(a), (b); also see *IRC* § 542(a)(2)).

(n8)Footnote 86. See [3], below, for a discussion of personal service corporations.

(n9)Footnote 87. *IRC* § 469(e)(2); see §§ 13.08[5] and *Treas Reg* § 1.49-2(f)(9)(iv), for a discussion.

(n10)Footnote 88. See *Temp Treas Reg* § 1.469-1T(g)(2)(ii).

(n11)Footnote 89. *IRC* § 469(a)(2)(C).

(n12)Footnote 90. *IRC* §§ 469(j)(2), 269A(b); *Temp Treas Reg* § 1.469-1T(g)(2)(i); *Treas Reg* § 1.441-3(c).

(n13)Footnote 91. See [b], below, for a definition of "employee-owners."

(n14)Footnote 92. *IRC* § 448(d)(2). See *Kraatz & Craig Surveying, Inc v Commr*, 134 TC No 8 (2010) (land surveying is included in engineering services, and taxpayer whose only activity was land surveying therefore was held to be a personal service corporation).

(n15)Footnote 93. *Treas Reg* § 1.441-3(e)(1).

(n16)Footnote 94. *Temp Treas Reg* § 1.469-1T(g)(2)(i); see *Treas Reg* § 1.441-3(f)(1).

(n17)Footnote 95. *Treas Reg* §§ 1.469-1T(g)(2)(i); see *Treas Reg* § 1.441-3(c)(1).

(n18)Footnote 96. *Treas Reg* § 1.441-3(c)(1).

(n19)Footnote 97. *Treas Reg* § 1.441-3(c)(2).

(n20)Footnote 98. *Treas Reg* § 1.441-3(c)(2)(ii).

(n21)Footnote 99. *IRC* § 469(j)(2); see *IRC* § 269A(b)(2).

(n22)Footnote 100. *IRC* § 269A(b)(2).

(n23)Footnote 101. *Treas Reg* §§ 1.469-1T(g)(2)(i); see *Treas Reg* §§ 1.441-3(c)(1), 1.441-3(g).

(n24)Footnote 102. *Treas Reg* §§ 1.441-3(c)(2), 1.441-3(g)(1); see [a], above, for detailed discussion.

(n25)Footnote 103. *Treas Reg* § 1.479-7.

(n26)Footnote 104. *Treas Reg* § 1.441-3(g)(2).

(n27)Footnote 105. *IRC* §§ 469(j)(2)(B), 318(a)(2)(C).

(n28)Footnote 106. *IRC § 318(a)(2)(C), as modified by IRC § 469(j)(2)(B).*

(n29)Footnote 106.1. *IRC §§ 469(j)(2)(B), 269A(b)(2), 318(a)(2), (5)(E).*

(n30)Footnote 106.2. *IRC § 318(a)(4).*

(n31)Footnote 107. *IRC § 469(j)(11).*

(n32)Footnote 108. *Treas Reg § 1.469-1(h)(4)(ii).*

(n33)Footnote 109. *Treas Reg § 1.469-1(h)(4)(ii).*

(n34)Footnote 110. *Treas Reg § 1.469-1(h)(4)(i).*

(n35)Footnote 111. *IRC § 469(a)(2).*

(n36)Footnote 112. See *IRC § 469(a)*. See *Ziegler v Commr, TC Memo 2007-166*, *affd in unpublished opinion 2008-2 USTC ¶ 50,412, 2008 U.S. App. LEXIS 13520 (2nd Cir 2008)*, *cert denied 3/30/09* (passive activity rules held constitutional when applied to a limited partner who purchased his partnership interest before the enactment of *IRC § 469*).

(n37)Footnote 113. *IRC § 469(k)(1).*

(n38)Footnote 114. *IRC § 469(k)(1).*

(n39)Footnote 115. See *IRC § 469(i)*.

(n40)Footnote 116. *IRC § 469(k)(1).*

(n41)Footnote 117. See *IRC §§ 42, 47*.

(n42)Footnote 118. *IRC § 469(k)(1).*

(n43)Footnote 119. *IRC § 469(k)(2)*. See § 13.09[5][h], below, for a discussion of the application of the \$25,000 offset as applied to publicly traded partnerships, and § 13.10[6], below, for a discussion of the disposition of the activity of a publicly traded partnership. See *IRC § 469(k)(1), (3)*.

(n44)Footnote 120. *IRC § 469(k)(4).*

(n45)Footnote 121. *IRC § 851(h)*; see *IRC §§ 851(b)(2)(A), 7704(b), (c)(2)*.

(n46)Footnote 122. See *IRC §§ 469(j)(1), (2), 269A(b), 465(a)(1)(B), 542(a)(2)*.

(n47)Footnote 123. *IRC § 469(f)(2).*

(n48)Footnote 124. See *IRC § 469(a)*.

(n49)Footnote 125. See *IRC § 469(g)*.

(n50)Footnote 125.1. *Ltr Rul 201017007*.

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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.03

§ 13.03 Grouping Activities under Passive Activity Rules

[1] How Separate "Activity" Information Is Used

The cornerstone for the proper application of the passive activity rules is the determination of what constitutes an "activity." The determination of an "activity" is critical because virtually every passive activity rule is applied on an activity-by-activity basis:

- material, active, and significant participation by a taxpayer is based upon the degree of involvement in the activity; n126
- passive income or loss is measured with respect to the specific activity; n127
- disposition of the activity may trigger suspended losses; n128 and
- the passive activity limitations are applied separately with respect to each passive activity in which a taxpayer owns an interest. n129

[2] "Activity" Is Defined Using Facts and Circumstances Test

IRC Section 469 does not define the term "activity" for purposes of the passive activity limitations, but authorizes the Treasury to do so in regulations. n130 Regulations do not define the term directly either, n131 but set forth a facts and circumstances approach for defining an activity. n132 The general rule is that one or more activities may be treated as a single activity if they constitute an appropriate economic unit for the measurement of gain or loss for purposes of *IRC Section 469*. n133 Whether activities constitute a single economic unit depends on all the relevant facts and circumstances. n134 The facts and circumstances inquiry comes into play primarily in grouping multiple activities. n135 In practical application, the regulations lack clarity and certainty.

In one case, a partnership in which the taxpayer was a partner rented an entire building to two corporations that were the sole tenants. The taxpayer was also a shareholder in each corporation. The court ruled that the two rentals were properly considered as one economic unit under the regulations and could therefore be treated as a single activity. n136

[3] Any Reasonable Method Generally May Be Used to Group Activities

Taxpayers may group multiple activities to constitute a single economic unit for the measurement of gain or loss for purposes of *Treas Reg § 1.479-7*. By doing so, activities within the single economic unit can be treated as a single activity under *IRC Section 469*. Taxpayers have significant leeway in making groupings, and may use "any reasonable method" of applying relevant facts and circumstances in grouping activities to do so. The following factors, however, are given the greatest weight in determining whether activities are an appropriate economic unit: n137

- similarities and differences in the types of business;
- the extent of common control;
- the extent of common ownership;
- geographical location; and
- interdependencies between the activities (for example, the extent to which the activities purchase or sell goods between themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Not all of the above factors need to point to treating more than one activity as a single activity. n138 Furthermore, apart from these factors, n139 several grouping rules and limitations may apply to restrict particular groupings. n140 Regulations provide examples that indicate the discretion that taxpayers may use in grouping different activities. n141

Example:

Steve has a significant ownership interest in a bakery and a movie theater in a shopping mall in Baltimore, and in a bakery and a movie theater in Philadelphia. Relevant facts and circumstances could indicate more than one reasonable method for grouping Steve's activities. For instance, depending on relevant facts and circumstances, four possible groupings are possible:

- (1) one activity encompassing all four businesses;
- (2) two activities: a bakery activity and a movie theater activity;
- (3) two activities: a Baltimore activity and a Philadelphia activity; or
- (4) four separate activities.

Once Steve groups the activities into appropriate economic units, however, he must continue to use that grouping in later tax years unless a change in the facts and circumstances makes it clearly inappropriate. n142

Practice Tip:

Large non-passive losses from passthrough entities on a Schedule E may be a red flag of an improper grouping. The IRS will view the grouping closely, to ascertain whether many activities have been grouped into a single activity, so that the taxpayer can meet the material participation standards and bypass the passive loss limitations altogether. The IRS will regroup the activities if the grouping does not

reflect an appropriate economic unit.

Another possible audit trigger based on groupings occurs when a return deducts losses as non-passive and reports gains as passive. This can indicate that the taxpayer is treating an activity with gains as passive when it should be part of a non-passive activity. If so, the IRS may reclassify these into different groupings. n143

[4] Limitation on Grouping Rental Activities with Other Trade or Business Activities

Notwithstanding the general discretion allowed to taxpayers in grouping activities under the facts and circumstances test, n144 special rules restrict the grouping of rental activities with nonrental trade or business activities. Under these rules, a rental activity may not be grouped with a trade or business activity unless the activities being grouped constitute an appropriate economic activity, and one of the following conditions is met: n145

- the rental activity is insubstantial in relation to the trade or business activity;
- the trade or business activity is insubstantial in relation to the rental activity; or
- each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

Example:

John and his wife Mary file a joint return. John is the sole shareholder of Goodfood Corporation, an S Corporation that conducts a grocery store business. Mary is the sole shareholder of Rentout Corporation, an S corporation that owns and rents out a building to John's grocery store. The rental to John's grocery store business and the grocery store are not insubstantial in relation to each other.

Because John and Mary file jointly for purposes of *IRC Section 469*, they each are treated as the sole owner of the grocery store. Therefore, each owner of the business activity has the same proportionate ownership interest in the rental activity. Accordingly, the rental and the grocery store business activity may be grouped together into a single activity if the grouping is an appropriate economic unit. n146

Note:

Neither the Code nor regulations define "insubstantial" for purposes of the above tests. n147 A preamble to final regulations, however, indicates that the term "insubstantial" refers to factors other than gross income. This reference has been interpreted to mean that although gross income may be used in analyzing insubstantiality, it is not alone conclusive. n148 Thus, both qualitative and quantitative factors may be considered in evaluating whether the "insubstantial" test is met. Qualitative factors can include the purpose for which the rental activity and/or trade or business activity is formed initially and the role of each in relation to the other. They can also include whether the closeness of the operating relationship between the two shows that they are two parts of a single economic enterprise and obtain economies of scale from that connectedness. Whether the activities use an integrated accounting system, similar employees, and whether they are economically dependent upon one another are relevant. Even if one activity plays an essential role relative to the other, however, the insubstantiality test may still be met. n149

Quantitative factors can include comparisons of gross income and/or fair market values between the two

activities. The "80/20" gross income test in temporary regulations can be a good starting point for gauging whether a rental activity is insubstantial in relation to trade or business activity or vice versa. Under that test, nonrental and rental operations can be grouped together if less than 20 percent of the combined undertaking's gross income is attributable to either the nonrental or rental operations. n150 Any resulting figures, however, must be viewed in context. For example, although a rental activity may appear to be insubstantial under the gross income test, the rental activity actually may require a far greater capital investment and have greater value than the business activity. Or, a rental activity might appear insubstantial when compared to a business activity that has high gross income, but little net income. In either case, the rental activity may be found not to be insubstantial with respect to the business activity with which it is being compared. n151 An 80/20 framework has also been used to evaluate insubstantiality when comparing market values of rental and trade or business activities. n152

[5] Limitation on Grouping Real Property Rentals and Personal Property Rentals

Notwithstanding the general discretion allowed to taxpayers in grouping activities under the facts and circumstances test, n153 real property rentals and personal property rentals generally cannot be grouped. Grouping is allowed, however, if the provision of one category of property is merely in connection with the rental of the other category of property. n154

[6] Limitation on Grouping Activities of Limited Partners and Limited Entrepreneurs

A taxpayer who is a limited partner or limited entrepreneur in one of the following activities may generally not group that activity with any other activity: n155

- holding, producing, or distributing motion picture films or video tapes;
- farming; n156
- leasing personal property; n157
- exploring for or exploiting oil and gas resources; or
- exploring for or exploiting geothermal deposits. n158

A limited partner or limited entrepreneur may, however, group that activity with another activity in the same type of business if the grouping is an appropriate economic unit. n159 A limited entrepreneur is a person who is not a limited partner and does not actively participate in management. n160

[7] IRS May Identify Activities That Cannot Be Grouped

The IRS has the power to identify activities that cannot be grouped with other activities or may be grouped with other activities only as provided in guidance by the IRS. A taxpayer that owns an interest in such an activity may group that activity only as provided in IRS guidance. n161 The IRS has yet to restrict groupings under this authority; presumably any pronouncement in this regard would be made in a revenue ruling or revenue procedure.

[8] Activities Conducted by C Corporations, S Corporations, and Partnerships

Real estate activities conducted through a C corporation subject to *IRC Section 469*, partnership, or S corporation must be grouped according to the rules described above, at the partnership or corporation level. A partner or shareholder may then group those activities with activities conducted directly by the taxpayer or conducted through other C corporations subject to *IRC Section 469*, partnerships, and S corporations, according to the rules described above. n162 A

shareholder or partner, however, may not treat activities grouped together by a closely held C corporation or personal service corporation as a separate activity. n163

One grouping limitation applies only with respect to C corporations. Any passive activity that a taxpayer conducts through a C corporation may be grouped with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity. n163.1 The Tax Court has applied this regulation to prohibit taxpayers from offsetting passive losses from their LLC's rental activity against non-passive wages they received from their C corporation. The taxpayers contended that their activities in the two entities could be treated as a single activity for purposes of *IRC Section 469*, but the Tax Court held that the regulation limited this activity grouping to the purposes of evaluating the taxpayers' participation in the LLC's activities. The grouping could not be used to offset the LLC's losses. In addition, the court found that the taxpayers' activities in the LLC were passive even if the taxpayers did materially participate in them (because they were rental activities). n163.2

[9] Grouping by IRS to Prevent Tax Avoidance

The IRS may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit, and a principal purpose of the taxpayer's grouping (or a failure to regroup) is to circumvent the passive activity limitations. n164

[10] Consistency and Disclosure Requirements for Groupings

[a] In General

A taxpayer who has grouped activities generally may not regroup them in later taxable years. n165 In the event of a material change in relevant facts and circumstances, or if it is later determined that the original grouping was clearly inappropriate, the taxpayer not only may, but must, regroup the affected activities and comply with any disclosure requirement prescribed by the IRS. n166 (The IRS, however, always has power to regroup activities in order to prevent tax avoidance. n167)

Taxpayers must report to the IRS their groupings and regroupings of activities and the addition of specific activities within their existing groupings of activities under *IRC Section 469*. The required disclosures must be made with the return for the tax year in which the changes occur. n168 The disclosure requirements vary, depending on the type of change, as discussed in [b] through [f], below. Special rules apply for groupings by partnerships and S corporations, as discussed in [e], below. n168.1 Failure to make a proper disclosure may result in each trade or business activity or rental activity being treated as a separate activity for purposes of applying the passive activity loss and credit limitation rules. n168.2

Practice Tip:

If a taxpayer's activities are fluctuating back and forth between passive and non-passive categorization from year to year, an audit is likely. On audit, an IRS examiner will probably do a 3-year or longer comparison of passive and non-passive income and losses on an entity-by-entity basis to look for inconsistencies in treatment. Fluctuation between active and passive categorization may be acceptable, if due to the annual test for material participation in each activity. n169 For the IRS, however, it can also indicate inconsistent regroupings that seek to deduct the greatest amount of losses each year. If the taxpayer has not been consistent or has used inappropriate groupings, the examiner will regroup the activities and apply material participation standards to the regroupings, in order to determine the proper amount of passive losses. n170

[b] Statement Required for New Groupings

If there is a new grouping of activities, the taxpayer must file a written statement with its original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity. The statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of *IRC Section 469*. n170.1

NOTE:

No disclosure or statement needs to be filed if an activity within a particular grouping is disposed of. Although a prior notice indicated that disclosure might be required in this circumstance, *Revenue Procedure 2010-13* dropped the requirement. n170.2

[c] Statement Required for Addition of New Activities to Existing Groupings

A taxpayer who adds a new trade or business activity or a rental activity to an existing grouping for a taxable year must file a written statement with the taxpayer's original income tax return for that taxable year. The statement must identify the names, addresses, and employer identification numbers, if applicable, for the new trade or business activity or rental activity that is being added to the existing grouping, as well as the names, addresses, and employer identification numbers, if applicable, for the activity or activities within the existing grouping. In addition, the statement reporting an addition to an existing grouping must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of *IRC Section 469*. n170.3

[d] Statement Required for Regroupings

If it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities. n170.4 If such a determination and regrouping is made, the taxpayer must file a written statement with the taxpayer's original income tax return for the taxable year in which the trade or business activities or rental activities are regrouped. The statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business or rental activities that are being regrouped. If two or more activities are regrouped into a single activity, the statement reporting a regrouping must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of *IRC Section 469*. Furthermore, the statement reporting a regrouping must contain an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate. n170.5

[e] Special Rules for Groupings by Partnerships and S Corporations

Partnerships and S corporations are not subject to the disclosure requirements in [b]-[d], above. Instead, they must comply with the disclosure instructions for grouping activities provided for on Form 1065, U.S. Return of Partnership Income and Form 1120S, U.S. Income Tax Return for an S Corporation, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1. A partner or shareholder who does any of the following, however, is required to make a separate disclosure of the groupings disclosed by the entity as described in [b]-[d], above: n170.6

- Groups together any of the activities that the entity does not group together;
- Groups the entity's activities with activities conducted directly by the partner or shareholder; or

- Groups the entity's activities with activities conducted through other entities.

NOTE:

A shareholder or partner may not treat activities grouped together by a C corporation, S corporation, or partnership as separate activities. n170.7

[f] Disclosure With Respect to Pre-Existing Groupings

A taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that have been made for tax years beginning before January 25, 2010 (pre-existing groupings) until the taxpayer makes a change to the grouping as described in [c] or [d], above. n170.8

[g] Effect of Failure to Report

If a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity in accordance with *Revenue Procedure 2010-13*, then each trade or business activity or rental activity will be treated as a separate activity for purposes of applying the passive activity loss and credit limitation rules. Notwithstanding the previous sentence, a timely disclosure will be deemed made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer. If the failure to disclose is first discovered by the IRS, however, the taxpayer must also have reasonable cause for not making the required disclosures. n170.9

NOTE:

Although the above "default" rule will generally result in unreported activities being treated as separate activities, the IRS may still regroup a taxpayer's activities to prevent tax avoidance. n170.10
Furthermore, because *Revenue Procedure 2010-13* provides alternative relief for untimely filing of the required disclosures, administrative extensions for relief for untimely disclosures are not available. n170.11

Practice Tip:

If a taxpayer's activities are fluctuating back and forth between passive and non-passive categorization from year to year, an audit is likely. On audit, an IRS examiner will probably do a 3-year or longer comparison of passive and non-passive income and losses on an entity-by-entity basis to look for inconsistencies in treatment. Fluctuation between active and passive categorization may be acceptable, if due to the annual test for material participation in each activity. n170.12 For the IRS, however, it can also indicate inconsistent regroupings that seek to deduct the greatest amount of losses each year. If the taxpayer has not been consistent or has used inappropriate groupings, the examiner will regroup the activities and apply material participation standards to the regroupings, in order to determine the proper amount of passive losses. n170.13

FOOTNOTES:

(n1)Footnote 126. *IRC § 469(h),(i)(1); Treas Reg §§ 1.469-4, 1.469-5; Temp Treas Reg § 1.469-5T.*

(n2)Footnote 127. *IRC § 469(d), (e).*

(n3)Footnote 128. *IRC § 469(g).*

- (n4)Footnote 129. *IRC § 469(a)*.
- (n5)Footnote 130. *IRC § 469(l)(1)*.
- (n6)Footnote 131. *Treas Reg § 1.469-4*.
- (n7)Footnote 132. *Treas Reg § 1.469-4(c)(2)*.
- (n8)Footnote 133. *Treas Reg § 1.469-4(c)(1)*.
- (n9)Footnote 134. *Treas Reg § 1.469-4(c)(2)*.
- (n10)Footnote 135. See [3], below.
- (n11)Footnote 136. *Kucera v Commr, TC Summary Opinion 2001-18* .
- (n12)Footnote 137. *Treas Reg § 1.469-4(c)(2)*.
- (n13)Footnote 138. *Treas Reg § 1.469-4(c)(2)*.
- (n14)Footnote 139. See *Treas Reg § 1.469-4(c)(2)*.
- (n15)Footnote 140. See *Treas Reg §§ 1.469-4(d)-(f)*, as discussed in [4]-[10], below.
- (n16)Footnote 141. *Treas Reg § 1.469-4(c)(3)*.
- (n17)Footnote 142. *Treas Reg §§ 1.469-4(c)(3)*, Example 1; 1.469-4(e).
- (n18)Footnote 143. See *Treas Reg § 1.469-4(c)*.
- (n19)Footnote 144. See *Treas Reg § 1.469-4(c)(2)*, discussed in [3], above.
- (n20)Footnote 145. *Treas Reg § 1.469-4(d)(1)*.
- (n21)Footnote 146. See *Treas Reg § 1.469-4(d)(1)*.
- (n22)Footnote 147. See *Treas Reg § 1.469-4(d)(1)*.
- (n23)Footnote 148. *Glick v US, 2000-1 USTC P 50,372 (SD Ind 2000); TAM 200014010* .
- (n24)Footnote 149. *Glick v US, 2000-1 USTC P 50,372 (SD Ind 2000); TAM 200014010* .
- (n25)Footnote 150. *Temp Treas Reg § 1.469-4T(d)(2)(ii), (iii)*.
- (n26)Footnote 151. *TAM 200014010* .
- (n27)Footnote 152. *Glick v US, 2000-1 USTC P 50,372 (SD Ind 2000); TAM 200014010* .
- (n28)Footnote 153. See *Treas Reg § 1.469-4(c)(2)*, discussed in [3], above.
- (n29)Footnote 154. *Treas Reg § 1.469-4(d)(2)*; see *Shaw v Commr, TC Memo 2002-35* (rentals of real property and an airplane not permitted).
- (n30)Footnote 155. *Treas Reg § 1.469-4(d)(3)(i)*; see *IRC § 465(c)(1)*.

(n31)Footnote 156. See *IRC* § 464(e) for definition.

(n32)Footnote 157. See *IRC* § 1245(a)(3).

(n33)Footnote 158. See *IRC* § 613(e)(2).

(n34)Footnote 159. *Treas Reg* § 1.469-4(d)(3)(i).

(n35)Footnote 160. *IRC* § 464(e)(2).

(n36)Footnote 161. *Treas Reg* § 1.469-4(d)(4).

(n37)Footnote 162. *Treas Reg* § 1.469-4(d)(5)(i); see *Treas Reg* § 1.469-4(c), (d)(1)-(4); see [3]-[7], above.

(n38)Footnote 163. *Treas Reg* § 1.469-4(d)(5)(i).

(n39)Footnote 163.1. *Treas Reg* § 1.469-4(d)(5)(ii).

(n40)Footnote 163.2. *Senra v Commr*, *TC Memo* 2009-79 . See *IRC* § 469(c)(2), (4) and § 13.04[3][a], below, for a discussion of rental activities generally being passive).

(n41)Footnote 164. See *Treas Reg* § 1.469-4(f)(1).

(n42)Footnote 165. *Treas Reg* § 1.469-4(e)(1).

(n43)Footnote 166. *Treas Reg* § 1.469-4(e)(2).

(n44)Footnote 167. See *Treas Reg* § 1.469-4(f)(1).

(n45)Footnote 168. *Rev Proc* 2010-13, 2010-4 *IRB* 329 , effective for tax years beginning on or after Jan 25, 2010 [*Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 5].

(n46)Footnote 168.1. *Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 4.05.

(n47)Footnote 168.2. *Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 4.07. See [g], below, for a discussion.

(n48)Footnote 169. See *IRC* § 469(h).

(n49)Footnote 170. See *Treas Reg* § 1.469-4(e).

(n50)Footnote 170.1. *Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 4.02.

(n51)Footnote 170.2. *Rev Proc* 2010-13, 2010-4 *IRB* 329 ; see *Notice* 2008-64, 2008-31 *IRB* 268 .

(n52)Footnote 170.3. *Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 4.03.

(n53)Footnote 170.4. *Treas Reg* § 1.469-4(e)(2).

(n54)Footnote 170.5. *Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 4.04.

(n55)Footnote 170.6. *Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 4.05.

(n56)Footnote 170.7. *Treas Reg* § 1.469-4(d)(5)(i).

(n57)Footnote 170.8. *Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 4.06.

(n58)Footnote 170.9. *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.07.

(n59)Footnote 170.10. *Treas Reg § 1.469-4(f)*.

(n60)Footnote 170.11. *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.07; *Treas Reg § 301.9100-1(d)(2)*.

(n61)Footnote 170.12. See *IRC § 469(h)*.

(n62)Footnote 170.13. See *Treas Reg § 1.469-4(e)*.

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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.04

§ 13.04 What Constitutes a "Passive Activity"

[1] Passive Activities Include the Conduct of Trades or Businesses in Which the Taxpayer Does Not Materially Participate

The statutory description of a passive activity is deceptively simple. An activity is a passive activity for a tax year if the activity n171 is a trade or business n172 in which the taxpayer does not materially participate, n173 or is a rental activity, regardless of whether the taxpayer materially participates or not.

The *per se* classification of rental activities as passive is subject to an exception for real estate professionals. n174

[2] Trade or Business Requirement

To the extent provided by regulations, trade or business activities for purposes of the passive activity rules include those in connection with a trade or business and any activity with respect to which expenses are deductible under *IRC Section 212*. n175 Trade or business activities for purposes of the passive activity rules also include any activity involving research or experimentation within the meaning of *IRC Section 174*. n176

Regulations clarify that trade or business activities are those (other than rental activities or activities treated as incidental to the holding of property for investment) that involve any of the following: n177

- the conduct of a trade or business (within the meaning of *IRC Section 162*);
- activities conducted in anticipation of the commencement of a trade or business; and
- activities that involve research or experimental expenditures that are deductible under *IRC Section 174* (or would be if the taxpayer adopted the method described in *IRC Section 174*).

Activities incidental to the holding of property for investment are not treated as trade or business activities. n178 In addition, although authorized by statute to do so, regulations do not extend the definition of trade or business activities for passive activity purposes to include other investment activities and other activities engaged in for the production or collection of income that would generate expenses deductible under *IRC Section 212*. n179

[3] Rental Activities Are Generally Passive

[a] Rental Activities Are Generally Passive Without Regard to Material Participation

Passive activities generally include any rental activity, regardless of whether the taxpayer materially participates or not. n180 Numerous activities are excluded from the definition of "rental activity," however, and are thereby not treated as passive activities. n181 In addition, there is one statutory exception to this rule, for professional taxpayers in a real property trade or business. n182

[b] Rental Activity Is One Where Payments Are Principally for Use of Tangible Property

A "rental activity" is defined as any activity where payments are principally for the use of tangible property. Tangible property includes real estate, so typical real property rental leases are included. n183 Regulations clarify that to qualify as rental activity during a tax year, two conditions must be met. First, the tangible property held in connection with the activity must be used by customers or held for use by customers. Second, the gross income from the conduct of the activity must be from amounts paid principally for the use of the property. In the case of property being held for use by customers (whether or not the property is ever in fact used by customers), this second condition is met if the expected gross income from the conduct of the activity will represent amounts paid principally for the use of the property. In either case, the second condition is met whether the use of the property is pursuant to a lease, service contract, or other arrangement that is not dominated a lease. n184

[4] Exceptions Under Which Use of Property Is Not a Rental Activity

[a] Regulations Exclude Certain Uses from "Rental Activity"

Of primary interest (especially for owners of real estate), are several regulatory exceptions to the definition of rental activity. An activity is not a "rental activity" (and is therefore not subject to the passive activity limitations) for a taxable year if for that year, any of the following occurs: n185

- the average period of customer use for the property is seven days or less; n186
- the average period of customer use for the property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers; n187
- extraordinary personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers (without regard to the average period of customer use); n188
- the rental of the property is treated as incidental to a nonrental activity of the taxpayer; n189
- the taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers; n190 or
- the property is provided for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest. n191

[b] Rentals Where Average Rental Is Seven Days or Less is Not Rental Activity

An activity is not a "rental activity" (and is therefore not subject to the passive activity limitations) for a taxable year if for that year the average period of customer use for the property is seven days or less. n192 Regulations provide detailed

rules on how to compute an activity's average period of customer use. The average period of customer use for an activity is the sum of the average use factors for each class of property held in connection with the activity. n193

NOTE:

If the average period of customer use for a taxpayer's property is seven days or less, the taxpayer will not be considered engaged in a rental activity. n193.1 Therefore, the activity of renting the property will not constitute a "rental real estate activity" for purposes of *IRC Section 469(i)*. This will prevent a taxpayer from using the \$25,000 offset provided in that provision. Although the activity will not be a rental activity, however, the activity may still avoid being considered a passive activity if the taxpayer can establish that he or she materially participated in the activity. n193.2

The "average use factor" for a class of property is the average period of customer use times that class of property's gross rental income, divided by the activity's gross rental income. n194 Use is determined by dividing the aggregate number of days in all periods of customer use for the year by the number of periods of customer use. n195 This formula takes into account the amount of income from each item of property and prevents property with insignificant income from affecting the average period of customer use. n196 Taxpayers may organize property into classes using any method that places into different classes items of property for which the amount of daily rent differs significantly. n197

Example:

Gene is engaged in the single activity of renting Property X and Property Y. Assume that Property X and Property Y are in different classes. Property X has an average period of customer use of four days and generates annual gross rental income of \$100,000. Property Y has an average period of customer use of ten days and generates gross rental income of \$300,000. Property X and Property Y are in different classes of property. The average use factor of the class for Property X is one day $[(100,000/400,000) \times 4 \text{ days}]$. The average use factor of the class for Property Y is 7.5 days $[(300,000/400,000) \times 10 \text{ days}]$. The average period of customer use for Gene's activity is 8.5 days $(1 + 7.5)$. Because this is more than 7 days, the exception does not apply, and the activity is treated as a rental activity for passive activity purposes. n198

Regulations contain several rules relating to determining the average period of customer use. Any period of customer use that ends during the tax year includes days in that period that were in the prior tax year. Similarly, a period of customer use that includes the last day of the taxable year includes days in that period that are in the subsequent tax year. n199 Each period during which a customer has a continuous or recurring right to use an item of property is treated as a separate period of customer use. This rule applies whether the customer uses the property for the entire period, or whether the right to use the property is pursuant to a single agreement or to renewals of it. The duration of a period of customer use that includes the last day of a tax year may be determined on the basis of reasonable estimates. n200

Practice Tip:

Taxpayers engaged in short term rental activity may be able to affect the average period of customer use by manipulating contract terms with customers. Terms that provide a continuous or recurring right to use an item or terms that allow renewals will extend the average period of customer use, thereby making it more likely that the activity will not qualify for the exception, but will be treated as a rental activity subject to the passive activity limitations. Taxpayers who wish to qualify for the exception should, to the extent possible, provide for express rental periods of a short duration without a right of renewal. n201

[c] Rentals Where Average Period of Customer Use Is 30 Days or Less and Significant Personal Services Are Provided Are Not Treated as Rental Activity

An activity is not a "rental activity" (and is therefore not subject to the passive activity limitations) for a taxable year if

for that year the average period of customer use for the property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers. n202

The determination of the average period of customer use is determined in the same manner as for the seven-day exception, n203 "Personal services" under this exception include only services performed by individuals, and do not include the following "excluded services": n204

- Services necessary to permit the lawful use of the property;
- Services performed in connection with the construction of improvements to the property or in connection with repairs that extend the property's useful life beyond the average period of customer use; or
- Services provided in connection with improved real property that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential property. These services include cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters.

Regulations do not clearly define when personal services are "significant"; they provide only that all the relevant facts and circumstances are taken into consideration in making this determination. Relevant facts and circumstances could include the frequency with which the services are provided and the type and amount of labor required to perform the services relative to the amount charged for the use of the property. n205

Example:

William is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exits, stairways, and lobbies, and collecting and removing trash, William provides a daily maid and linen service at no additional charge. All the services other than maid and linen services are "excluded services" because they are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen service (measured by the cost to William of employees performing those services) is less than 10 percent of the amount charged to tenants for occupancy of apartments. Because of the relatively small value of the maid and linen service to the amount charged to customers for rental, the services are not "significant." Accordingly, because significant personal services are not provided in connection with making apartments available for use by customers, the exception does not apply, and the activity is a rental activity, and is subject to the passive activity limitations. n206

[d] Providing Extraordinary Personal Services Prevents Classification as Rental Activity

An activity is not a "rental activity" (and is therefore not subject to the passive activity limitations) if extraordinary personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers. n207 To qualify as "extraordinary personal services," the services must be performed by individuals, and the use of the property by the customers must be incidental to the receipt of services. The regulations mention hospital boarding facilities and boarding school dormitories as possible examples falling within this exception. n208 Extensive recreational, meal, laundry, and transportation services provided in connection with the management of a retirement center can also constitute extraordinary personal services that fall within the exception. This could occur if the residents' monthly payments far exceeded the cost of luxury apartments in the vicinity, largely because of those services. n209

Example:

Happy Homes, an LLC, is engaged in an activity of running a retirement home. The average stay for a resident exceeds 30 days. Nurses and other individuals employed by Happy Homes provide personalized care, social activities, and services to each resident for no additional charge. The primary purpose of this facility is to provide housing for the elderly and not to provide medical services. The value of the services provided (measured by the cost to Happy Homes of employees performing these services) is less than 50 percent of the amount charged to each resident. Under these facts, services performed by individuals are provided in connection with the rental of the rooms, but the rental is not merely incidental to the receipt of the services. Therefore, extraordinary personal services are not provided in connection with renting the rooms, and the activity is a rental activity. If the average period of customer use by a resident exceeded seven days but did not exceed 30 days, then the services would be considered significant personal services, and the activity would not be considered a rental activity. n210

A rare case involving the extraordinary personal services exception n211 as it pertains to real estate involved real estate leasing activities in conjunction with legal support services. The taxpayers, husband and wife, were sole shareholders of an LLC, which owned an office building. The LLC's main activity was providing extensive legal support services, including legal research, to attorneys to whom it leased office space in the building. The Tax Court concluded that the attorney-tenants leased from the LLC primarily to obtain its legal support services and not to lease its office space. While the space leased may have factored into the attorney-tenants' determination, it was incidental to the support services they received. The Tax Court concluded that the leasing activity was not rental activity, and that the passive loss rules therefore did not preclude the taxpayers from deducting leasing activity losses incurred by the LLC. n212

[e] Rental Activities Incidental to Nonrental Activities Are Not Treated as Rental Activities

An activity is not a "rental activity" (and is therefore not subject to the passive activity limitations) if the rental of the property is treated as incidental to a nonrental activity of the taxpayer. n213 Regulations specify several situations when rental is treated as incidental to a nonrental activity. n214 First, the rental of property is incidental to the activity of holding the property for investment if (1) the principal purpose of holding the property is to realize gain from the appreciation of the property, and (2) the gross rental income from the property is less than two percent of the lesser of the unadjusted basis or fair market value of the property. n215 This exception can come into play for unproductive real estate held for investment that is rented out for nominal amounts to defray carrying costs. Land may be leased to farmers, for example, or signs may be placed on the property for a small payment. This nominal rental activity does not ordinarily convert a real estate holding into a passive activity. n216

Example (1):

Ted owns 1,000 acres of unimproved land with a fair market value of \$350,000 and an unadjusted basis of \$210,000. Ted holds the land for the principal purpose of realizing gain from appreciation. To defray the cost of carrying the land, Ted leases the land to a rancher, who uses it to graze cattle for a rent of \$4,000 per year. The gross rental income is less than 2 percent of the lesser of the fair market value or the unadjusted basis of the land ($.02 \times \$210,000 = \$4,200$). Accordingly the rental is not a rental activity because it is incidental to the activity of holding the property for investment. n217

Example (2):

In Year 1, Richard acquires vacant land for the purpose of constructing a shopping mall. Before commencing construction, Richard leases the land under a one-year lease to an automobile dealer, who uses the land to park cars held in its inventory. Richard begins construction of the mall in Year 2. Because Richard acquired the land for the principal purpose of constructing a mall, and not for realizing gain from its appreciation, the rental of the property in Year 1 is not treated as incidental to an activity of holding the property. Rather, it is treated as a rental activity. n218

Second, the rental of property is incidental to trade or business activity during a tax year if all of the following requirements are met: n219

- the taxpayer owns an interest in the trade or business activity during that year;
- the property was predominantly used in the trade or business activity during that year or during at least two of the five preceding tax years; and
- the gross rental income from the property for the tax year is property is less than two percent of the lesser of the unadjusted basis or fair market value of the property.

NOTE:

In determining whether a taxpayer qualifies for the incidental activity exception, activity conducted through a closely held C corporation can be classified as an activity of the taxpayer. Therefore, a rental activity conducted by a taxpayer can be treated as a nonrental activity (and therefore nonpassive) if it is incidental to a nonrental activity conducted by the taxpayer through a closely-held C corporation. n219.1

Finally, the provision of lodging to an employee or an employee's spouse or dependents is treated as incidental to the activity (or activities) of the taxpayer for which the employee performs services (i.e. a nonrental activity) if that lodging is furnished for the convenience of the employer. n220

[f] Nonexclusive Use Exception

An activity is not a "rental activity" (and is therefore not subject to the passive activity limitations) if the taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers. n221 This could occur, for example, with a golf course that is open for play to customers at specified times for daily, weekly, monthly, or annual fees. The activity of running the golf course would not be treated as a rental activity, regardless of the average period of customer use for the course. n222

[g] Provision of Property to Certain Passthrough Entities In Which the Taxpayer Owns an Interest is Not A Rental Activity

An activity is not a "rental activity" (and is therefore not subject to the passive activity limitations) if property is provided for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest. n223 For this exception to apply, the taxpayer must provide the property in the taxpayer's capacity as an owner of an interest in the entity. Whether property is provided in that capacity is determined on the basis of all facts and circumstances. n224

Example:

Sally makes farmland available to a tenant farmer, Mark, pursuant to an arrangement designated a "crop-share lease." Under the arrangement, Mark is required to use his best efforts to farm the land and produce marketable crops. Sally is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced, or 50 percent of the proceeds from marketing the crops. Despite their characterization of the arrangement as a "crop-share lease," Sally and Mark have actually entered into a joint venture. Therefore, Sally will not be treated as participating in a rental activity. n225

[5] Rental Real Estate Activities for Taxpayers in Real Property Trade or Business May Be Treated as Non-Passive

[a] Rental Real Estate Activities May Be Treated as Non-Passive If Personal Service and Other Requirements Are Met

Normally, any rental activity is treated as a passive activity. n226 This general rule does not apply, however, with respect to any rental real estate activity of a taxpayer in a real property trade or business if certain requirements are met. n227 If this exception applies, the taxpayer avoids the automatic characterization of the rental activities as passive, and may thereby use rental losses to offset other non-passive income. It is critical to note that if the exception applies, the activity is not automatically non-passive. Rather, the exception merely allows the taxpayer to show that the rental activity is non-passive by showing that he or she materially participates in the activity. Thus, a taxpayer may determine the nature (passive versus active) of the rental real estate activity by reference to his or her participation in the activity. n228

NOTE:

A taxpayer who does not satisfy the real estate professional exception n228.1 cannot deduct real estate losses in excess of the statutory \$25,000 offset. n228.2 The amount of any losses or credits allowed under the \$25,000 offset for rental real estate activities n229 is determined after the exception for real estate professionals discussed here is applied. Accordingly, the \$25,000 offset will be applied only against passive losses from rental real estate activities, and not against losses that are allowable as a result of *IRC Section 469(c)(7)*. n230

[b] Definitions of Rental Real Estate and Real Property Trade or Business

For purposes of the exception, n231 rental real estate is any real property used by customers or held for customers in a rental activity. Any rental real estate that the taxpayer has grouped with a trade or business activity as an appropriate economic unit, and which is insubstantial in relation to the trade or business activity, however, is not treated as an interest in rental real estate. Nor is rental real estate that has been grouped with a trade or business activity as an appropriate economic unit by virtue of being rented for use in that trade or business, when there is proportionate ownership of the trade or business activity and the rental activity. n232

For purposes of the exception, a real property trade or business includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. n233 The determination of a taxpayer's real property trades or businesses is based on all relevant facts and circumstances. Taxpayers may use any reasonable method of applying facts and circumstances in making this determination for businesses in which they provide personal services. n234 Once made, however, the determination cannot be changed in later years unless it was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate. n235

[c] Each Real Estate Interest Is Treated as a Separate Real Estate Activity Unless Taxpayer Elects Otherwise

In applying the exception for taxpayers in a real property business, n236 each interest in real estate of a qualifying taxpayer is treated as a separate rental real estate activity, unless the taxpayer elects to treat all interests in rental real estate as a single rental real estate activity. n237 The election to treat all interests in rental real estate as a single rental real estate activity is made by filing a statement to that effect with the taxpayer's original income tax return for the taxable year. The statement must contain a declaration that the taxpayer is a qualifying taxpayer for that year, and is making the election pursuant to *IRC Section 469(c)(7)(A)*. n238 The IRS may grant extensions of time for filing the election. n239

The election may be revoked if there is a material change in the taxpayer's facts and circumstances. There is not bright-line test for determining when there is a material change for this purpose. Rather, the determination is intended to

be a broad factual inquiry. n240

NOTE:

An election to treat all interests in rental real estate as a single rental real estate activity will have no effect in any year that the taxpayer is not a qualifying taxpayer. For those years, the taxpayer's activities will be determined under the "activity" definition and grouping rules. n241

[d] Personal Service Eligibility Requirements Must Be Met to Qualify for the Exception

To be eligible for the exception for taxpayers in a real property business for a taxable year, a taxpayer must meet two tests: n242

- more than one-half of the personal services performed in trades or businesses by the taxpayer during the year must be performed in real property trades or businesses in which the taxpayer materially participates; n243 and
- the taxpayer must perform more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. n244

If a joint return is filed, the above tests are met if and only if either spouse separately satisfies the participation requirements. Thus, the tests are not met if one spouse satisfies the 50-percent test, while the other spouse satisfies the 750-hour test. Similarly, the 750-hour test cannot be met by combining hours of services performed by both spouses. n245 As with material participation generally, n245.1 proof of an individual's participation sufficient to satisfy the above tests may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the necessary extent of participation may be established by other reasonable means. Reasonable means may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing those services during the period, based on appointment books, calendars, or narrative summaries. Post-event "ballpark guesstimates" will not suffice. n245.2

If the taxpayer does not make an election to treat all interests in rental real estate as a single rental real estate activity, n246 the above personal service requirements, as well as the material participation requirement, must be met with respect to each separate interest in real estate. n247

Personal services, for purposes of the above tests, include any work performed by an individual in connection with a trade or business, other than in that individual's capacity as an investor. n248 Personal services as an employee, however, are taken into account only if the employee is a 5-percent owner of the employer. n249 If an employee is not a 5-percent owner at all times during the tax year, only the personal services performed by the employee during the period the employee is a 5-percent owner are treated as performed in a real property trade or business. n250 This 5-percent rule has been upheld. n251

In the case of a closely held C corporation, the eligibility tests n252 are met for any taxable year in which more than 50 percent of the corporation's gross receipts are derived from real property trades or businesses in which the corporation materially participates. n253 For this purpose, gross receipts do not include items of portfolio income. n254

[e] Grouping of Rental Real Estate Activities with Other Activities Is Generally Prohibited in Applying the Exception

For purposes of applying the exception for rental real estate activities of real estate professionals, n255 a taxpayer may not group a rental real estate activity with any other activity. For example, if a taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be

grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity. n256

A special rule applies for certain management activities. A taxpayer may participate in a rental real estate activity through participation n257 in an activity involving the management of rental real estate, even if this management activity is conducted through a separate entity. In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate interests. n258

Interests in rental real estate held by certain passthrough entities (partnerships or S corporations) are generally treated as a single interest in rental real estate if the passthrough entity grouped its rental real estate as one rental activity. If the passthrough entity grouped its rental real estate into separate rental activities, each rental real estate activity of the passthrough entity is treated as a separate interest in rental real estate of the qualifying taxpayer. n259 If the qualifying taxpayer holds at least a 50-percent interest in the passthrough entity, however, each interest in rental real estate held by the passthrough entity is treated as a separate interest in rental real estate of the taxpayer regardless of the entity's grouping. The taxpayer may, however, elect to treat all interests in rental real estate, including those interest held through passthrough entities, as a single rental real estate activity. n260 For interests held in tiered passthrough entities in which the upper-tier passthrough entity owns at least a 50 percent interest, each interest in rental real estate held by the lower-tier entity is treated as a separate interest in the rental real estate of the upper tier entity, regardless of the lower-tier entity's grouping of activities. n261

[f] Special Treatment of Limited Partnership Interests in Rental Real Estate

Nothing in the exception for rental real estate professionals affects the determination of whether a taxpayer materially participates with respect to any interest in a limited partnership as a limited partner. n262 Regulations clarify the effect of owning limited partnership interests in rental real estate for purposes of the exception. If a taxpayer elects to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held as a limited partnership interest, then the combined rental real estate activity will be treated as a limited partnership interest for purposes of determining material participation. The taxpayer will therefore have to meet the material participation tests of a limited partner. n263

There is a de minimis exception. If a taxpayer elects to treat all interests in rental real estate as a single rental real estate activity, and the taxpayer's share of gross rental income from all the taxpayer's limited partnership interests in rental real estate is less than 10 percent of the taxpayer's share of gross rental income from all interests in rental real estate for the taxable year, then the taxpayer may determine material participation under any of the material participation tests that apply to rental real estate activities. n264

[6] Working Interest in Oil and Gas Property Is Not a Passive Activity

A working interest in oil or gas property is not a passive activity if the taxpayer holds the interest directly or through an entity that does not limit the taxpayer's liability with respect to that interest. n265 This rule applies whether or not the taxpayer materially participates in the activity. n266 A working interest for this purpose is a working or operating mineral interest in any tract or parcel of land. n267 The working interest in any oil or gas property is limited to a working interest in natural deposits of oil and gas. n267.1 The production and sale of landfill gas (or other non-oil or non-gas substances) does not qualify. n267.2 Deductions for which economic performance occurs during a period in the year in which the taxpayer's liability was limited, however, will be treated as passive. Similarly, a ratable portion of the taxpayer's gross income from an interest in oil or gas property will be treated as passive during any time the taxpayer's liability was limited. n268

If a taxpayer has any loss from a working interest in oil or gas property that is treated as non-passive under this rule (rather than treated as non-passive because of the taxpayer's limited participation in the activity), any net income in subsequent years from that property will be treated as non-passive also. So will net income from property with a basis determined in whole or in part by reference to the basis of that property (such as property acquired in a *IRC Section 1031* like-kind exchange). Furthermore, certain credits that are attributable to that property in subsequent years with net income from that property will be treated as credits from a non-passive activity to the extent that they do not exceed the regular tax liability allocable to that net income for the year. n269 The property to which this income recharacterization applies includes both the well and any other item of property (such as additional wells) the value of which is enhanced by drilling or other activities the costs of which were taken into account in determining the amount of the taxpayer's income or loss from the well. n270

These rules for working interests in oil and gas wells are applied by treating spouses as separate taxpayers, whether or not they file a joint return. n271

FOOTNOTES:

(n1)Footnote 171. *IRC § 469(c)(1), (2); Temp Treas Reg § 1.469-1(e)(1).*

(n2)Footnote 172. See [2], below, for a discussion.

(n3)Footnote 173. An exception exists for working interest in oil or gas property (see *IRC § 469(c)(3)*; see [6], below, for a discussion). See § 13.06, below, for a discussion of material participation.

(n4)Footnote 174. *IRC § 469(c)(7)*; see [5], below, for a discussion.

(n5)Footnote 175. *IRC § 469(c)(6)(A), (B).*

(n6)Footnote 176. *IRC § 469(c)(5).*

(n7)Footnote 177. *Treas Reg §§ 1.469-1(e)(2), 1.469-4(b)(1).*

(n8)Footnote 178. See *Treas Reg §§ 1.469-1(e)(2), 1.469-4(b)(1).*

(n9)Footnote 179. See *IRC § 469(c)(6)(B).*

(n10)Footnote 180. *IRC § 469(c)(2), (4).*

(n11)Footnote 181. *Temp Treas Reg § 1.469-1T(e)(3)(ii)*; see [4], below, for a discussion.

(n12)Footnote 182. *IRC § 469(c)(7)*, discussed in [5], below.

(n13)Footnote 183. *IRC § 469(j)(8).*

(n14)Footnote 184. *Temp Treas Reg § 1.469-1T(e)(3)(i)(B).*

(n15)Footnote 185. *Temp Treas Reg § 1.469-1T(e)(3)(ii).*

(n16)Footnote 186. See [b], below, for a discussion.

(n17)Footnote 187. See [c], below, for a discussion.

(n18)Footnote 188. See [d], below, for a discussion.

(n19)Footnote 189. See [e], below, for a discussion.

(n20)Footnote 190. See [f], below, for a discussion.

(n21)Footnote 191. See [g], below, for a discussion.

(n22)Footnote 192. *Temp Treas Reg § 1.469-1T(e)(3)(ii)*; *Akers v Commr, TC Memo 2010-85 (2010)* (average period of customer use was three days).

(n23)Footnote 193. *Treas Reg § 1.469-1(e)(3)(iii)(A)*.

(n24)Footnote 193.1. *Temp Treas Reg § 1.469-1T(e)(3)(ii)*.

(n25)Footnote 193.2. See *IRC § 469(c)(1)(B)*; *Madler v Commr, TC Memo 1998-112 (1998)* .

(n26)Footnote 194. *Treas Reg § 1.469-1(e)(3)(iii)(B)*.

(n27)Footnote 195. *Treas Reg § 1.469-1(e)(iii)(C)*.

(n28)Footnote 196. See *Treas Reg § 1.469-1(e)(iii)*.

(n29)Footnote 197. *Treas Reg § 1.469-1(e)(3)(iii)(E)*.

(n30)Footnote 198. *Temp Treas Reg § 1.469-1T(e)(3)(ii)*; *Treas Reg § 1.469-1(e)(3)(iii)*.

(n31)Footnote 199. *Treas Reg § 1.469-1(e)(3)(iii)(C)*.

(n32)Footnote 200. *Treas Reg § 1.469-1(e)(3)(iii)(D)*.

(n33)Footnote 201. See *Treas Reg § 1.469-1(e)(3)(iii)*.

(n34)Footnote 202. *Temp Treas Reg § 1.469-1T(e)(3)(ii)*.

(n35)Footnote 203. *Treas Reg § 1.469-1(e)(3)(iii)*; *Temp Treas Reg § 1.469-1(e)(3)(iii)*; see [b], immediately above, for a discussion.

(n36)Footnote 204. *Temp Treas Reg § 1.469-1T(e)(3)(iv)(A), (B)*.

(n37)Footnote 205. *Temp Treas Reg § 1.469-1T(e)(3)(iv)(A)*.

(n38)Footnote 206. See *Temp Treas Reg §§ 1.469-1T(e)(3)(ii)(B), 1.469-1T(e)(3)(iv)*.

(n39)Footnote 207. *Temp Treas Reg §§ 1.469-1T(e)(3)(ii)(C), 1.469-1T(e)(3)(v)*.

(n40)Footnote 208. *Temp Treas Reg § 1.469-1T(e)(3)(v)*.

(n41)Footnote 209. See TAM 9247003 ; TAM 9842001 .

(n42)Footnote 210. See *Temp Treas Reg § 1.469-1T(e)(3)(ii)(B), (C), 1.469-1T(e)(3)(iv), (v)*. See *Temp Treas Reg § 1.469-1T(e)(viii)*, Examples (1) and (2).

(n43)Footnote 211. See *Temp Treas Reg § 1.469-1T(e)(3)(ii)(C), (v)*.

(n44)Footnote 212. *Assaf v Commr, TC Memo 2005-14* .

(n45)Footnote 213. *Temp Treas Reg § 1.469-1T(e)(3)(ii)(D)*.

(n46)Footnote 214. *Temp Treas Reg § 1.469-1T(e)(3)(vi)*.

(n47)Footnote 215. *Temp Treas Reg § 1.469-1T(e)(3)(vi)(B)*.

(n48)Footnote 216. *Temp Treas Reg § 1.469-1T(e)(3)(ii)(D)*. See *Vandeyacht v Commr, TC Memo 1994-148* (court held that expenses connected with property were investment expenses and not passive activity expenses when there was no trade or business, and (1) the taxpayer-owners did not use the property, (2) minimal rental of the property to friends and family was not considered a for-profit activity, and (3) the property was held primarily for its expected appreciation in value).

(n49)Footnote 217. *Temp Treas Reg § 1.469-1T(e)(3)(viii)*, Example (5).

(n50)Footnote 218. *Temp Treas Reg § 1.469-1T(e)(3)(viii)*, Example (7).

(n51)Footnote 219. *Temp Treas Reg § 1.469-1T(e)(3)(vi)(C)*.

(n52)Footnote 219.1. *Misko, Jr v Commr, TC Memo 2005-166* (attorney conducting business through his C corporation could deduct as nonpassive the losses he incurred in leasing equipment to the law business because he met the incidental use exception).

(n53)Footnote 220. *Temp Treas Reg § 1.469-1T(e)(3)(vi)(C)*; *Treas Reg § 1.469-1(e)(3)(vi)(E)*; see *IRC § 119*.

(n54)Footnote 221. *Temp Treas Reg § 1.469-1T(e)(3)(ii)(E)*.

(n55)Footnote 222. *Temp Treas Reg § 1.469-1T(e)(3)(viii)*, Example (10).

(n56)Footnote 223. *Temp Treas Reg § 1.469-1T(e)(3)(ii)(F)*.

(n57)Footnote 224. *Temp Treas Reg § 1.469-1T(e)(3)(vii)*; see *TAM 200014010* (No joint venture found when taxpayer supplied petroleum products that were sold at convenience stores that the lessee also rented from the taxpayer; although a joint venture existed regarding the sale of petroleum products, the venture did not extend to the general operation of the convenience store. The leasing of the property was a rental activity.)

(n58)Footnote 225. *Temp Treas Reg § 1.469-1T(e)(3)(viii)*, Example (8).

(n59)Footnote 226. *IRC § 469(c)(2)*.

(n60)Footnote 227. *IRC § 469(c)(7)(A)(i)*.

(n61)Footnote 228. See *Treas Reg § 1.469-9(e)(1)*. See § 13.05, below, for a discussion of material participation.

(n62)Footnote 228.1. See *IRC § 469(c)(7)*.

(n63)Footnote 228.2. See *IRC § 469(i)*; *Akers v Commr, TC Memo 2010-78 (2010)*.

(n64)Footnote 229. See *IRC § 469(i)*; see § 13.09[5], below, for a discussion.

(n65)Footnote 230. *Treas Reg § 1.469-9(j)(1)*.

(n66)Footnote 231. See *IRC § 469(c)(7)*.

(n67)Footnote 232. *Treas Reg § 1.469-9(b)(3)*; see *Treas Reg § 1.469-4(d)(1)(i)(A)*, (C), discussed in § 13.03[4], above.

(n68)Footnote 233. *IRC § 469(c)(7)(C)*.

(n69)Footnote 234. *Treas Reg § 1.469-9(d)(1)*.

(n70)Footnote 235. *Treas Reg § 1.469-9(d)(2)*.

(n71)Footnote 236. See *IRC § 469(c)(7)*.

(n72)Footnote 237. *IRC § 469(c)(7)(A)(ii)*; *Treas Reg § 1.469-9(e)(1)*.

(n73)Footnote 238. *Treas Reg § 1.469-9(g)(3)*; see *Trask v Commr, TC Memo 2010-78 (2010)* (consistent aggregation of rental income and expenses from multiple rental properties over several years did not constitute a valid election); *Kosonen v Commr, TC Memo 2000-107* (court held that mere aggregation of losses from rental properties on tax return without an express statement of election did not constitute an election).

(n74)Footnote 239. *Ltr Rul 201029004* ; *Ltr Rul 201027028* ; *Ltr Rul 201027018* ; *Ltr Rul 201026002* ; *Ltr Rul 201014038* ; *Ltr Rul 200946011* ; *Ltr Rul 200009040* ; *Ltr Rul 200206016* ; *Ltr Rul 200332004* ; *Ltr Rul 200303052* ; *Ltr Rul 200534003* ; *Ltr Rul 200606017* ; *Ltr Rul 200816005*, *Ltr Rul 200834020* .

(n75)Footnote 240. *Treas Reg § 1.469-9(g)(3)*.

(n76)Footnote 241. *Treas Reg § 1.469-9(g)(1)*; see *Treas Reg § 1.469-4* and § 13.03, above, for a discussion of activity grouping rules.

(n77)Footnote 242. *IRC § 469(c)(7)(B)*; *Trask v Commr, TC Memo 2010-78 (2010)* (tests met; taxpayer offered evidence of handling over 80 issues for 11 pieces of property, including work logs and details of repairs); *Lee v Commr, TC Memo 2006-193* (tests not met because reconstructed time logs and testimony were not credible); *Mowafi v Commr, TC Memo 2001-111* (tests not met because the only evidence offered by the taxpayer was his testimony and logs prepared several years after the year in issue); *Bailey v Commr, TC Memo 2001-296* (taxpayer's ballpark guess of time spent in real property trades or business did not satisfy the reasonable means of establishing participation under *Temp Treas Reg § 1.469-5T(f)(4)*).

(n78)Footnote 243. See § 13.05, below, for a discussion of material participation.

(n79)Footnote 244. *Fowler v Commr, TC Memo 2002-223* ; *DeGuzman v US, 2001-2 USTC P 50,560 (D NJ 2001)* (750-hour service requirement not met).

(n80)Footnote 245. *IRC § 469(c)(7)(B)*.

(n81)Footnote 245.1. See § 13.05[9], below.

(n82)Footnote 245.2. *Goolsby v Commr, TC Memo 2010-64 (2010)* (activity log created after audit began and which contained implausible hours of service was insufficient).

(n83)Footnote 246. See [c], above, for a discussion of the election.

(n84)Footnote 247. See *IRC § 469(c)(7)(A)(ii)*; *Fowler v Commr, TC Memo 2002-223* ; *Shaw v Commr, TC Memo 2002-35* ; *Kosonen v Commr, TC Memo 2000-107* .

(n85)Footnote 248. *Treas Reg § 1.469-9(b)(4)*.

(n86)Footnote 249. *IRC § 469(c)(7)(D)(ii)*; *Treas Reg § 1.469-9(c)(5)*; see *IRC § 416(i)(1)(B)* (definition and rules for determining 5-percent owner).

- (n87)Footnote 250. *Treas Reg* § 1.469-9(c)(5).
- (n88)Footnote 251. *Pungot v Commr, TC Memo 2000-60*.
- (n89)Footnote 252. See *IRC* § 469(c)(7)(B).
- (n90)Footnote 253. *IRC* § 469(c)(7)(D)(i); *Treas Reg* § 1.469-9(c)(2); see *IRC* § 469(h)(4).
- (n91)Footnote 254. *Treas Reg* § 1.469-9(c)(2); see *Temp Treas Reg* § 1.469-2T(c)(3) (listing of items of portfolio income).
- (n92)Footnote 255. See *IRC* § 469(c)(7).
- (n93)Footnote 256. *Treas Reg* § 1.469-9(e)(3)(i).
- (n94)Footnote 257. See *Treas Reg* § 1.469-5(f) and *Temp Treas Reg* § 1.469-5T(f).
- (n95)Footnote 258. *Treas Reg* § 1.469-9(e)(3)(ii).
- (n96)Footnote 259. *Treas Reg* § 1.469-9(h)(1).
- (n97)Footnote 260. *Treas Reg* § 1.469-9(h)(2).
- (n98)Footnote 261. *Treas Reg* § 1.469-9(h)(3).
- (n99)Footnote 262. *IRC* § 469(c)(7)(A).
- (n100)Footnote 263. *Treas Reg* § 1.469-9(f)(1); see *Treas Reg* § 1.469-5T(e)(2); see § 13.05[3], below, for a discussion of these tests.
- (n101)Footnote 264. *Treas Reg* § 1.469-9(f)(2).
- (n102)Footnote 265. *IRC* § 469(c)(3)(A).
- (n103)Footnote 266. *IRC* § 469(c)(4).
- (n104)Footnote 267. *Treas Reg* §§ 1.469-1(e)(4)(iv), 1.612-4(a).
- (n105)Footnote 267.1. See *IRC* § 469(c)(3)(A).
- (n106)Footnote 267.2. CCA 200952054.
- (n107)Footnote 268. *Temp Treas Reg* § 1.469-1T(e)(4)(ii).
- (n108)Footnote 269. *IRC* § 469(c)(3)(B); *Treas Reg* § 1.469-2(c)(6)(i).
- (n109)Footnote 270. *Treas Reg* § 1.469-2(c)(6)(iii).
- (n110)Footnote 271. *Temp Treas Reg* § 1.469-1T(j)(2)(iii).

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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.05

§ 13.05 Taxpayers Subject to the Passive Activity Limitations

[1] Material Participation Can Avoid Classification as Passive Activity

An activity is generally not a passive activity if the taxpayer materially participates in it. n272 Therefore, if a taxpayer materially participates in an activity, income from the activity is nonpassive and cannot be used to trigger passive losses. On the other hand, if the taxpayer does not materially participate, losses are not deductible unless the taxpayer has passive income from another activity. n273 Whether a taxpayer materially participates is therefore a critical inquiry in nonrental real estate activities and the few rental real estate activities that are not automatically passive activities. Whether a taxpayer materially participates in a particular activity is determined anew each year. n274

There are two exceptions, under which an activity may be passive even if the taxpayer materially participates in the activity. First, rental activities are generally treated as passive whether or not the taxpayer materially participates. n275 Second, certain working interests in oil and gas property are treated as passive whether or not the taxpayer materially participates in the activity. n276

Generally, a taxpayer can be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. n277 In making this determination, the participation of the taxpayer's spouse is taken into account, n278 without regard to whether the spouse owns an interest in the activity or whether the spouses file a joint return. n279

Regulations set forth seven alternative tests for determining material participation by individuals. A taxpayer can be treated as materially participating in an activity for a tax year only by meeting one of the tests. n280 Special rules apply with respect to material participation by limited partners in limited partnerships, n281 material participation by closely held C corporations and personal service corporations, n282 material participation by trusts and estates, n283 material participation by passthrough entities, n284 and material participation in farming activity by retired individuals and surviving spouses, n285 The work that is taken into account in evaluating material participation is described in [8], below.

[2] Alternative Tests for Material Participation by Individuals

[a] Satisfaction of One of The Alternative Tests Will Qualify as Material Participation

An individual is treated as materially participating in an activity for a taxable year if and only if the individual satisfies any one of seven alternative tests. n286 Whether an individual materially participates in an activity must be determined each year. Meeting any one of the tests will satisfy the material participation standard for that year, even if the test met is a different one from the one met in a prior year. n287

NOTE:

A red flag to the IRS indicating that material participation in an activity may not be present is out-of-state employer identification numbers (EIN) on flow through losses that have been deducted in full in the non-passive loss column on Schedule E. Another audit trigger can be a Schedule C or F with out-of-state EINs and wages or labor indicating an on-site manager. For partnerships or S corporations, the IRS reviews Forms 1120-S and 1065 for listings of investors with out-of-state EINs or small percentages of ownership, both of which can indicate a lack of material participation.

[b] More Than 500 Hours Test

An individual is treated as materially participating in an activity for a taxable year if the individual participates in the activity for more than 500 hours during the year. n288

Practice Tip:

This test is a simple, numeric one. Proving the hours of participation, however, is more problematic. n289 Even with supporting evidence, IRS examiners will determine whether the quantity of time documented is reasonable in light of the taxpayer's other obligations. For example, it would be difficult for a surgeon who is on call to materially participate in an activity operating in an out-of-town location. Similarly, large W-2 wages from an employer could indicate that the taxpayer might have difficulty applying 500 hours to another activity, particularly if it is located a significant distance from his or her personal residence or place of employment. n290 In addition, the IRS may determine that the work done is that of an investor or that it otherwise cannot be taken into account in determining material participation. This can eliminate many hours from the 500-hour goal. n291

[c] Substantially All Participation Test

An individual is treated as materially participating in an activity for a taxable year if the individual's participation in the activity for the taxable year constitutes substantially all of the participation in the activity for the year of all individuals, including those who do not own interests in the activity. n292 Meeting this test does not require a minimum number of hours of participation by the taxpayer, but does require a comparison of the activities performed by the taxpayer with those performed by others. Work by a single employee or non-owner could cause the taxpayer to fail this test. n293 The term "substantially all" is not defined or clarified by the regulations. n294

[d] 100-500 Hours and More than Anyone Else Test

An individual is treated as materially participating in an activity for a taxable year if the individual participates in the activity for more than 100 hours during the taxable year, and the individual's participation in the activity for the year is not less than that of any other individual. n295

[e] Significant Participation Activity Test

An individual is treated as materially participating in an activity for a taxable year if the activity is a "significant participation activity" (SPA) for the taxable year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours. n296

NOTE:

A taxpayer with more than one SPA, but whose aggregate hours participating in all SPAs is not more than 500, does not materially participate in any of the SPAs. n297

A "significant participation activity" is one in which the taxpayer participates for more than 100 hours, but which fails to constitute material participation under one of the other six tests. Thus, in order for an activity to be considered a significant participation activity, the taxpayer (a) must have more than 100 hours of participation; (b) must have less than 500 hours of participation, as participation in excess of 500 hours would satisfy the first alternative material participation test; n298 and (c) must not be the individual with the most hours of participation in the activity, as a person with the greatest amount of participation in the activity, if in excess of 100 hours, satisfies the third alternative material participation test. n299 To meet this test, the taxpayer must also have at least one other significant participation activity besides the one being tested. n300 A rental activity cannot be included in the significant participation. n301

Example:

Cynthia has the following activities and income/losses during the tax year:

Activity A	220 hours	\$4,000 loss
Activity B	250 hours	\$6,500 loss
Activity C	220 hours	\$6,000 income
	690 hours	\$4,500 loss

Cynthia has treated all these activities as non-passive on her return and deducted a net Schedule C loss of \$4,500. In Activities A and C, Cynthia has a part-time employee who does not participate more than Cynthia. In Activity B, Cynthia has a full-time employee who runs the business during the day

Activities A and C are non-passive since Cynthia materially participates under the "100-500 Hours and More Than Anyone Else" test. n302 Accordingly, Cynthia has net non-passive income of \$2,000 from Activities A and C. Activity B, in contrast, is passive, because the employee spends more time in the activity than Cynthia does. Activity B generates a passive loss of \$6,500. n303

NOTE:

The IRS sometimes uses this test to recharacterize the income of taxpayers who have more than one business activity reporting passive income, especially if it appears that gains from these activities are being used to offset rental losses. The IRS will use this SPA test to find material participation and recharacterize those gains as non-passive. n304

[f] Any Five of Ten Past Years Test

An individual is treated as materially participating in an activity for a taxable year if the individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately preceded the taxable year in question. n305 Material participation for the prior years must be determined under one of the other alternative tests. n306

NOTE:

This test can be a two-edged sword. On one hand, it may enable a taxpayer to deduct current year losses in full as non-passive. On the other hand, a taxpayer who has materially participated in any 5 of the prior 10 years must thereby treat income from the activity in the current year as non-passive, even if the activity would otherwise be considered passive in the current year. This will preclude the use of income from the activity to offset other passive losses. Income issues arise on audit with respect to this test more

frequently than loss issues. n307

[g] Any Three Years in Personal Service Activity Test

An individual is treated as materially participating in an activity for a taxable year if the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year in question. n308 A personal service activity for this purpose includes activity performed in any trade or business in which capital is not a material income-producing factor. It also specifically includes activity performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. n309

[h] Facts and Circumstances Test

An individual is treated as materially participating in an activity for a taxable year if, based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year. n310 Regulations clarify that this test can be met only if the taxpayer materially participates in the activity for at least 100 hours during the taxable year. n311 Services performed in the management of an activity cannot be taken into account unless: (a) no other person receives compensation for performing management services, and (b) no other person spends more hours than the taxpayer managing the activity. n312

NOTE:

Taxpayers typically argue the facts and circumstances test when they fail the others. As a practical matter, however, the stringent limitations prevent most taxpayers from meeting the facts and circumstances standard. n313

[3] Material Participation by Limited Partners

Generally, limited partners cannot be treated as materially participating in any activity of a limited partnership in which they hold an interest. n314 This restriction applies with respect to applying the passive activity restrictions to the individual's share of income, gain, loss, deduction or credit from activity that is attributable to the limited partnership interest in the partnership, and to any gain or loss from that activity that is recognized upon a sale or exchange of the interest. n315

The only exceptions to this rule are if: n316

- the limited partner participates in the activity for more than 500 hours during the year;
- the limited partner materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year in question; or
- the activity is a personal service activity, and the limited partner materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year in question. n317

A limited partnership interest is one that is designated as such by the entity documents, without regard to whether the liability of the limited partner is limited under state law, or one under which the liability of the holder of the interest is limited under state law to a determinable fixed amount (such as the capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership). n318 An individual's interest in a partnership cannot be treated as a limited partnership interest if the individual is a general partner at all times during the partnership's tax year ending with or within the individual's tax year. n319

NOTE:

The IRS has made several attempts to treat member interests in LLCs as limited partnership interests for purposes of applying the passive activity rules. It has also tried to treat limited liability partnerships (LLPs) as limited partnerships for purposes of applying the passive activity rules. Courts have so far refused to treat ownership interests in these entities as limited partnership interests for purposes of *IRC Section 469(h)(2)*. Instead, LLP and LLC members are treated as general partners for purposes of *IRC Section 469(h)(2)*, and are therefore not subject to that provision. These court decisions allow LLPs and LLCs to avoid the statutory presumption which applies to limited partnerships--i.e. that losses from those entities are passive. n319.1 Furthermore, a member whose interest in an LLC is not a limited partnership interest may be able to establish material participation in the LLC, so that losses from the LLC will not be passive. n319.2 In light of these losses before courts, the IRS has added material participation under *IRC Section 469* to its guidance business plan, but it is unclear what the focus of the future guidance will be. The above cases leave open the application of the self-employment tax for taxpayers with interests in LLCs and LLPs. Because those interests are not treated as limited partnership interests by the cases, the IRS has a stronger position in claiming that distributive shares of income from those entities are net earnings from self-employment and subject to the self-employment tax. Taxpayers will likely be less successful in arguing that the exception for distributive shares of income of limited partners n319.3 applies. This aspect is discussed in numerous articles. n319.4

[4] Material Participation by Closely Held C Corporations and Personal Service Corporations

For personal service corporations and closely held C corporations, material participation is generally determined with reference to the participation of shareholders with aggregate ownership of more than 50 percent in value of the corporation's outstanding stock. n320 For this purpose, all activities of the corporation are treated as activities that the individual holds an interest in. n321 In addition, an individual's participation in all noncorporate activities is disregarded. n322

Closely held C corporations that are not personal service corporations also have an important alternative means of meeting the material participation requirement that does not require active involvement in an activity by shareholders owning more than a majority of the stock. The alternative test is applied to each activity of the corporation for which the material participation test would be relevant. The corporation is considered to have materially participated in any activity that is a "qualifying business" for purposes of the at-risk rules, n323 without regard to whether the activity is an "excluded business" for purposes of the at-risk rules. Under this alternative test, a closely held C corporation is treated as materially participating in an activity if the following three requirements are met with respect to that activity: n324

- During the entire taxable year, the corporation had at least 1 full-time employee substantially all of whose services were in the management of the activity;
- During the entire taxable year, the corporation had at least 3 full-time, non-owner employees. A "non-owner employee" is one who does not own more than 5 percent in value of the corporation's outstanding stock at any time during the taxable year, n325 and substantially all of whose services were directly related to that activity; and
- Allowable trade or business deductions n326 and deductions for employer contributions to deferred payment employee trusts and annuity plans n327 attributable to the activity for the taxable year exceed 15 percent of the gross income from the activity for that year.

[5] Material Participation by Trusts and Estates

When an entity rather than an individual is the taxpayer, the material participation rules are modified. In general,

entities potentially subject to the passive activity limitations are treated as materially participating in an activity if the appropriate related individuals are considered to be material participants.

For trusts (other than grantor trusts), the IRS takes the position that material participation must be determined by looking to the activities performed by the trustee or fiduciary in that capacity. Thus, the IRS takes the position that the sole means by which a trust may establish material participation is by having its fiduciary being involved in the operations of the activity on a regular, continuous, and substantial basis. n328 A court, however, has rejected this position and has held that the proper focus is on the activities of the entire trust, taking into account all activities of the trust fiduciaries, agents, and trustees. n329 For estates, the IRS also takes the position that material participation by the executor or administrator determines the character of the income and deductions of the estate for purposes of computing the estate's taxable income. n330

[6] Material Participation by Passthrough Entities

Material participation by partnerships, S corporations, and LLCs taxed as partnerships is determined with respect to each partner, shareholder, or LLC member. The participation is determined with reference to the taxable year of the entity, rather than the taxable year of the taxpayer. n331 This material participation is also treated as material participation in applying two of the alternative tests for material participation--the 5-of-past-10 years test n332 and the 3-year personal service activity test. n333

[7] Material Participation by Retirees and Surviving Spouses in Farming Activities

A special rule recognizes material participation in farming activities by disabled and retired farmers and surviving spouses of deceased farmers. n334 Material participation for these taxpayers is determined by reference to estate tax special use valuation rules for farm property. The material participation requirement for decedents under the estate tax rules is met if a decedent materially participates in the operation of a farm or other business for 5 of the 8 years ending on the decedent's death. n335 A decedent is treated as meeting this requirement, however, if he or she meets that requirement for 5 of the 8 years ending on the date he or she began receiving old-age Social Security benefits or became continuously disabled, but had materially participated in that farming activity until that time. Therefore, disabled and retired farmers meet the material participation requirement if they materially participate in farming activity in 5 of 8 years before the began receiving old-age Social Security benefits or became continuously disabled. n336

A surviving spouse of a farmer is treated as materially participating in a farming activity if the real property used in the activity meets the estate tax rules for special valuation of farm property passed from a qualifying decedent, and the surviving spouse continues to actively manage the farm. n337 This active management by the surviving spouse is treated for passive activity purposes as material participation in the operation of the farm. n338

[8] Work That Is Included in Material Participation

In determining whether any of the above material participation tests is met, n339 participation by a taxpayer's spouse is treated as participation by the taxpayer in the activity. n340

For purposes of determining material participation, all work done in connection with an activity by an individual is taken into account as participation by the individual in the activity, without regard to the capacity in which the individual does the work. Thus, work performed by an individual as an employee is taken into account as participation by that individual in the activity. The individual must own an interest in the activity at the time the work is done, however, in order for the work to be treated as participation in meeting any of the alternative tests. n341

There are three exceptions to this general rule:

(1) Work that is not customarily done by an owner is not taken into account if a principal purpose for the performance of the work is to avoid the disallowance of a passive activity loss or credit. n342

(2) Work done in the individual's capacity as an investor in the activity is not taken into account unless the individual is directly involved in the day-to-day management or operations of the activity. n343 Regulations treat the following activities as those of an investor: (a) studying and reviewing financial statements or reports on operations of the activity; (b) preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and (c) monitoring the finances or operations of the activity in a non-managerial capacity. n344 Participation on a condominium board, however, has been held to go beyond mere investor participation, and can be taken into account in satisfying material participation requirements. n345

(3) For the facts-and-circumstances test only (but not the other alternative tests), n346 services performed in the management of an activity cannot be taken into account, unless: (a) no other management person receives compensation for performing the services, and (b) no other management person devotes more management hours to the activity. n347 This rule has been applied to prevent services performed on a condo association board from being taken into account for purposes of material participation when others receive compensation for management services in connection with the operation of the condominium association. n348

[9] Material Participation May Be Established by Any Reasonable Means

Material participation may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required. The regulations indicate that reasonable means may include identification of services performed over a period of time and the approximate number of hours spent performing services during that period, based on appointment books, calendars, or narrative summaries. n349

Practice Tip:

Even though the regulations impose no specific record-keeping requirements to establish material participation, n350 most of the alternative tests require a minimum number of hours of participation. n351 Therefore, although not required to do so, taxpayers wishing to avoid the passive activity limitations with respect to an activity should keep contemporaneous logs detailing the hours of their participation and the particular activities performed. Ballpark "guesstimates" will not suffice. n352 In addition, courts routinely reject testimony about participation that is not corroborated by other contemporaneously-produced evidence. They also give little credibility to time logs, summary reports, or other records that are produced several years after the alleged participation took place, or after an audit has begun. n353 The necessity of keeping track of participation in activities can also arise when taxpayers wish to show that they did not materially participate in an activity, in order to show that an activity was passive. In one case, the taxpayers wanted to offset undisputed passive losses against income from another activity, but they failed to show that they did not materially participate in that activity. n354 If contemporaneously made records are lost or destroyed, a taxpayer should attempt to reconstruct them at the time the loss or destruction is discovered. A taxpayer who fails to do so or who attempts to reconstruct records years later on audit or in preparation for trial will almost never be able to credibly establish material participation. n354.1

FOOTNOTES:

(n1)Footnote 272. IRC § 469(c)(1)(B).

(n2)Footnote 273. IRC § 469(a)(1).

(n3)Footnote 274. See *IRC § 469(a), (h)*.

(n4)Footnote 275. *IRC § 469(c)(4)*; see also § 13.04[5], above, for a discussion of the exception under *IRC § 469(c)(7)* under which taxpayers may show that certain rental real estate activities are non-passive.

(n5)Footnote 276. *IRC § 469(c)(3)*; see § 13.04[6], above, for a discussion.

(n6)Footnote 277. *IRC § 469(h)(1)*; *Toups v Commr, TC Memo 1993-359* (taxpayers' activities as mere investors in rental cottage were not material participation, and therefore the passive activity limitations applied to their losses. Their hours of travel were considered investor hours).

(n7)Footnote 278. *IRC § 469(h)(5)*.

(n8)Footnote 279. *Temp Treas Reg § 1.469-1.469-5T(f)(3)*.

(n9)Footnote 280. *Temp Treas Reg § 1.469-5T(a)*; see [2], below, for a discussion of the tests.

(n10)Footnote 281. *IRC § 469(h)(2)*; see [3], below, for a discussion.

(n11)Footnote 282. *IRC § 469(h)(4)*; see [4], below, for a discussion.

(n12)Footnote 283. See [5], below, for a discussion.

(n13)Footnote 284. See [6], below, for a discussion.

(n14)Footnote 285. *IRC § 469(h)(3)*; see [7], below, for a discussion.

(n15)Footnote 286. *Temp Treas Reg § 1.469-5T(a)(1)-(7)*; see [b]-[h], below.

(n16)Footnote 287. See *IRC § 469(a), (h)*; see *Temp Treas Reg § 1.469-5T(a)*.

(n17)Footnote 288. *Temp Treas Reg § 1.469-5T(a)(1)*.

(n18)Footnote 289. See [9], below, for a discussion of means that may be used to show material participation.

(n19)Footnote 290. See *Temp Treas Reg § 1.469-5T(a)(1)*.

(n20)Footnote 291. See *Treas Reg § 1.469-5(f)(1)*; *Temp Treas Reg § 1.469-5T(f)(2)*. See [8], below, for a discussion of work taken into account.

(n21)Footnote 292. *Temp Treas Reg § 1.469-5T(a)(2)*.

(n22)Footnote 293. See *Akers v Commr, TC Memo 2010-85 (2010)* (test not met in part because of activities by daughter, outside professionals, and property management company); *Bailey v Commr, TC Memo 2001-296* (test not met in part because of extensive activities by a real estate management company with respect to the taxpayer's property); *Chapin v Commr, TC Memo 1996-56* (test not met with respect to taxpayers' beach condo; most activities with respect to the condo were performed by a rental agent).

(n23)Footnote 294. See *Temp Treas Reg § 1.469-5T(a)*.

(n24)Footnote 295. *Temp Treas Reg § 1.469-5T(a)(3)*; see *Akers v Commr, TC Memo 2010-85 (2010)* (taxpayer didn't prove 100 hours of participation, and daughter, outside professionals, and property management company performed services); *Serenbetz v Commr, TC Memo 1996-510* (taxpayers' activities with respect to a resort condo were held to be those of investors; court rejected argument that activities performed by on-site staff had to be determined on a

per-unit basis); *Scheiner v Commr*, TC Memo 1996-554 (taxpayer's activity on condo board was counted toward material participation in condo rental activity, but participation of full-time staff exceeded hours spent by the taxpayer, and they were compensated); *Pohoski v Commr*, TC Memo 1998-17 (taxpayers met the safe harbor for a vacation condo, by providing ample evidence of their time and efforts, which exceeded that of the managing corporation and maid staff); *Chapin v Commr*, TC Memo 1996-56 (test was not met with respect to taxpayers' beach condo because most of the activities with respect to the condo were performed by a rental agent).

(n25)Footnote 296. *Temp Treas Reg* § 1.469-5T(a)(4), (c); *Shaw v Commr*, TC Memo 2002-35 (taxpayer could not include participation in rental activities as significant participation activity in meeting the 500-hour test).

(n26)Footnote 297. See *Temp Treas Reg* § 1.469-5T(a)(4), (c).

(n27)Footnote 298. See *Temp Treas Reg* § 1.469-5T(a)(1).

(n28)Footnote 299. See *Scheiner v Commr*, TC Memo 1996-554 . See *Temp Treas Reg* § 1.469-5T(a)(3).

(n29)Footnote 300. See *Temp Treas Reg* § 1.469-5T(a)(4).

(n30)Footnote 301. See *Temp Treas Reg* § 1.469-5T(c)(1); *Shaw v Commr*, TC Memo 2002-35 .

(n31)Footnote 302. See *Temp Treas Reg* § 1.469-5T(a)(3); see [d], above, for a discussion.

(n32)Footnote 303. See *Temp Treas Reg* § 1.469-5T(a)(4), (c).

(n33)Footnote 304. See *Temp Treas Reg* § 1.469-5T(a)(4), (c).

(n34)Footnote 305. *Temp Treas Reg* § 1.469-5T(a)(5).

(n35)Footnote 306. See *Treas Reg* § 1.469-5(k), Example (5); *Temp Treas Reg* § 1.469-5T(k), Example (6).

(n36)Footnote 307. See *Temp Treas Reg* § 1.469-5T(a)(5).

(n37)Footnote 308. *Temp Treas Reg* § 1.469-5T(a)(6).

(n38)Footnote 309. See *Temp Treas Reg* § 1.469-5T(d).

(n39)Footnote 310. *Temp Treas Reg* § 1.469-5T(a)(7). see *Chapin v Commr*, TC Memo 1996-56 (test not met with respect to taxpayers' beach condo).

(n40)Footnote 311. *Temp Treas Reg* § 1.469-5T(b)(2)(iii).

(n41)Footnote 312. *Temp Treas Reg* § 1.469-5T(b)(2)(ii).

(n42)Footnote 313. See *Temp Treas Reg* § 1.469-5T(a)(7), (b).

(n43)Footnote 314. *IRC* § 469(h)(2); *Temp Treas Reg* § 1.469-5T(e).

(n44)Footnote 315. *Temp Treas Reg* § 1.469-5T(e)(1).

(n45)Footnote 316. *Temp Treas Reg* § 1.469-5T(a)(1), (5), (6), (e)(2).

(n46)Footnote 317. See *Temp Treas Reg* § 1.469-5T(a)(6); see [2], above, for a discussion of the material participation tests.

(n47)Footnote 318. *Temp Treas Reg § 1.469-5T(e)(3)(i)*.

(n48)Footnote 319. *Temp Treas Reg § 1.469-5T(e)(3)(ii)*.

(n49)Footnote 319.1. *Garnett v Commr*, 132 TC No 19 (2009) (LLP and LLC interests); *Gregg v US*, 186 F Supp 2d 1123 (D Or 2000) (LLC interests); *Thompson v US*, 2009-2 USTC P 50,501, 87 Fed Cl 728, 2009 US Claims Lexis 250 (US Ct of Fed Claims 2009), *acq in result only* AOD 2010-02 [see 2010-14 IRB] (member interest in LLC is not limited partnership interest); *Newell v Commr*, TC Memo 2010-23 (2010) (taxpayer's managing member interest in a California LLC was not a limited partnership interest in a limited partnership; both state law and the LLC's operating agreement authorized him to act on the LLC's behalf and manage the LLC's operations); *Hegarty v Commr*, TC Summary Opinion 2009-153. Note that Tax Court summary opinions cannot be treated as precedent [IRC § 7463(b)]. The cases have been the subject of commentary; see Coder and Elliott, "Claims Court Rejects Passive Loss Limits on LLC Interests," 124 Tax Notes 311 (July 27, 2009); Kalinka, "Garnett and Thompson: Tax Court Holds LLC and LLP Members Are General Partners Under Code Sec. 469(h)(2); U.S. Court of Federal Claims Agrees, Part II: Unanswered Questions," 87 Taxes 9 (Nov 2009); Luscombe, "Treatment of Losses of Limited Liability Companies," 87 Taxes 3 (Sept 2009); "Value of the *Garnett* and *Thompson* Opinions," 87 Taxes 13 (Sept 2009); "LLC Is Not Limited Partnership for Passive Loss Rule," 82 Practical Tax Strategies 180 (Sept 2009); S Banoff and R Lipton, "Passive Losses, LLCs and LLPs--Two Courts Reject the Service's Attempt to Limit Losses," 110 J of Taxation 204 (Oct 2009); V Valdez, "Passive Activity Rules Not Presumed to Apply to LLCs and LLPs," 40 The Tax Adviser 671 (Oct 2009).

(n50)Footnote 319.2. *Thompson v US*, 2009-2 USTC P 50,501, 87 Fed Cl 728, 2009 U.S. Claims Lexis 250 (US Ct of Fed Claims, 2009), *acq in result only* AOD 2010-02 [see 2010-14 IRB].

(n51)Footnote 319.3. See IRC § 1402(a)(13).

(n52)Footnote 319.4. See V Valdez, "Passive Activity Rules Not Presumed to Apply to LLCs and LLPs," 40 The Tax Adviser 671 (Oct 2009); Kalinka, "Garnett and Thompson: Tax Court Holds LLC and LLP Members Are General Partners Under Code Sec. 469(h)(2); U.S. Court of Federal Claims Agrees, Part II: Unanswered Questions," 87 Taxes 9 (Nov 2009); G Maydew, "Recent Cases Favorably Apply Passive Activity Loss Rules to LLC Interests," 82 Practical Tax Strategies 260 (Nov 2009).

(n53)Footnote 320. IRC § 469(h)(4)(A); *Temp Treas Reg § 1.469-1T(g)(3)(i)*.

(n54)Footnote 321. *Temp Treas Reg § 1.469-1T(g)(3)(iii)(A)*.

(n55)Footnote 322. *Temp Treas Reg § 1.469-1T(g)(3)(iii)(B)*.

(n56)Footnote 323. See IRC § 465.

(n57)Footnote 324. IRC § 469(h)(4)(B); see IRC § 465(c)(7)(C), but without regard to IRC § 465(c)(7)(C)(iv).

(n58)Footnote 325. IRC § 465(c)(7)(E)(i).

(n59)Footnote 326. See IRC § 162.

(n60)Footnote 327. See IRC § 404.

(n61)Footnote 328. See Ltr Rul 201029014, citing S Rep No 313, 99th Cong, 2nd Sess 735.

(n62)Footnote 329. *Mattie K. Carter Trust v US*, 256 F Supp 2d 536 (ND Tex 2003).

(n63)Footnote 330. See S Rep No 313, 99th Cong, 2nd Sess 735.

(n64)Footnote 331. *Temp Treas Reg* § 1.469-2T(e)(1).

(n65)Footnote 332. See *Temp Treas Reg* § 1.469-5T(a)(5); see [2][f], above, for a discussion.

(n66)Footnote 333. See *Temp Treas Reg* § 1.469-5T(a)(6); see [2][g], above, for a discussion.

(n67)Footnote 334. *IRC* § 469(h)(3).

(n68)Footnote 335. *IRC* § 2032A(b)(1)(C)(ii).

(n69)Footnote 336. *IRC* §§ 469(h)(3), 2032A(b)(1)(C)(ii), (4).

(n70)Footnote 337. *IRC* § 2032A(c)(5)(A).

(n71)Footnote 338. *IRC* §§ 469(h)(3), 2032A(c)(5)(A).

(n72)Footnote 339. *Temp Treas Reg* § 1.469-5T(a); discussed in [2], above.

(n73)Footnote 340. *IRC* § 469(h)(5); *Temp Treas Reg* § 1.469-5T(f)(3).

(n74)Footnote 341. *Treas Reg* § 1.469-5(f)(1).

(n75)Footnote 342. *Temp Treas Reg* § 1.469-5T(f)(2)(i).

(n76)Footnote 343. *Temp Treas Reg* § 1.469-5T(f)(2)(ii).

(n77)Footnote 344. *Temp Treas Reg* § 1.469-5T(f)(2)(ii)(B).

(n78)Footnote 345. *Scheiner v Commr*, *TC Memo* 1996-554 (although taxpayer's activity on condo board was counted in evaluating material participation in condo rental activity, the participation of compensate full-time staff exceeded hours spent by the taxpayer); see *Mordkin v Commr*, *TC Memo* 1996-187 .

(n79)Footnote 346. See *Temp Treas Reg* § 1.469-5T(a)(7); see [2][h], above, for a discussion.

(n80)Footnote 347. *Temp Treas Reg* § 1.469-5T(b)(2)(ii).

(n81)Footnote 348. *Mordkin v Commr*, *TC Memo* 1996-187 .

(n82)Footnote 349. *Temp Treas Reg* § 1.469-5T(f)(4).

(n83)Footnote 350. See *Temp Treas Reg* § 1.469-5T(f)(4).

(n84)Footnote 351. *Temp Treas Reg* § 1.469-5T(a)(1)-(6); see [2], above.

(n85)Footnote 352. *Ackerman v Commr*, *TC Memo* 2009-80 ; *Speer v Commr*, *TC Memo* 1996-323 (no records to support taxpayer's testimony); *Goshorn v Commr*, *TC Memo* 1993-578 .

(n86)Footnote 353. See *Ackerman v Commr*, *TC Memo* 2009-80 (documentation showed insufficient involvement in business matters, and testimony was unconvincing); *Shaw v Commr*, *TC Memo* 2002-35 ; *Bailey v Commr*, *TC Memo* 2001-296 ; *Rapp v Commr*, *TC Memo* 1999-249 ; *Speer v Commr*, *TC Memo* 1996-323 ; *Toups v Commr*, *TC Memo* 1993-359 ; but see *Harrison v Commr*, *TC Memo* 1996-509 (post-event narrative of activities was sufficient to establish material participation); *D'Avanzo v US*, 67 *Fed Cl* 39 (*US Ct Fed Cl* 2005) , *affd per curiam without publ opinion* 2007-1 *USTC* P 50,371 (*Fed Cir* 2007) (evidence setting forth hours worked were created 1 years after year in question).

(n87)Footnote 354. See *Carlstedt v Commr*, *TC Memo* 1997-331 .

(n88)Footnote 354.1. *D'Avanzo v US*, 67 *Fed Cl* 39 (*US Ct Fed Cl* 2005) , *affd per curiam without publ opinion* 2007-1 *USTC P* 50,371 (*Fed Cir* 2007) .

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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.06

§ 13.06 Passive Activity Income

[1] Passive Activity Gross Income Includes Income from Passive Activities

A passive activity loss occurs when the aggregate passive activity losses from all passive activities for the tax year exceed the aggregate income from passive activities for that year. n355 Unless otherwise provided by regulations, in determining the income or loss from a passive activity, passive activity gross income for a tax year includes only gross income that is from a passive activity. n356

NOTE:

IRC Section 469 was intended to prevent taxpayers from using losses from rental activities and passive business activities to shelter personal service income, active business income, and portfolio investment income. Congress recognized the difficulty of writing statutes that would clearly distinguish these different types of income. Congress also anticipated the need for additional provisions on transactions structured to maximize the amount of rental or passive income. Therefore, the Secretary was given express authority to prescribe regulations that recharacterize certain items of gross income and net income from certain activities as income not from a passive activity. n357 Numerous items discussed in the subsections below detail rules in the regulations that recharacterize items of income. It is critical to note that these rules recharacterize only income, not losses. If any of the activities result in a net loss, the loss will be treated as passive and subject to the passive loss limitations. n358

[2] Income from Portfolio Activities Generally Is Not Passive Activity Income

Portfolio activities are those typically considered to be investments. They are not treated as a passive activities, and are not subject to the passive activity rules. Income from portfolio activities is therefore not included in passive activity gross income. n359 The following items of portfolio income are specifically excluded from passive activity gross income: n360

- interest, dividends (after reduction by any dividends-received deduction n361), annuities, or royalties that are not derived in the ordinary course of a trade or business;
- expenses (other than interest) which are clearly and directly allocable to that gross income; and

- interest expense properly allocable to that gross income.

Also excluded from passive activity gross income is gain or loss not derived in the ordinary course of a trade or business which is attributable to the disposition of property held for investment, or property producing interest, dividends, annuities, royalties and other income not derived in the ordinary course of a trade or business. For this purpose, any interest in a passive activity is not treated as property held for investment. n362

For purposes of determining portfolio income, any income, gain, or loss that is attributable to an investment of working capital is treated as not derived in the ordinary course of a trade or business. n363

Regulations amplify the statutory list of items that are treated as portfolio income, and which therefore are not passive activity gross income. The following items are included: n364

- interest, annuities, royalties, dividends on C corporation stock, real estate investment trust (REIT) income, regulated investment company income, real estate mortgage investment conduit (REMIC) income, common trust fund income, income from a controlled foreign corporation, income from a qualified electing fund, and income from a cooperative;
- income from the disposition of property that produces the above type of income;
- dividends on S corporation stock; and
- income from the disposition of property held for investment

Income that is described above and that is derived in the ordinary course of a trade or business is not automatically classified as portfolio income. Rather, the character of the income is determined under the general passive activity rules (i.e., whether there was material participation in the business activity by the taxpayer). Under the regulations, however, portfolio-type income is treated as derived in the ordinary course of a trade or business only if it falls in one of the following categories: n365

- interest on loans or investments made in the ordinary course of the business of lending money;
- interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of business, but only if credit is customarily offered to customers in the business;
- income from investments made in the ordinary course of an insurance business;
- income or gain derived in the ordinary course of business of trading or dealing in property;
- certain royalties and cooperative income; or
- any other income identified by the Commissioner as income derived in the ordinary course of business.

Income derived from working capital--i.e., amounts set aside for the reasonable needs of a trade or business--is typically treated as portfolio income. Although setting aside those amounts may be necessary to the trade or business, the income earned on those set-aside amounts is investment-related and not a part of the trade or business itself. Thus, interest earned on funds set aside by a business for expansion, construction, or payment of licensing fees will usually be treated as portfolio income. n365.1

Regulations also contain a special rule for dealers in property that can have a substantial impact on real estate developers and homebuilders. Any gain or income received by a dealer in property that would otherwise be classified as income from the trade or business will be recharacterized as portfolio income if the dealer held the property for investment at any time before its disposition. Similar business losses are not subject to this recharacterization. n366 This rule has the effect of significantly reducing the passive income against which passive losses can be offset.

Example:

Tom holds unimproved land for investment for 10 years. Because of growth in the area where the land is located, Tom subdivides the land and sells the lots. Normally, the income from those sales would be treated as income derived in the business of selling the lots, and the characterization of the income as active or passive would be based on Tom's participation in the activity. However, under the special rule, The income from the sales of the lots is characterized as portfolio income because of Tom's prior investment intent with respect to the land. n367

[3] Gain from Certain Dispositions of Property Used in a Passive Activity

[a] Character of Gain as Passive or Non-passive Depends on Use of Property in Year of Disposition

Whether gain recognized from the sale, exchange or other disposition of property is passive or non-passive generally depends on the nature of the activity the property is used in at the time of disposition. The same rule applies with respect to gain from the disposition of an interest in an activity held through a partnership or S corporation. If the activity is passive for the tax year of disposition, then the gain will be treated as passive gross income. If the activity is not a passive activity for the tax year of disposition, then the gain will be treated as not from a passive activity. n368 If a portion of the property was used in any activity, while another portion was not (such as seven floors of a 10-story building being used in a trade or business activity and three floors being used in a passive rental activity), then each portion is treated as a separate interest in property. n369 The amount realized from the disposition and the adjusted basis of the property must be allocated to those separate interests in a reasonable manner. n370 Several clarifications and exceptions to these rules are discussed in [b]-[e], below.

[b] Gain Recharacterization When Property Is Used in More Than One Activity in the 12 Months Preceding Disposition

If property (or any interest in property) is used in more than one activity during the 12-month period before its disposition, the amount realized from the disposition and the adjusted basis of the property must be allocated among those different activities in a manner that reasonably reflects the use of the property during that 12-month period. n371 This recharacterization rule prevents taxpayers from changing the use of property shortly before sale in order to create a non-passive loss or a passive gain from the disposition. If the property was acquired by the taxpayer in a fully taxable transaction, any use of the property before that transaction is ignored in determining the use of property for purposes of characterizing the gain as passive or non-passive on any later disposition of the property by the taxpayer. n372

There need not be an allocation among activities under this rule, however, if the fair market value of the property being disposed of does not exceed the lesser of (1) \$10,000, or (2) 10 percent of the sum of the fair market value of that property and the fair market value of all other property used in that activity immediately before the disposition. In that case, the entire amount realized and adjusted basis of the property may be allocated solely to the activity in which the property is predominantly used during the 12-month period prior to disposition. n373

[c] Gain From Disposition of Substantially Appreciated Property Formerly Used in a Non-Passive Activity May Be Recharacterized

A special gain recharacterization rule applies when substantially appreciated property (or an interest in substantially

appreciated property) is disposed of. Substantially appreciated property for this purpose includes property with a fair market value that exceeds 120 percent of its adjusted basis. n374 Any gain from the disposition of substantially appreciated property is treated as not from a passive activity unless the property was used in a passive activity for one of the following periods: n375

- 20 percent of the period during which the taxpayer held the property; or
- the entire 24-month period ending on the date of disposition.

The "date of disposition" for this purpose is the date that the interest in property becomes subject to an oral or written agreement that either requires the owner or gives the owner an option to transfer the interest in property for consideration that is fixed or otherwise determinable on that date. n376

The regulations clarify that for purposes of this disposition rule, property is treated used in a non-passive activity and as property held for investment for any period it is held through a C corporation or similar entity. n377 If property was acquired by the taxpayer in a fully taxable transaction, any use of the property before that transaction is ignored in applying this recharacterization rule to any later disposition of the property by the taxpayer. n378

The gain that is not treated as passive activity income under this rule will be classified as portfolio income only if the property was held for investment for more than 50 percent of the time during which the owner held the property in a non-passive activity. Otherwise, it will be treated as active income. n379

Example (1):

Carla acquires a building on January 1, Year 1, and uses the building in a business activity in which she materially participates until March 31, Year 12. On April 1, Year 12, she rents the building to Rose. On December 31, Year 13, Carla sells the building for a gain of \$150,000. At that time, the fair market value of the building was \$450,000 and Carla's adjusted basis was \$300,000. Although the building was used in a passive activity at the time of disposition, Carla's gain would not be treated as passive. The property is considered substantially appreciated because its fair market value (\$450,000) is in excess of \$360,000, which is 120 percent of the \$300,000 adjusted basis. In addition, the building was not used in a passive activity for 20 percent of Carla's 13-year holding period ($13 \text{ year holding period} \times 20 \text{ percent} = 2.6$ years, and the building was not rented for that length of time before sale). In addition, the building was not used in a passive activity (in this case rented) for the 2 years prior to the sale because it was rented only 21 months before the date of sale. Since the building was not rented the entire 2 years prior to the sale and was not rented for 20 percent of the holding period, Carla's gain on disposition is recharacterized as non-passive. n380

Exmample (2)

Matt is a shareholder of Rebar Corporation. Rebar Corporation is a C corporation until December 31, Year 1, and is an S corporation thereafter. Rebar acquires a building on January 1, Year 1, and sells the building on March 1, Year 2. At the time of sale, Matt's only interest in the building is through his shares of Rebar Corporation, and the building is substantially appreciated. The building is leased to various tenants at all times, and the leasing constitutes a rental activity. Example (2): Matt is a shareholder of Rebar Corporation. Rebar Corporation is a C corporation until December 31, Year 1, and is an S corporation thereafter. Rebar acquires a building on January 1, Year 1, and sells the building on March 1, Year 2. At the time of sale, Matt's only interest in the building is through his shares of Rebar Corporation, and the building is substantially appreciated. The building is leased to various tenants at all times, and the leasing constitutes a rental activity.

Matt's interest in the building throughout Year 1 is treated as being held for investment because during

that period his interest was held through a C Corporation. Matt's interest in the building in Year 2 is treated as an interest in property used in a passive activity because for that period Rebar Corporation is an S corporation. Matt's interest in the building throughout Year 1 is treated as being held for investment because during that period his interest was held through a C Corporation. Matt's interest in the building in Year 2 is treated as an interest in property used in a passive activity because for that period Rebar Corporation is an S corporation.

The gain on the sale of the building is treated as being not from a passive activity. This is because (1) the building was not used in a passive activity for the entire 24-month period ending on the date of sale, and because the 2 months in Year 2 that the building was treated as used in a passive activity is less than 20 percent of the period during which Matt held an interest in the building ($.20 \times 14 \text{ months} = 2.8 \text{ months}$).

In addition, Matt's gain from the sale of the building is also treated portfolio income. This is because the building was held for investment for more than 50 percent of the period during which Matt held an interest in activities other than passive activities (i.e. the 12 months in Year 1). n381

[d] Gain from Disposition of Property Held for Sale to Customers May Be Recharacterized if Previously Held for Another Purpose

Special recharacterization rules (so-called "dealer rules") apply with respect to gain from the disposition of property that was held for sale to customers in the ordinary course of a trade or business (called a "dealing activity" in the regulations), but which was acquired and held by the taxpayer for some other principal purpose (called a "nondealing activity" in the regulations). For the rules to apply, the taxpayer must be engaged in nondealing activities, and the property must have been used in nondealing activities for more than 80 percent of the period during which the taxpayer held the property. n382

If the above conditions are met, holding of the property in the dealing activity is ignored. Instead, for purposes of characterizing gain as passive or non-passive, the property is treated as being used in the last nondealing activity of the taxpayer in which the property was used before its disposition. n383

In contrast, if the above conditions are not met, and the property is used in a nondealing activity that is merely incidental to its sale, then the use of the property in the nondealing activity is ignored, and for purposes of characterizing the gain as passive or non-passive, the property is treated as being used in the dealing activity. n384

The regulations provide a rebuttable presumption as to the principal purpose for which property is acquired and held. A taxpayer is presumed to have acquired and held an interest in property principally for the purpose of selling it to customers in the ordinary course of business if either of the following is met n385

- The taxpayer used the property in nondealing activities for the lesser of 24 months or 20 percent of the property's recovery period; or
- The taxpayer simultaneously offered the property for sale to customers and used it in a nondealing activity for more than 25 percent of the period during which the property was used in nondealing activities. The grant to a lessee of an option to purchase the property is not treated as an offer of property for sale to customers for this purpose.

Example (1):

Terry acquires a residential apartment building on January 1 of Year 1 and uses it in a rental activity. On January 1, Year 4, Terry converts the apartments into condominium units. After the conversion, Terry

holds the units for sale to customers in the ordinary course of business. In addition, Terry continues to use the units in the rental activity until they are sold. The units are first held for sale on January 1, Year 4 and the last unit is sold on December 31, Year 4.

The apartments were used in a rental activity for the entire period Terry held them. Therefore they were used in a nondealing activity for more than 80 percent of Terry's holding period in the property, and the marketing of the property satisfies the holding period requirement. In addition, the apartments were used in rental activity for 36 to 48 months (i.e. from January 1, Year 1 through the date of sale in the period from January through December, Year 4). They were therefore used in nondealing activity for more than 24 months, so the first rebuttable presumption above does not apply. Because the apartments were offered for sale only for 12 months, no apartment was offered for sale to customers during more than 25 percent of the period during which the property was used in nondealing activities. Therefore, the second rebuttable presumption does not apply.

Terry is therefore not treated as having a dealer purpose unless other facts and circumstances establish that he acquired and held the apartments for the principal purpose of selling them to customers in the ordinary course of business. Assuming this is not the case, Terry's holding the apartments in his dealing activity is treated as the use of the apartments in his nondealing activity. This nondealing activity was rental activity. Therefore, the apartments are treated as having been used in rental activity for the entire period Terry held interests in them, and all gain from the sale of the apartments is treated as passive activity gross income. n386

Example (2):

Assume the same facts as in Example (1), except that Terry converts the apartments into condominium units on July 1 of Year 1 and the first unit is sold on January 1 of Year 2 and the final unit is sold on December 31 of Year 3. Because all the apartments are simultaneously offered for sale to customers and used in a nondealing activity for more than 25 percent of the period during which they were used in dealing activity, Terry is rebuttably presumed to have acquired the apartments (including those used in rental activity for at least 24 months) for the principal purpose of selling them to customers in the ordinary course of a trade or business. If the facts and circumstances do not rebut this presumption, Terry has a dealing purpose and the rental of the apartment is treated as part of that dealing activity. Gain from the sale of the apartments is treated as income from Terry's dealing activity. n387

[e] Gain From Dispositions of Partnership Interests and S Corporation Stock is Allocated Among Different Activities of the Entity

For purposes of characterizing gain or loss for purposes of the passive activity limitations, the gain or loss from a disposition of a partnership interest, S corporation stock, or an interest in an other passthrough entity is treated as gain or loss from the disposition of interests in the various activities in which the partnership, S corporation, or other passthrough entity has an interest. n388 Thus, if a holder of an interest in a passthrough entity disposes of the interest, a ratable portion of any gain or loss from the disposition is treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which the passthrough entity owns an interest. n389

When there is a gain on the disposition, the ratable portion of gain that is allocated to an activity is determined by dividing (1) the net gain that would have been allocated to the holder of the interest had the entity sold its entire interest in the activity for its fair market value on the applicable valuation date, by (2) the total net gain that would have been allocated to the holder of the interest had the entity sold its entire interest in each appreciated activity for its fair market value on the applicable valuation date. n390

When there is a loss on the disposition, the ratable portion of loss that is allocated to an activity is determined by

dividing (1) the net loss that would have been allocated to the holder of the interest had the entity sold its entire interest in the activity for its fair market value on the applicable valuation date, by (2) the total net loss that would have been allocated to the holder of the interest had the entity sold its entire interest in each depreciated activity for its fair market value on the applicable valuation date. n391

If an allocation cannot be done under one of the above rules, a default rule applies, under which gain or loss is allocated to activities in proportion to their respective fair market values of the entity's interest in them on the applicable valuation date. The gain or loss allocated to each activity is treated as gain or loss from the disposition of an interest in that activity. n392

The gain from a holder's disposition of an interest in a passthrough entity that is allocated to a passive activity may be treated as gain that is not from a passive activity under certain circumstances. This rule is designed to prevent taxpayers from using passthrough entities to structure dispositions of property to generate passive income, when the income would not otherwise be from a passive activity. n393 If the amount of gain from the disposition that would have been treated as non-passive under one of the recharacterization rules n394 exceeds 10 percent of the total amount of the gain that is allocated to the passive activity, n395 then the gain recognized from the disposition of the interest is treated as gain that is non-passive. n396

A special disposition rule applies for interests in publicly traded partnerships. A taxpayer is not treated as having disposed of an entire interest in an activity of a publicly traded partnership until the taxpayer completely disposes of his or her entire interest in the partnership. n397

For purposes of the above rules, the "applicable valuation date" is, at the choice of the entity, either the beginning of the tax year of the entity in which the disposition occurs, or the date of the disposition. n398 The valuation date is the date before the date of the disposition, however, if any of the following occur after the beginning of the entity's tax year and before the date of the disposition: n399

- the entity disposes of more than 10 percent of its interest by value in any activity;
- more than 10 percent of the property by value used in any activity by the entity is disposed of; or
- the holder of the interest disposed of contributes to the entity substantially appreciated or depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the entity as of the beginning of the tax year.

[4] Compensation for Personal Services Is Not Passive Activity Income

Earned income and other compensation for personal services is excluded from passive activity gross income. n400 Earned income from personal services includes wages, fees, salaries, and commissions. n401 Other compensation for this purpose includes property transferred in connection with the performance of services, n402 distributions from employee retirement and pension plans and employee annuities, Social Security benefits, and other compensation for personal services. n403 The rule is unambiguous and its application is clear for most taxpayers. Its purpose is to emphasize that even if personal service income is received in connection with a passive activity, it must be treated as a separate activity. n404

Regulations point out, however, that no portion of a partner's distributive share of partnership income or a shareholder's pro rata share of income from an S corporation is treated as compensation for personal services. n405 Unexpected results can follow from this treatment. For example, assume the sole shareholder in an S corporation engaged in a passive activity receives a salary of \$5,000 for services and that the deduction at the corporate level will result in a \$5,000 loss. The individual will have \$5,000 in earned income and a \$5,000 passive activity loss passed through from

the S corporation. The passive loss cannot be used to offset the income, and the taxpayer will have \$5,000 in taxable income. n406

[5] Cancellation of Indebtedness Income May Be Treated as Passive Activity Income

The IRS has ruled that cancellation of indebtedness income (COD income) is properly characterized as income from a passive activity if, at the time the indebtedness is discharged, the debt is allocated to passive activity expenditures in a manner consistent with interest tracing rules in temporary regulations. n407 To the extent the debt being discharged cannot be allocated to passive activity expenditures, the IRS takes the position that the resulting COD income must be characterized as income from a non-passive activity. n408

[6] Recharacterization of Income from Significant Participation Passive Activities

The regulations distinguish between a significant participation activity (SPA) and a significant participation passive activity (SPPA). For an activity to be an SPA or SPPA, an individual must significantly participate in the activity for a taxable year, i.e. participate for more than 100 hours during the year. n409

An activity is an SPA of an individual only if it is a trade or business activity in which the individual "significantly" participates, but does not "materially" participate for the taxable year (i.e. participates between 100 and 500 hours during the year). Because the trade or business requirement, an SPA cannot be a rental activity. n410 For this purpose, material participation is determined by disregarding the aggregation rule discussed below under which all SPAs of an individual are aggregated. n411

An SPPA is essentially the same as an SPA. The only difference between an SPA and an SPPA is that, in determining whether an activity is an SPPA, the special aggregation rule (discussed immediately below) is taken into account. n412

Once all of an individual's SPAs have been identified, an aggregation rule is applied to determine whether the individual will be deemed to have materially participated in them. An individual materially participates in each SPA if his or her aggregate participation in all SPAs exceeds 500 hours. If the application of the aggregation rule causes the individual to be treated as having materially participated in the SPAs, the SPAs cannot be treated as SPPAs. However, this aggregation rule cannot cause a limited partner to be a material participant. n413

The results of being classified as an SPA or SPPA are twofold: n414

- (1) if an individual has more than one SPA, the special aggregation rule can have the effect of reclassifying into a non-passive activity what would otherwise be a passive activity; and
- (2) if an SPA is also an SPPA, a portion of its gross income may be recharacterized from passive activity gross income to non-passive activity gross income.

A taxpayer must aggregate all passive activity gross income and passive activity deductions from all SPPAs for the taxable year. If the aggregate passive activity gross income exceeds the aggregate passive activity deductions, an amount of the gross income from each SPPA, equal to a ratable portion of the taxpayer's net passive income from the activity, is treated as non-passive activity gross income. Moreover, if the taxpayer's aggregate passive activity gross income from all SPPAs exceeds aggregate passive activity deductions from all SPPAs, all SPPAs are treated as a single passive activity that does not have a loss for the taxable year. n415

The recharacterization rule for SPPAs produces the following three results: n416

- (1) If the taxpayer's aggregate SPPAs generate passive activity gross income for a taxable year in excess

of their passive activity deductions, the excess cannot be used to offset passive activity deductions from other non-SPPA passive activities of the taxpayer. Instead, the excess is recharacterized as gross income from a non-passive activity. The recharacterization has the impact of increasing the amount of any non-SPPA passive activity loss for the year. This means that any passive activity loss for the year is apportioned only among the taxpayer's non-SPPA passive activities;

(2) If a taxpayer's aggregate SPPAs have passive activity deductions in excess of passive activity gross income for a taxable year, the recharacterization rule does not apply, and the income and deductions from the taxpayer's SPPAs for the taxable year are combined with the income and deductions from the taxpayer's other passive activities for the year; or

(3) If a taxpayer's only passive activity income and deductions for the taxable year come from SPPAs, the recharacterization rule has no impact.

The amount that may be recharacterized under this rule is subject to an overall limitation, discussed in [13], below. n417

[7] Recharacterization of Rents from Nondepreciable Property

A recharacterization rule applies if the unadjusted basis of the depreciable property used or held for use by customers in a rental activity is less than 30 percent of the unadjusted basis of all property used in that activity. In that case, the taxpayer's net passive income from the activity is recharacterized as non-passive. The net income that can be recharacterized includes any gain on disposition. n418 The amount that may be recharacterized under this rule is subject to an overall limitation, discussed in [13], below. n419

Example:

Robert purchases land for \$300,000 and constructs a building for \$100,000. The building was used in a rental activity for several years and then was sold for \$600,000. Since the unadjusted basis of improvements (\$100,000/\$400,000) is 25 percent of the unadjusted basis of all property, the net gain is treated as nonpassive. In addition, if Robert had net income from the rental activity, that income would also be recharacterized as non-passive. n420

Practice Tip:

This rule has the effect of treating income from leasing any undeveloped land as nonpassive. Income from mobile home parks, parking lots, or other ground rents are typically recharacterized as non-passive. n421 Farmers are sometimes audited on this issue to determine if income reported is from leasing agricultural property. n422

[8] Recharacterization of Net Rental Income from Property Rented Incidental to Taxpayer's Development Activity

As discussed elsewhere, an activity involving the rental of property is generally a passive activity. n423 In addition, any gain or loss from the disposition of property used in a passive activity generally is treated as passive activity income or loss. n424 In certain situations, however, an amount equal to the taxpayer's "net rental activity income" from an item of property for the year may be treated as income not from a passive activity. In general, this rule applies if three criteria are met: n425

- Gain from the sale, exchange, or other disposition of the property is included in the taxpayer's income for the taxable year;

- The taxpayer's use of the property in an activity involving its rental began less than 12 months before the date of the property's disposition. The date of disposition is the date the property becomes subject to an oral or written agreement that either requires the owner or gives the owner an option to transfer the property for consideration that is fixed or otherwise determinable on that date; n426 and
- During any taxable year, the taxpayer materially or significantly participated in a trade or business activity involving the performance of services for the purpose of enhancing the value of the property.

If the criteria are met, an amount equal to the net passive income from the rental and disposition of the property during the year of disposition is recharacterized as non-passive income. n427

[9] Recharacterization of Income from Self-Rented Property

If property is rented for use in a trade or business (other than a business conducted by a C corporation) in which the taxpayer materially participates for the taxable year, and the property is not subject to the rule for rental income incidental to the development of property by the taxpayer, n428 the taxpayer's gross income from renting the property may be treated as income not from a passive activity. n429 If this rule applies, part or all of the taxpayer's rental expense may be treated as a self-charged item.

Under the self-rented property rule, the net rental income from self-rented property is treated as non-passive income and the net rental losses are treated as passive losses, even though the rental activities are passive activities. The self-rented property rule explicitly recharacterizes net rental activity income as being from an "item of property" rather than as being net income from the entire rental "activity." Both *IRC Section 469* and the regulations thereunder clearly distinguish between net income from an "item of property" and net income from the entire "activity," which might include rental income from multiple items of property. n430

Example:

Katie is the 100-percent shareholder in a Dineout Corporation, which runs a restaurant in which she materially participates. Katie also owns a building, which she rents to Dineout Corporation, and her Schedule E reflects the net income from the rental of \$45,000. Katie also has losses of \$20,000 from a limited partnership in which she does not materially participate. Because Katie materially participates in Dineout's restaurant activity, her net rental income of \$45,000 is treated as nonpassive. If Katie has no other passive income for the tax year, the \$20,000 losses from the limited partnership would not be deductible in the current year. n431

The self-rented property regulation has been upheld when applied to recharacterize rental income received from a taxpayer's personal service corporation as non-passive income. In each case, the taxpayer had hoped to offset other passive losses against the rental income. n432 The regulation has also been cited in characterizing as non-passive the rental income from a building leased by one spouse to a personal service corporation in which the other spouse was the president and a shareholder. The taxpayers had filed a joint return. n433 In another case, the taxpayer rented an office building to her law practice, in which she materially participated. The court determined that the rental income from her law practice was non-passive, and ruled that she could not offset the office rental income with losses from other passive residential rental activities. Rather, she had to suspend those losses until she either had other passive income against which to offset them or disposed of her interest in those activities. n433.1

The Tax Court has also held that a grouping of rental properties as a single activity does not preclude recharacterization of income from one of the properties under the self-rental rule. n434 In the case, the taxpayers had properly grouped two commercial rental properties together as a single passive activity, and then netted the income and loss from the two properties. Each of the lessees was an S corporation owned entirely by the taxpayers, and the taxpayers were actively

engaged in the conduct of each corporation's business. The taxpayers reported the net rental income as non-passive, and didn't report any passive activity loss. The Tax Court held that the income and loss items could not be netted. It also concluded that the income from renting the profitable property was non-passive, and that the loss from renting the unprofitable property was passive. The court rejected the taxpayers' argument that the computation of a passive activity loss required the netting of income and loss from all items of rental property grouped within the single passive activity, and that only after that computation did the self-rental rule apply to recharacterize passive income as non-passive. It held instead that the self-rental rule required the removal of self-rental income from the passive activity loss computation altogether. Therefore, the income from the profitable rental property had to be withdrawn from the passive activity loss computation. This, in turn, left the taxpayers with no passive income with which to offset against the passive loss from the unprofitable property. n435

[10] Recharacterization of Self-Charged Interest Income

Under self-charged interest regulations, partners and S corporation shareholders may offset non-passive interest income and passive interest deductions from the same loans. n436 The self-charged interest provisions apply to the following transactions:

- loans from partners or shareholders to a partnership or S corporation; n437
- loans from an S corporation or partnership to its shareholders or partners; n438
- lending transactions between identically owned passthrough entities (i.e., where each owner of the borrowing entity has the same proportionate ownership interest in the lending entity); n439 and
- lending transactions involving guaranteed payments for the use of capital under *IRC Section 707(c)*. n440

The regulations do three things: n441

- recharacterize non-passive interest income from the loan as passive income to the extent of the taxpayer's allocation of passive interest expense from the same transaction;
- recharacterize certain interest expense that is allocable to the interest income as a passive activity deduction; and
- allocate the passive activity gross income and passive activity deductions resulting the recharacterizations among the taxpayer's activities.

Taxpayers may avoid application of the self-charged interest rules if the passthrough entity makes an election for its taxable year to do so. n442 The election is made by for a tax year by attaching to the passthrough entity's return or amended return a written statement that includes the name, address, and taxpayer identification number of the passthrough entity and a declaration that the election is being made. n443 Once made, the election applies to the tax year for which the return is filed and all later tax years that end before the date on which the election is revoked. n444 The election may be revoked only with the consent of the Commissioner. n445

There are several limitations to the self-charged interest provisions: n446

- they apply only to self-charged items of interest income and interest expense that are recognized in the same taxable year; n447

- they do not contain any special rules for capitalized items;
- they do not apply to non-loan transactions involving rental real estate activities, such as the payment of management fees and salaries; and
- they do not apply to transactions between entities other than S corporations and partnerships, such as trusts, estates, REMICs, or housing cooperatives. n448

Notwithstanding the express limitation of the regulation's scope to self-charged interest, n449 taxpayers have tried unsuccessfully to extend its application to other self-charged items. In one case, the court rejected the taxpayer's attempt to offset self-charged non-passive management fee income with passive management fee expenses. n450

[11] Recharacterization of Interest Income from Passive Equity-Financed Lending Activities

An equity-financed lending activity is an activity in the trade or business of lending money. The regulations treat as non-passive income an amount of the taxpayer's gross income from an equity-financed lending activity. The amount treated as non-passive is equal to the lesser of the taxpayer's equity-financed interest income from the activity for the year or the taxpayer's net passive income from the activity for the year. n451

This recharacterization rule applies to lending activities in which the average balance of debt incurred in the activity does not exceed 80 percent of the average balance of interest-bearing assets held in the activity. A taxpayer's equity-financed interest income from the activity is equal to the taxpayer's interest income from the activity multiplied by the activity's ratio of equity to interest-bearing assets. This rule is designed to treat as non-passive income only that portion of the taxpayer's income from the activity that approximates the product of the average interest rate of the activity's interest-bearing assets and the taxpayer's equity contribution to the activity. n452 The amount that may be recharacterized under this rule is subject to an overall limitation, discussed in [13], below. n453

[12] Recharacterization of Net Royalty Income from Acquired Passthrough Entities

If a taxpayer acquires an interest in a development entity (which is a passthrough entity), after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs in developing or marketing the property, the taxpayer's net royalty income for the year from the item of property is recharacterized as portfolio income, and therefore is treated as income from a non-passive activity. n454

[13] Limitation on Recharacterized Income

The total amount of income from an activity that is recharacterized as non-passive under the above rules for significant participation, n455 rental of nondepreciable property, n456 and net interest income from passive equity-financed lending activity n457 cannot exceed the greatest amount that would be recharacterized under any one of those rules. n458

[14] Treatment of Income From *IRC Section 481* Adjustments Related to Change of Accounting Method

A taxpayer who changes accounting methods may have to adjust various income and deduction items under *IRC Section 481*. If there is a positive *IRC Section 481* adjustment with respect to income from an activity, a ratable portion of that amount is treated as gross income from the activity for the taxable year. Gross income is treated as passive activity gross income if the activity from which it is derived is a passive activity for the year of change. n459 The ratable portion taken into account is determined with respect to an activity by dividing the positive *IRC Section 481* adjustment with respect to the activity by the sum of positive *IRC Section 481* adjustments with respect to all activities of the taxpayer. n460

[15] Miscellaneous Exclusions from Passive Activity Gross Income

Regulations specifically exclude a number of items from passive activity gross income. The following items are excluded: n461

- gross income of an individual from intangible property, such as a patent, copyright, or literary, musical, or artistic composition, if the taxpayer's personal efforts significantly contributed to the creation of the property;
- gross income attributable to a refund of state, local, or foreign income, war profits, or excess profits tax;
- gross income of an individual from a covenant not to compete;
- gross income that is treated as not from a passive activity under any provision of the regulations under *IRC Section 469*, including those related to inter-company transactions of members of an affiliated group of corporations filing a consolidated return, n462 and recharacterized passive income; n463
- gross income attributable to certain reimbursements from casualty or theft losses that were deducted in a prior year, if the deduction for the loss was not a passive activity deduction; n464
- gross income or gain allocable to business or rental use of a dwelling unit for a tax year in which deductions are limited by the statutory gross income limitation; n465 and
- gross income from certain low-income housing projects placed in service before 1989 during a specified relief period; this item is now primarily of historical interest. n466

FOOTNOTES:

(n1)Footnote 355. *IRC § 469(d)(1)*.

(n2)Footnote 356. *Temp Treas Reg § 1.469-2T(c)(1)*.

(n3)Footnote 357. *IRC § 469(l)*.

(n4)Footnote 358. See *Treas Reg § 1.469-2(f)*; *Temp Treas Reg § 1.469-2T(f)*.

(n5)Footnote 359. *IRC § 469(e)(1)(A)*.

(n6)Footnote 360. *IRC § 469(e)(1)(A)(i)*; see *Temp Treas Reg § 1.469-2T(c)(3)(i)*.

(n7)Footnote 361. *IRC § 469(e)(4)*.

(n8)Footnote 362. *IRC § 469(e)(1)(A)(ii)*.

(n9)Footnote 363. *IRC § 469(e)(1)(B)*.

(n10)Footnote 364. *Temp Treas Reg § 1.469-2T(c)(3)(i)*.

(n11)Footnote 365. *Temp Treas Reg § 1.469-2T(c)(3)(ii)*.

(n12)Footnote 365.1. *Ltr Rul 201005016*.

- (n13)Footnote 366. *Temp Treas Reg § 1.469-2T(c)(3)(iii)*.
- (n14)Footnote 367. See *Temp Treas Reg § 1.469-2T(c)(iii)*.
- (n15)Footnote 368. *Temp Treas Reg § 1.469-2T(c)(2)(i)(A)*.
- (n16)Footnote 369. *Temp Treas Reg § 1.469-2T(c)(2)(i)(C)(1)*.
- (n17)Footnote 370. *Temp Treas Reg § 1.469-2T(c)(2)(i)(C)(2)*.
- (n18)Footnote 371. *Temp Treas Reg § 1.469-2T(c)(2)(ii)*.
- (n19)Footnote 372. *Treas Reg § 1.469-2(c)(2)(iv)*.
- (n20)Footnote 373. *Temp Treas Reg § 1.469-2T(c)(2)(ii)*.
- (n21)Footnote 374. *Treas Reg § 1.469-2(c)(2)(iii)(C)*.
- (n22)Footnote 375. *Treas Reg § 1.469-2(c)(2)(iii)(A)*.
- (n23)Footnote 376. *Treas Reg § 1.469-2(c)(2)(iii)(B)*.
- (n24)Footnote 377. *Treas Reg § 1.469-2(c)(2)(iii)(D)*.
- (n25)Footnote 378. *Treas Reg § 1.469-2(c)(2)(iv)*.
- (n26)Footnote 379. *Treas Reg § 1.469-2(c)(2)(iii)(F)*.
- (n27)Footnote 380. See *Treas Reg § 1.469-2(c)(2)(iii)*.
- (n28)Footnote 381. See *Treas Reg § 1.469-2(c)(2)(iii)(D), (F); Treas Reg § 1.469-2(c)(2)(iii)(G)*, Example 2.
- (n29)Footnote 382. *Treas Reg § 1.469-2(c)(2)(v)(A)(1)(i)*.
- (n30)Footnote 383. *Treas Reg § 1.469-2(c)(2)(v)(A)(2)*.
- (n31)Footnote 384. *Treas Reg § 1.469-2(c)(2)(v)(B)*.
- (n32)Footnote 385. *Treas Reg § 1.469-2(c)(2)(v)(1)(ii)*.
- (n33)Footnote 386. *Treas Reg § 1.469-2(c)(2)(v)(1)(ii)*, Example 1.
- (n34)Footnote 387. *Treas Reg § 1.469-2(c)(2)(v)(1)(ii)*, Example 1.
- (n35)Footnote 388. *Temp Treas Reg § 1.469-2T(e)(3)*.
- (n36)Footnote 389. *Temp Treas Reg § 1.469-2T(e)(3)(ii)(A)*.
- (n37)Footnote 390. *Temp Treas Reg § 1.469-2T(e)(3)(ii)(B)(1)*.
- (n38)Footnote 391. *Temp Treas Reg § 1.469-2T(e)(3)(ii)(B)(2)*.
- (n39)Footnote 392. *Temp Treas Reg § 1.469-2T(e)(3)(ii)(C)*.
- (n40)Footnote 393. See *Temp Treas Reg § 1.469-2T(e)(3)(iii)*.

- (n41)Footnote 394. See *Treas Reg* § 1.469-2(e)(3)(iii)(B).
- (n42)Footnote 395. See *Temp Treas Reg* § 1.469-2T(e)(3)(iii)(A).
- (n43)Footnote 396. *Temp Treas Reg* § 1.469-2T(c)(3)(iii).
- (n44)Footnote 397. *IRC* § 469(k)(3).
- (n45)Footnote 398. *Temp Treas Reg* § 1.469-2T(e)(3)(D)(1)(i).
- (n46)Footnote 399. *Treas Reg* § 1.469-2T(e)(3)(E)(1)(ii).
- (n47)Footnote 400. *IRC* § 469(e)(3); see *IRC* § 911(d)(2)(A) (definition of earned income for this purpose); *Temp Treas Reg* § 1.469-2T(c)(4)(i).
- (n48)Footnote 401. *IRC* § 911(d)(2)(A); *Temp Treas Reg* § 1.469-2T(c)(4)(i)(A).
- (n49)Footnote 402. See *IRC* § 83.
- (n50)Footnote 403. *Temp Treas Reg* § 1.469-2T(c)(4)(i).
- (n51)Footnote 404. *Temp Treas Reg* § 1.469-2T(c)(4)(i).
- (n52)Footnote 405. *Temp Treas Reg* § 1.469-2T(c)(4)(i); see *IRC* §§ 704(b), 1377(a).
- (n53)Footnote 406. See *IRC* § 469(e)(3).
- (n54)Footnote 407. See *Temp Treas Reg* § 1.163-8T.
- (n55)Footnote 408. *Rev Rul* 92-92, 1992-2 CB 103 .
- (n56)Footnote 409. *Temp Treas Reg* § 1.469-5T(c)(2).
- (n57)Footnote 410. *Temp Treas Reg* § 1.469-5T(c)(1); see *Shaw v Commr*, *TC Memo* 2002-35 .
- (n58)Footnote 411. *Temp Treas Reg* § 1.469-5T(a)(4), (c)(1).
- (n59)Footnote 412. *Temp Treas Reg* § 1.469-2T(f)(2)(ii).
- (n60)Footnote 413. *Temp Treas Reg* § 1.469-5T(a)(4), (e).
- (n61)Footnote 414. *Temp Treas Reg* § 1.469-2T(f)(2).
- (n62)Footnote 415. *Temp Treas Reg* § 1.469-2T(f)(2)(i).
- (n63)Footnote 416. *Temp Treas Reg* § 1.469-2T(f)(2)(i).
- (n64)Footnote 417. *Temp Treas Reg* § 1.469-2T(f)(8).
- (n65)Footnote 418. *Temp Treas Reg* § 1.469-2T(f)(3); see *Temp Treas Reg* § 1.469-2T(f)(9)(i) (definition of net passive income).
- (n66)Footnote 419. *Temp Treas Reg* § 1.469-2T(f)(8).
- (n67)Footnote 420. See *Temp Treas Reg* § 1.469-2T(f)(3).

- (n68)Footnote 421. See *Wiseman v Commr, TC Memo 1995-203* .
- (n69)Footnote 422. See *Temp Treas Reg § 1.469-2T(f)(3)*.
- (n70)Footnote 423. *IRC § 469(c)(2)*; see *§ 13.04[3][a]*, above.
- (n71)Footnote 424. *Temp Treas Reg § 1.469-2T(c)(2)(i)(A)*; see *[3][a]*, above.
- (n72)Footnote 425. *Treas Reg § 1.469-2(f)(5)*.
- (n73)Footnote 426. See *Treas Reg § 1.469-2(c)(2)(iii)(B)*.
- (n74)Footnote 427. *Treas Reg § 1.469-2(f)(5)*; see *Treas Reg § 1.49-2(f)(9)(iv)* (definition of net rental activity income).
- (n75)Footnote 428. See *Treas Reg § 1.469-2(f)(5)*; see *[8]*, above.
- (n76)Footnote 429. *Treas Reg § 1.469-2(f)(6)*.
- (n77)Footnote 430. See *Treas Reg § 1.469-2(f)(6)*.
- (n78)Footnote 431. See *Treas Reg § 1.469-2(f)(6)*.
- (n79)Footnote 432. *Cal Interiors Inc et al v Commr, TC Memo 2004-99* , *affd sub nom Beecher v Commr, 481 F3d 717 (9th Cir 2007)* ; *Shaw v Commr, TC Memo 2002-35* ; *Sidell v Commr, 225 F 3d 103 (1st Cir 2000)* , *affg TC Memo 1999-301* ; *Schwalback v Commr, 111 TC 215* ; *Fransen, Jr v US, 98-2 USTC P 50,776 (ED La 1998)*, *affd 191 F 3d 599 (5th Cir 1999)* ; *Krukowski v Commr, 114 TC 366* , *affd 279 F3d 547(7th Cir 2002)* .
- (n80)Footnote 433. *Connor v Commr, TC Memo 1999-185* , *affd 218 F 3d 733 (7th Cir 2000)* .
- (n81)Footnote 433.1. *Langille v Commr, TC Memo 2010-49 (2010)* .
- (n82)Footnote 434. *Carlos v Commr, 123 TC 275 (2004)* .
- (n83)Footnote 435. *Carlos v Commr, 123 TC 275 (2004)* .
- (n84)Footnote 436. *Treas Reg § 1.469-7*.
- (n85)Footnote 437. *Treas Reg § 1.469-7(a)(1)*.
- (n86)Footnote 438. *Treas Reg § 1.469-7(d)*.
- (n87)Footnote 439. *Treas Reg § 1.469-7(e)*.
- (n88)Footnote 440. *Treas Reg § 1.469-7(a)(1)*.
- (n89)Footnote 441. *Treas Reg § 1.469-7(a)(1), (c), (d)*.
- (n90)Footnote 442. *Treas Reg § 1.469-7(g)(1)*.
- (n91)Footnote 443. *Treas Reg § 1.469-7(g)(2)*.
- (n92)Footnote 444. *Treas Reg § 1.469-7(g)(3)*.
- (n93)Footnote 445. *Treas Reg § 1.469-7(g)(4)*.

(n94)Footnote 446. See *Treas Reg* § 1.479-7.

(n95)Footnote 447. *Treas Reg* § 1.469-7(a)(1).

(n96)Footnote 448. See *Treas Reg* § 1.469-7(b)(1).

(n97)Footnote 449. See *Treas Reg* § 1.469-7.

(n98)Footnote 450. *Hillman v Commr*, 114 TC 103 (2000) , revd 250 F 3d 228 (4th Cir 2001) , *affd on petition for rehearing* 263 F 3d 338 (4th Cir 2001) , *on remand* 118 TC 323 (2002) .

(n99)Footnote 451. *Temp Treas Reg* § 1.469-2T(f)(4)(i).

(n100)Footnote 452. *Temp Treas Reg* § 1.469-2T(f)(4)(iii).

(n101)Footnote 453. *Temp Treas Reg* § 1.469-2T(f)(8).

(n102)Footnote 454. *Temp Treas Reg* § 1.469-2T(f)(7).

(n103)Footnote 455. See *Temp Treas Reg* § 1.469-2T(f)(2); see [6], above, for a discussion.

(n104)Footnote 456. See *Temp Treas Reg* § 1.469-2T(f)(3); see [7], above, for a discussion.

(n105)Footnote 457. See *Temp Treas Reg* § 1.469-2T(f)(4); see [11], above, for a discussion.

(n106)Footnote 458. *Temp Treas Reg* § 1.469-2T(f)(8).

(n107)Footnote 459. *Temp Treas Reg* § 1.469-2T(c)(5)(i).

(n108)Footnote 460. *Temp Treas Reg* § 1.469-2T(c)(5)(iii).

(n109)Footnote 461. *Temp Treas Reg* § 1.469-2T(c)(7); *Treas Reg* § 1.469-2(c)(7)(iv)-(vi).

(n110)Footnote 462. *Temp Treas Reg* § 1.469-1T(h)(6).

(n111)Footnote 463. See *Temp Treas Reg* § 1.469-2T(f); *Treas Reg* § 1.469-2(f).

(n112)Footnote 464. See § 13.01[3][i], above, for a discussion of this item.

(n113)Footnote 465. See *IRC* § 280A(c)(5). See § 13.01[3][g], above, for a discussion.

(n114)Footnote 466. See Pub Law No 99-514, § 502.

* Revised by Elsbeth Peshel, Esq. The author holds an LL.M in taxation from New York University School of Law.



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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.07

§ 13.07 Passive Activity Deductions

[1] Deductions from Passive Activities

In determining the amount of passive activity gain or loss, a deduction must be a passive activity deduction in order to be taken into account. In general, a deduction is treated as a passive activity deduction for a taxable year if and only if it arises in connection with an activity that is a passive activity during the tax year or is allowed as a carryover of a disallowed deduction from a prior year. n467

[2] Miscellaneous Deductions That Are Treated as Not from Passive Activities

The following deductions are not passive activity deductions: n468

- deductions for an item of expense (other than interest) that are allocable to portfolio income;
- dividends-received deductions n469 with respect to any dividend that is not included in passive activity gross income;
- interest expense (other than certain interest expense allocated to a passive activity expenditure); n470
- losses on the disposition of portfolio property;
- losses on the disposition of certain interests in passive activities that are treated as a deduction that is not a passive activity deduction; n471
- deductions for state, local, or foreign income, war profits, or excess profits tax;
- miscellaneous itemized deductions that are subject to disallowance in whole or in part under *IRC Section 67(a)* (without regard to whether any amount of the deduction is actually disallowed);
- charitable contribution deductions; n472
- net operating losses and capital loss carrybacks and carryforwards; n473

- certain deductions that were disallowed n474 and certain pre-1987 losses; and
- casualty loss deductions if similar losses do not recur regularly in the conduct of the activity. n475

[3] Interest Expense Is Generally a Passive Deduction Only if Traced to a Passive Activity Expenditure

Interest expense is taken into account as a passive activity deduction only if it is allocated under interest tracing and allocation regulations to a passive activity expenditure. n476 Qualified residence interest or interest that is capitalized pursuant to a capitalization provision, however, cannot be taken into account as a passive activity deduction. n477 Interest expense that is properly allocable to portfolio income is not taken into account in determining gain or loss from a passive activity. n478

When debt repayments involving interest are allocated to more than one expenditure, ordering rules in temporary regulations are used to determine the extent to which a repayment and the interest component of it are allocated to a passive activity. n479

[4] Recharacterization of Self-Charged Interest Expense Deductions

Under self-charged interest regulations, partners and S corporation shareholders may offset non-passive interest income and passive interest deductions from the same loans. n480 The self-charged interest provisions apply to the following transactions:

- loans from partners or shareholders to a partnership or S corporation; n481
- loans from an S corporation or partnership to its shareholders or partners; n482
- lending transactions between identically owned passthrough entities (i.e., where each owner of the borrowing entity has the same proportionate ownership interest in the lending entity); n483 and
- lending transactions involving guaranteed payments for the use of capital under *IRC Section 707(c)*. n484

The regulations do three things: n485

- (1) recharacterize non-passive interest income from the loan as passive income to the extent of the taxpayer's allocation of passive interest expense from the same transaction;
- (2) recharacterize certain interest expense that is allocable to the interest income as a passive activity deduction; and
- (3) allocate the passive activity gross income and passive activity deductions resulting the recharacterizations among the taxpayer's activities.

Taxpayers may avoid application of the self-charged interest rules if the passthrough entity makes an election for its taxable year to do so. n486 The election is made by for a tax year by attaching to the passthrough entity's return or amended return a written statement that includes the name, address, and taxpayer identification number of the passthrough entity and a declaration that the election is being made. n487 Once made, the election applies to the tax year for which the return is filed and all later tax years that end before the date on which the election is revoked. n488 The election may be revoked only with the consent of the Commissioner. n489

There are several limitations to the self-charged interest provisions: n490

- they apply only to self-charged items of interest income and interest expense that are recognized in the same taxable year; n491
- they do not contain any special rules for capitalized items;
- they do not apply to non-loan transactions involving rental real estate activities, such as the payment of management fees and salaries; and
- they do not apply to transactions between entities other than S corporations and partnerships, such as trusts, estates, REMICs, or housing cooperatives. n492

Notwithstanding the express limitation of the regulation's scope to self-charged interest, n493 taxpayers have tried unsuccessfully to extend its application to other self-charged items. In one case, the court rejected the taxpayer's attempt to offset self-charged non-passive management fee income with passive management fee expenses. n494

[5] Losses from Certain Dispositions of Property Used in a Passive Activity

Any loss from a disposition of an interest in property used in an activity at the time of the disposition (or of an interest in an activity held through a partnership or S corporation) is treated as a deduction from that activity. So is any deduction allowed on account of the abandonment or worthlessness of such an interest. n495 Any such deduction is a passive activity deduction if the activity is a passive activity of the taxpayer for the taxable year of the disposition or other event giving rise to the deduction. n496

[6] Deductions from *IRC Section 481* Adjustments Related to Change of Accounting Method

A taxpayer who changes accounting methods may have to adjust various income and deduction items under *IRC Section 481*. If there is a net negative *IRC Section 481* adjustment with respect to an activity, a ratable portion of that amount is treated as a deduction from the activity for the taxable year. The deduction is treated as a passive activity deduction if the activity to which it relates is a passive activity for the year of change. n497

The ratable portion taken into account for a tax year is determined with respect to an activity by multiplying that amount by a fraction. The numerator of the fraction is the negative *IRC Section 481* adjustment with respect to the activity, and the denominator is the sum of the negative *IRC Section 481* adjustments with respect to all of the taxpayer's activities. n498

[7] Deductions Relating to Rental of Taxpayer's Residence

The rental of a taxpayer's residence is not a passive activity. Therefore, passive losses and deductions do not include any deduction or loss allocable to business or rental use of a dwelling unit that is used by the taxpayer during the taxable year as a residence. n499

FOOTNOTES:

(n1)Footnote 467. *Temp Treas Reg § 1.469-2T(d)(1)*.

(n2)Footnote 468. *Temp Treas Reg § 1.469-2T(d)(2); Treas Reg § 1.469-2(d)(2)(ix)-(xii)*.

(n3)Footnote 469. See *IRC §§ 243, 244, 245*.

(n4)Footnote 470. See *Temp Treas Reg* § 1.469-2(d)(3).

(n5)Footnote 471. See *IRC* § 469; *Temp Treas Reg* § 1.469-6T.

(n6)Footnote 472. See *IRC* § 170.

(n7)Footnote 473. See *IRC* §§ 172, 613A(d), 1212(a)(1), (b). See § 13.01[3][j], above, for a discussion of NOLs.

(n8)Footnote 474. See *IRC* §§ 465, 704(d), 1366. See § 13.01[3], above, for a discussion.

(n9)Footnote 475. See *IRC* § 165(c)(3). See § 13.01[3][i], above, for a discussion.

(n10)Footnote 476. See *Temp Treas Reg* § 1.163-8T(a)(4)(i)(B).

(n11)Footnote 477. *Temp Treas Reg* § 1.469-2T(d)(3).

(n12)Footnote 478. *IRC* § 469(e)(1)(A)(i)(III).

(n13)Footnote 479. *Temp Treas Reg* § 1.163-8T(d)(1).

(n14)Footnote 480. *Treas Reg* § 1.469-7.

(n15)Footnote 481. *Treas Reg* § 1.469-7(a)(1).

(n16)Footnote 482. *Treas Reg* § 1.469-7(d).

(n17)Footnote 483. *Treas Reg* § 1.469-7(e).

(n18)Footnote 484. *Treas Reg* § 1.469-7(a)(1).

(n19)Footnote 485. *Treas Reg* § 1.469-7(a)(1), (c), (d).

(n20)Footnote 486. *Treas Reg* § 1.469-7(g)(1).

(n21)Footnote 487. *Treas Reg* § 1.469-7(g)(2).

(n22)Footnote 488. *Treas Reg* § 1.469-7(g)(3).

(n23)Footnote 489. *Treas Reg* § 1.469-7(g)(4).

(n24)Footnote 490. See *Treas Reg* § 1.479-7.

(n25)Footnote 491. *Treas Reg* § 1.469-7(a)(1).

(n26)Footnote 492. See *Treas Reg* § 1.469-7(b)(1).

(n27)Footnote 493. See *Treas Reg* § 1.469-7.

(n28)Footnote 494. *Hillman v Commr*, 114 TC 103 (2000) , revd 250 F 3d 228 (4th Cir 2001) , *affd on petition for rehearing* 263 F 3d 338 (4th Cir 2001) , *on remand* 118 TC 323 (2002) .

(n29)Footnote 495. *Temp Treas Reg* § 1.469-2T(d)(5)(i)(A).

(n30)Footnote 496. *Temp Treas Reg* § 1.469-2T(d)(5)(i)(B).

(n31)Footnote 497. *Temp Treas Reg* § 1.469-2T(d)(7)(i).

(n32)Footnote 498. *Temp Treas Reg* § 1.469-2T(d)(7)(iii).

(n33)Footnote 499. *Temp Treas Reg* § 1.469-1T(e)(5); *Treas Reg* § 1.469-2(d)(2)(xii); see *IRC* § 280A(c)(5).

* Revised by Elsbeth Peshel, Esq. The author holds an LL.M in taxation from New York University School of Law.



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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.08

§ 13.08 Taxpayers Subject to the Passive Activity Limitations

[1] Passive Activity Credits Are Disallowed

The passive activity rules limit the use of certain tax credits that arise from passive activities. Any passive activity credit for the tax year is disallowed. n500 A passive activity credit is the amount by which the sum of certain credits from all passive activities allowable for the taxable year exceeds the regular tax liability for that year allocable to all passive activities. n501 Thus, if the taxpayer has an aggregate passive activity loss for the year, no tax credits from passive activities can be used currently, even though the taxpayer has a net regular tax liability for the year.

[2] Credits Subject to the Passive Activity Limitations

A credit is subject to the passive activity limitations only if it is used in connection with a passive activity. n502 Even then, only certain credits are subject to the passive activity limitations. The credits taken into account for this purpose that will most likely come into play for real estate and other passive activities are the low-income housing credit and components of the general business credit that deal with real estate, such as the rehabilitation credit. n503 The current year general business credit includes the following credits: n504

- investment credit, n505 which is the sum of the rehabilitation credit, n506 the energy credit, n507 the qualifying advanced coal project credit, n508 the qualifying gasification project credit, n509 the qualifying advanced energy project credit, n509.1 and the qualifying therapeutic discovery project credit; n509.2
- work opportunity credit; n510
- alcohol and other fuels credit; n511
- research credit; n512
- low-income housing credit; n513
- enhanced oil recovery credit; n514

- disabled access credit (for small businesses); n515
- renewable electricity production credit; n516
- Indian employment credit; n517
- employer social security credit for certain tips; n518
- orphan drug credit; n519
- new markets credit; n520
- credit for small employer pension plan startup costs; n521
- employer-provided child care credit; n522
- railroad track maintenance credit; n523
- biodiesel and renewable diesel credit; n524
- low sulfur diesel fuel production credit; n525
- marginal Oil and gas well production credit; n526
- distilled spirits credit; n527
- advanced nuclear power facility production credit; n528
- nonconventional source production credit; n529
- new energy efficient home credit; n530
- energy efficient appliance credit; n531
- a portion of the alternative motor vehicle credit, to the extent it is available for depreciable property; n532
- a portion of the alternative fuel vehicle refueling property credit, to the extent it is available for depreciable property; n533
- the Hurricane Katrina housing credit; n534
- the Hurricane Katrina employee retention credit; n535
- the Hurricane Rita employee retention credit; n536
- the Hurricane Wilma employee retention credit; n537
- the mine rescue team training credit; n537.1

- the agricultural chemicals security credit; n537.2
- the differential wage payment credit; n537.3
- the carbon dioxide sequestration credit; n537.4
- the new qualified plug-in electric drive motor vehicle credit, to the extent connected with depreciable business property; n537.5
- the retained worker credit; n537.6 and
- the small employer health insurance credit. n537.7

Other credits arising from passive activities that are potentially subject to the passive activity credit limitations are the following:

- Puerto Rico and possession tax credit; n538
- credit for certain plug-in electric vehicles; n539
- Puerto Rico economic activity credit; n540
- alternative motor vehicle credit, to the extent it is not part of the general business credit, as noted above; n541
- alternative fuel vehicle refueling property credit, to the extent it is not part of the general business credit, as noted above; n542 and
- a portion of the new qualified plug-in electric drive motor vehicle credit, to the extent it is not part of the general business credit, as noted above. n542.1

[3] Allocation of Disallowed Credits

If a taxpayer has a disallowed passive activity credit, a ratable portion of each credit from each passive activity of the taxpayer is disallowed. This ratable portion is computed by multiplying the portion of the taxpayer's passive activity credit that is disallowed by a fraction. The numerator of the fraction is the amount of that credit. The denominator of the fraction is the sum of all the taxpayer's credits from passive activities for the tax year. n543

Not all credits are taken into account for purposes of identifying disallowed credits. The following credits are treated as not being from a passive activity for this purpose: n544

- any credit allowed with respect to rental real estate activities to which the \$25,000 offset applies; n545 and
- any credit remaining unused upon the disposition of passive activity property for which an election is made to increase the basis of property. n546

Furthermore, in identifying disallowed credits, only those credits that if separately taken into account would affect the taxpayer's income tax liability for the year are taken into account. n547

[4] Carryover of Disallowed Passive Activity Credits

As with disallowed passive activity losses, n548 disallowed passive activity credits can be carried forward indefinitely. Any carried over passive activity credits are held in suspense until there is adequate regular tax liability from passive activities to trigger their use. n549 Any disallowed credit must be allocated among the taxpayer's activities for the succeeding year in a manner that reasonably reflects the extent to which each activity continues the loss activity. Disallowed credits may not be carried back to a prior tax year. n550

[5] Passive Credits May Offset Active Income of Certain Closely Held C Corporations

Closely held C corporations other than personal-service corporations may use their passive activity credits to offset their net active income for the year. n551 "Net active income" includes the corporation's taxable income for the tax year, determined without regard to income or losses from a passive activity or items of gross income, expense, gain, or loss that are related to portfolio income, and therefore treated as not being from a passive activity. n552 Personal service corporations, even if closely held, cannot take advantage of this offset. n553

[6] Treatment of Passive Activity Credits on Disposition of Passive Activity

Unlike the situation with passive activity losses, there is no statutory provision allowing the use of suspended credits upon a taxpayer's disposition of an entire interest in a passive activity. n554 A taxpayer may, however, elect to add the amount of the unused credit to the basis of the property disposed of, thereby increasing the amount of loss or decreasing the amount of gain that may be recognized from the disposition of the passive activity. Under the election, the taxpayer's basis in the passive activity is increased by the amount that the unused credit reduced the basis of the property for the year in which the credit arose. n555 The election is made by completing Part VI of Form 8582-CR (for noncorporate taxpayers) or Part III of Form 8810 (for corporations).

Practice Tip:

A taxpayer who makes the election gives up whatever amount of the credit remains in exchange for the basis increase. This can be a good trade-off if the taxpayer has no other passive income against which the credit can be used. Otherwise, the taxpayer may be better off to apply the credit against that other passive income. n556

FOOTNOTES:

(n1)Footnote 500. *IRC § 469(a)(1)*.

(n2)Footnote 501. *Treas Reg 1.465-6*.

(n3)Footnote 502. *IRC § 469(a)(1), (d)(2)*.

(n4)Footnote 503. See *IRC §§ 38, 42, 46, 469(d)(2)*.

(n5)Footnote 504. *IRC § 38(b)*.

(n6)Footnote 505. See *IRC § 46*. Note that rental buildings did not qualify for the former investment tax credit. See former *IRC § 48(a)(1)(B)*; *Hall v Commr, TC Memo 1993-198* ; *Binns v Commr, TC Memo 1988-362* .

(n7)Footnote 506. See *IRC § 47*.

(n8)Footnote 507. See *IRC § 48*.

(n9)Footnote 508. See *IRC § 48A*.

(n10)Footnote 509. See *IRC § 48B*. For expenditures paid or incurred before 10/23/04, the investment credit also included the former reforestation credit (see *IRC § 48(b)*, *before repeal* by Pub Law No 108-357).

(n11)Footnote 509.1. See *IRC § 48C*.

(n12)Footnote 509.2. See *IRC § 48D*.

(n13)Footnote 510. See *IRC § 51*.

(n14)Footnote 511. See *IRC § 40*.

(n15)Footnote 512. See *IRC § 41*.

(n16)Footnote 513. See *IRC § 42*.

(n17)Footnote 514. See *IRC § 43*.

(n18)Footnote 515. See *IRC § 44*.

(n19)Footnote 516. See *IRC § 45*.

(n20)Footnote 517. See *IRC § 45A*.

(n21)Footnote 518. See *IRC § 45B*.

(n22)Footnote 519. *IRC § 45C*.

(n23)Footnote 520. *IRC § 45D*. See Rev Rul 2010-16, 2010-26 *IRB* 769 (ruling that the new markets tax credit is a not a passive activity credit where the acquisition of the qualified equity investment in a qualified community development entity (CDE) is not in connection with the conduct of a trade or business or in anticipation of a trade or business).

(n24)Footnote 521. See *IRC § 45E*.

(n25)Footnote 522. See *IRC § 45F*.

(n26)Footnote 523. See *IRC § 45G*.

(n27)Footnote 524. See *IRC § 40A*.

(n28)Footnote 525. See *IRC § 45H*.

(n29)Footnote 526. See *IRC § 45I*.

(n30)Footnote 527. See *IRC § 5011*.

(n31)Footnote 528. See *IRC § 45J*.

(n32)Footnote 529. See *IRC § 45K*, effective for tax years beginning after Dec 31, 2005.

(n33)Footnote 530. See *IRC § 45L*.

(n34)Footnote 531. See *IRC § 45M*.

(n35)Footnote 532. See *IRC § 30B(a), (g)(1)*.

(n36)Footnote 533. See *IRC § 30C(a), (d)(1)*.

(n37)Footnote 534. See *IRC § 1400P(b)*.

(n38)Footnote 535. See *IRC § 1400R(a)*.

(n39)Footnote 536. See *IRC § 1400R(b)*.

(n40)Footnote 537. See *IRC § 1400R(c)*.

(n41)Footnote 537.1. See *IRC § 45N*.

(n42)Footnote 537.2. See *IRC § 45O*.

(n43)Footnote 537.3. See *IRC § 45P*.

(n44)Footnote 537.4. See *IRC § 45Q(a)*.

(n45)Footnote 537.5. See *IRC § 30D(a), (c)(1)*.

(n46)Footnote 537.6. This is an uncodified credit that is included in the general business credit for retaining certain individuals hired between February 3, 2010 and January 1, 2011 for at least 52 consecutive weeks [Pub Law No 111-147, § 102].

(n47)Footnote 537.7. See *IRC § 45R*.

(n48)Footnote 538. See *IRC §§ 27(b), 936*. Subject to grandfathering rules, this credit is repealed for tax years ending after 1995 [see *IRC § 936(j)(1)*].

(n49)Footnote 539. See *IRC § 30*.

(n50)Footnote 540. See *IRC § 30A*.

(n51)Footnote 541. See *IRC § 30B*.

(n52)Footnote 542. See *IRC § 30C*.

(n53)Footnote 542.1. See *IRC § 30D(a), (d)(2)*.

(n54)Footnote 543. *Temp Treas Reg § 1.469-1T(f)(3)(i)*.

(n55)Footnote 544. *Temp Treas Reg § 1.469-1T(f)(3)(ii)*.

(n56)Footnote 545. See *IRC § 469(i)*.

(n57)Footnote 546. See *IRC § 469(j)*.

(n58)Footnote 547. *Temp Treas Reg § 1.469-1T(f)(3)(iii)*.

(n59)Footnote 548. See § 13.09, below, for a discussion.

(n60)Footnote 549. *IRC § 469(b)*.

(n61)Footnote 550. *Treas Reg § 1.469-1(f)(4)(i)*.

(n62)Footnote 551. *IRC § 469(e)(2)(A)*. A similar rule applies to the corporation's passive activity losses. See § 13.09[4], below, for a discussion.

(n63)Footnote 552. *IRC § 469(e)(2)(B)*; see *IRC § 469(e)(1)(A)*; see § 13.06[2], above, for a discussion of these items.

(n64)Footnote 553. *IRC § 469(e)(2)*.

(n65)Footnote 554. See *IRC § 469(g)*.

(n66)Footnote 555. *IRC § 469(j)(9)*.

(n67)Footnote 556. See *IRC § 469(j)(9)*.

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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.09

§ 13.09 Applying the Passive Activity Loss Limitations

[1] Passive Losses Are Not Deductible

If a taxpayer has activities that are subject to the passive activity limits, it must be determined whether there is a net gain or loss from those activities. To determine if there is a passive activity loss for a year, the total losses from all passive activities (including disallowed losses that are carried over from prior years) are netted against total income from passive activities for the year. n557

If the aggregate passive activity income exceeds losses from passive activities for the year, the disallowance rule for passive activity losses does not come into play, and all losses, including those from prior years, are allowed. n558 If the aggregate passive losses exceed the aggregate income from passive activities, however, the excess is disallowed as a passive activity loss. n559

[2] Disallowed Passive Activity Losses Must Be Allocated Among Passive Loss Activities

[a] Losses Are Allocated Only to Passive Activities with Net Losses

When a taxpayer has multiple passive activities and there is an overall disallowed passive activity loss, a ratable portion of the loss (if any) from each loss activity is disallowed. n560 No amount of the loss is allocated to any passive activity that has a net gain for the tax year. The ratable portion of a loss that is disallowed with respect to each loss activity is computed by multiplying the passive loss that is disallowed for the taxable year by a fraction. The numerator is the loss from the passive activity, and the denominator is the sum of losses from all passive activities. n561 In computing the amount of loss for this purpose, the amount of loss is reduced by any part of the \$25,000 offset that may apply. n562

[b] Disallowed Losses Must Be Allocated Among Deductions Within Each Passive Loss Activity

Any disallowed loss must be allocated among deductions of each passive loss activity, so that a ratable portion of each passive activity deduction from the activity is disallowed. n563 The amount of each passive activity deduction that is disallowed is determined by multiplying that deduction by a fraction. The numerator of the fraction is the amount of the deduction, and the denominator is the sum of all passive activity deductions of the taxpayer from the activity for the tax year. n564

Special rules apply to two categories of deductions for purposes of the proration. The first category is "excluded deductions", which include deductions related to certain income that is not treated as from a passive activity. Excluded deductions are ignored for purposes of the prorated disallowance. n565 Items in this category include certain deductions related to the following: n566

- oil and gas property;
- property rented incidental to development activity;
- property rented to a non-passive activity; and
- interests in passthrough entities engaged in licensing intangible property.

A separate rule applies for a second category, "separately identified deductions." In identifying disallowed deductions, a taxpayer need not account separately for a deduction unless it would otherwise change the taxpayer's tax liability if separately taken into account separately. n567 Deductions that must be accounted for separately under this rule include (but are not limited to) those that:

- arise in a real estate rental activity, whether or not the taxpayer actively participates during the year;
- or
- are taken into account under *IRC Section 1211* (dealing with limitations on capital losses) or *IRC Section 1231* (relating to property used in a trade or business and involuntarily converted property).

[c] Significant Participation Passive Activities May Be Treated as a Single Non-Loss Activity for Passive Loss Allocation Purposes

A special aggregation rule applies if a taxpayer has significant participation passive activities (SPPAs), and has gross income from them that exceeds deductions from them. If that is the case, all of the SPPAs are treated for the tax year as a single activity that does not have a loss for the year. This aggregation rule applies only for purposes of identifying and allocating disallowed passive activity deductions. If this rule applies, no passive activity loss is allocated to any SPPA during the year, even one with a loss. n568

[3] Carryover of Disallowed Losses

[a] Indefinite Carryforward of Losses Is Allowed

To the extent a passive activity loss is disallowed a given tax year, the amount disallowed is carried forward to the next tax year as a passive activity loss deduction for that year. Disallowed losses may be carried forward indefinitely. n569 Disallowed passive losses may not be carried back to prior years. n570 The carried over disallowed deductions must be allocated among the taxpayer's activities for the succeeding year in a manner that reasonably reflects the extent to which each activity continues the loss activity. n571

If a taxpayer continues part or all of a loss activity through a C corporation (or similar entity from which the owners derive only portfolio income from their interests), the taxpayer's interest in that entity is treated for purposes of allocating the carryover loss among activities as an interest in a passive activity that continues the loss activity. n572 If the activity for which a loss is carried over is no longer a passive activity, the activity is a former passive activity, and special loss carryover rules apply. n573

When a taxpayer has multiple passive activities, the amount of loss that is carried over from each activity must be

determined on a pro rata basis. n574

Example:

Doug has four passive activities with the income and expense items indicated. He has no tax credits. Doug's disallowed passive activity losses total \$200, allocated to the two loss activities as follows:

Application of Passive Activity Loss Limits

Activity	Gross Income	Deductions	New Gain or (Loss)	Carryover
1	\$500	\$900	(\$400)	(\$107)**
2	900	450	450	-----
3	650	1,000	(350)	(93)***
4	100	-----	100	-----
Totals	\$2,150	\$2,350	(\$200)*	(\$200)

* The Total amount of Doug's disallowed passive activity losses is \$200.

** The amount carried over from Activity 1 is \$107 ($\$400/\$750 \times \$200$).

*** The amount carried over from Activity 3 is \$93 ($\$350/\$750 \times \$200$).

[b] Carryover of Passive Losses from C Corporation to S Corporation Years

The Tenth Circuit has held that an S corporation may carry forward from its C corporation years any passive activity losses that were suspended from its C corporation years. When the S corporation sells the properties used in passive activities, S corporation shareholders may take advantage of the losses at that time. n575

The Tenth Circuit's decision noted that two carryover provisions--*IRC Section 469(b)* and *IRC Section 1371(b)(1)*--are in conflict. *IRC Section 469(b)* provides that except as otherwise provided in that section, a disallowed passive activity loss or credit must be treated as a deduction or credit allocable to that activity in the next taxable year. *IRC Section 1371(b)(1)*, in contrast, provides that no carryforward arising for a taxable year in which a corporation is a C corporation may be carried to a taxable year for which the corporation is an S corporation. The Tenth Circuit held that the plain language of *IRC Section 469* precluded application of *IRC Section 1371* to the suspended passive activity losses of a C corporation after it elected S corporation status. For the Tenth Circuit, the matter was one of simple statutory construction. The key focus was the "except as otherwise provided in this section" language of *IRC Section 469(b)*. The court interpreted this language to require that any exceptions to the general rule had to be enumerated in *IRC Section 469* and not in any other Code provision. The court held that because *IRC Section 1371*'s restrictions on carryforwards from a C year to an S year were not enumerated in *IRC Section 469*, they had no effect on the operation of *IRC Section 469(b)*. Accordingly, the court held that the taxpayer's suspended passive activity losses from C corporation years were deductible after the taxpayer elected S corporation status, subject only to restrictions that might exist in *IRC Section 469* itself. The court also found support for its interpretation in *IRC Section 469(f)(2)*, which provides that if a taxpayer ceases to be a closely held C corporation or personal service for any taxable year, *IRC Section 469* applies as if that corporation continued its prior status. The court found that the provision applied to the situation here, where a C corporation later became an S corporation. n576

Note:

The Tenth Circuit's decision n577 is by no means the last word. The IRS has not acquiesced in the decision, other circuits have not yet ruled on the issue, and even the Tax Court is not required to follow the Tenth Circuit's decision in cases that are appealed to other circuits. n578

[c] Carryover of Passive Losses and Credits to Bankruptcy Estate of an Individual

The bankruptcy estate of an individual in either a Chapter 7 or Chapter 11 case succeeds to and takes into account the debtor's unused passive activity losses and credits. The credits and losses are determined as of the first day of the debtor's taxable year in which the case commences. n579 Any transfers by the bankruptcy estate of an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange) is not treated as a disposition for tax purposes. n580 If, before the termination of the bankruptcy estate, it transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange), the estate must allocate to the transferred interest a proportional part of the estate's unused passive activity loss and credit. The debtor then succeeds to and takes those items into account, beginning with the debtor's tax year in which the transfer occurs. n581 Upon termination of the estate the debtor succeeds to and takes into account any passive activity losses and credits that are disallowed under *IRC Section 469* for the estate's last taxable year. n582

[4] Passive Losses May Offset Active Income of Certain Closely Held C Corporations

Closely held C corporations other than personal-service corporations are allowed greater flexibility in the use of their passive activity losses. While they are not permitted to use passive losses to reduce portfolio income, they may use those losses to offset their net active income for the year. n583 Net active income" includes the corporation's taxable income for the tax year, determined without regard to income or losses from a passive activity or items of gross income, expense, gain, or loss that are related to portfolio income, and therefore treated as not being from a passive activity. n584

Personal service corporations, even if closely held, cannot take advantage of this offset. n585

[5] \$25,000 Offset for Rental Real Estate Activities

[a] Certain Losses from Rental Real Estate Activities May Offset Non-Passive Income

There is an offset of up to \$25,000 for individuals and estates for rental real estate activities. Under the offset, if the taxpayer's adjusted gross income does not exceed \$100,000, n586 up to \$25,000 of passive activity losses may be used to offset non-passive income for that year. n587 For a married person who lives apart from his or her spouse the entire taxable year and files separately, the maximum offset amount is \$12,500. n588 Alternatively, an equivalence deduction may be claimed to cover an unusable credit. n589

[b] Adjusted Gross Income Eligibility Requirements for the \$25,000 Offset

The \$25,000 offset is available only if the taxpayer's adjusted gross income for the tax year does not exceed \$100,000. n590 Adjusted gross income for this purpose is computed without regard to the following: n591

- inclusion in income of Social Security and Tier 1 Railroad retirement benefits; n592
- the income exclusions for income from U.S. savings bonds used to pay higher education costs and amounts received under adoption assistance programs; n593
- deductions based on income attributable to domestic production activities n594 and deductions for IRA contributions, interest on education loans, and qualified tuition and related costs; n595 and

- any passive activity loss or loss deductible by certain real estate professionals with respect to rental real estate activity. n596

[c] Phase-Out of \$25,000 Offset

If a taxpayer's adjusted gross income exceeds \$150,000, the \$25,000 offset is generally not available. n597 If a taxpayer files a joint return, the income of both the taxpayer and the spouse must be included in computing AGI for this purpose. n598

For adjusted gross income between \$100,000 and \$150,000, the offset amount is reduced by 50 percent of the excess of adjusted gross income over \$100,000 (for instance, at adjusted gross income of \$130,000, the offset amount is \$10,000 (\$25,000-\$15,000). n599 For a married person who lives apart from his or her spouse the entire taxable year and files separately, the maximum offset amount is \$12,500 and the adjusted gross income floor for the phase-out is \$50,000. n600

To the extent that the taxpayer has an unusable rehabilitation credit, n601 whether current or carried over from a prior year, the adjusted gross income floor for purposes of the phase-out is \$200,000 instead of \$100,000. n602 To the extent that the taxpayer has an unusable low-income housing credit n603 whether current or carried over from a prior year, there is no phase-out of the \$25,000 offset in calculating an equivalence deduction. n604 The phase-out also does not apply to any portion of the passive activity loss for the year that is attributable to the commercial revitalization deduction. n605

[d] Ordering Rules Apply to Determine Application of the Phase-Out

Ordering rules provide how the phase-out and the exceptions to it are applied. The phaseout of the offset applies in the following order: n606

- first, to the portion of the passive activity loss to which the exception for commercial revitalization deduction does not apply; n607
- second, to the portion of the passive activity loss to which the exception for commercial revitalization deduction does apply; n608
- third, to the portion of the passive activity credit to which the special phase-out rule for the rehabilitation credit or the exception for the low-income housing credit does not apply; n609
- fourth, to the portion of the passive activity credit to which the special phase-out rule for the rehabilitation credit applies; n610 and
- fifth, to the portion of the passive activity credit to which the exception for the low-income housing credit applies. n611

[e] Active Participation Requirement Must Be Met to Be Eligible for Offset

In order to be eligible for the \$25,000 offset, the taxpayer must meet an "active participation" requirement. n612 Meeting this requirement is easier than meeting the "material participation" requirement for classifying an activity as not passive, n613 because active participation can be satisfied without the regular, continuous, and substantial involvement in operations that is required for "material participation." Legislative history states that the standard can be met if the taxpayer participates in a significant, bona fide sense. Legislative history indicates that this can be done by making management decisions or arranging for others to provide services. n614

The joint committee report accompanying the legislation indicates that approval of tenants, setting rental terms, and approving repairs and capital expenditures are the types of activities that can qualify as active participation. The use of a rental agent and hired management services is permissible. On the other hand, the committee report states that a taxpayer probably cannot actively participate with respect to a property subject to a net lease. n615

The basic premise appears to be that in order to meet the active participation requirement, a taxpayer must make important management decisions and exercise independent judgment in doing so. If a management firm is used, the IRS may inspect a copy of the taxpayer's contract to determine the responsibilities of the management firm, as well as the rights and responsibilities of the taxpayer. If a taxpayer has no more involvement than deciding whether to continue to use a management firm and does not otherwise participate in management decisions in a way that requires the exercise of independent discretion and judgment, then the active participation requirement will not be met. n616

Although "active participation" is not defined by statute or regulations, the statute does clarify that the active participation requirement requires ownership (by the taxpayer or the taxpayer's spouse or both of them), at all times during the taxable year, of at least 10 percent, by value, of all interests in the activity. n617 In determining whether a taxpayer actively participates, any participation by the taxpayer's spouse is taken into account. n618

There are some exceptions and qualifications regarding the active participation requirement:

- to the extent that the taxpayer has an unusable low-income housing credit, n619 an unusable rehabilitation credit, n620 or a commercial revitalization deduction, n621 the \$25,000 offset is available without regard to the active participation requirement; n622
- until otherwise provided by regulations, an interest as a limited partner in a limited partnership can never be considered as an interest with respect to which the taxpayer actively participates; n623 and
- if the taxpayer has any carried-over deductions or credits because of application of the passive activity limitations in past taxable years, the \$25,000 offset is not available as to any of those amounts carried over from a taxable year in which the taxpayer did not meet the active participation requirement.

[f] Application of the Offset to Credits

In lieu of applying the \$25,000 offset for rental real estate activities to deductions, the offset may be applied to credits through a deduction equivalent. n624 The deduction equivalent is the amount which (if allowed as a deduction) would reduce regular tax liability by the amount of the credits. n625 Assuming a 35-percent marginal tax rate, n626 the \$25,000 special real estate rental deduction is equivalent to an \$8,750 credit. n627

The range of adjusted gross income, over which the offset is phased out, is higher when the rehabilitation credit n628 is involved. For this credit, the phaseout range is between \$200,000 and \$250,000 of AGI. n629 There is no phase-out to the extent any portion of the passive activity credit for the year is attributable to the low-income housing credit. n630

[g] Application of Offset for Estates

A decedent's estate is entitled to the \$25,000 offset for taxable years ending less than two years after the date of death, with respect to any rental real estate activity in which the decedent actively participated. n631 If there is a surviving spouse, the estate's maximum offset is \$25,000 minus whatever offset amount is allowable to the surviving spouse for his or her taxable year ending with or within the estate's taxable year. n632

[h] Application of Offset for Publicly Traded Partnerships

The \$25,000 offset generally may not be used with respect to items attributable to any publicly traded partnership. n633 However, to the extent that the taxpayer has a low-income housing credit, n634 or rehabilitation credit n635 in excess of regular tax liability n636 attributable to the income from that partnership, the taxpayer may use the \$25,000 offset. n637

[6] Treatment of Former Passive Activities

Any activity that was a passive activity for the taxpayer for a past taxable year, but is not a passive activity for the current taxable year, is called a former passive activity. n638 Any unused deduction allocable to a former passive activity and carried over to the current taxable year must be set off against income from the activity for the current taxable year. n639 If any deduction remains unused after the setoff, it is carried over and must be set off against income from the activity in a later taxable year. n640

Any unused credit allocable to a former passive activity and carried over to the current taxable year must be set off against the regular tax liability n641 for the current taxable year that is allocable to the former passive activity (computed after application of the preceding rule regarding setoff of unused deductions). n642 If any credit remains unused after the setoff, it is carried over and must be set off against regular tax liability, under this rule, in a later taxable year. n643

NOTE:

The transition from a passive activity into a non-passive one is not treated as a disposition that otherwise triggers the allowance of losses. n644 As noted above, disallowed deductions from the activity continue to be carried over, but they only be used against income from the activity, and not against other non-passive income of the taxpayer. n645

FOOTNOTES:

(n1)Footnote 557. *IRC § 469(d)(1)*. The items of income taken into account in determining income from a passive activity are discussed in § 13.06, above. Deductions that are taken into account are discussed in § 13.07, above.

(n2)Footnote 558. See *IRC § 469(a)*.

(n3)Footnote 559. *IRC § 469(a)*.

(n4)Footnote 560. See *IRC § 469(j)(4)*.

(n5)Footnote 561. *Temp Treas Reg § 1.469-1T(f)(2)(i)(A)*.

(n6)Footnote 562. *Temp Treas Reg § 1.469-1T(f)(2)(i)(B)*; see *IRC § 469(i)*, discussed in [5], below.

(n7)Footnote 563. See *IRC § 469(j)(4)*.

(n8)Footnote 564. *Temp Treas Reg § 1.469-1T(f)(2)(ii)(A)*.

(n9)Footnote 565. *Temp Treas Reg § 1.469-1T(f)(2)(ii)(A)*.

(n10)Footnote 566. *Temp Treas Reg § 1.469-1T(f)(2)(ii)(B)*; see *Temp Treas Reg §§ 1.469-2T(c)(6), 1.469-2T(f)(5), (6), (7)*.

(n11)Footnote 567. *Temp Treas Reg § 1.469-1T(f)(2)(iii)*.

(n12)Footnote 568. *Temp Treas Reg § 1.469-1T(f)(2)(i)(C)*.

(n13)Footnote 569. *IRC § 469(b)*; *Treas Reg § 1.469-1(f)(4)(i)*.

(n14)Footnote 570. See *IRC* § 469(b).

(n15)Footnote 571. *Treas Reg* § 1.469-1(f)(4)(i).

(n16)Footnote 572. *Treas Reg* § 1.469-1(f)(4)(ii).

(n17)Footnote 573. *IRC* § 469(f); see [6], below, for a discussion.

(n18)Footnote 574. *IRC* § 469(j)(4); see *Temp Treas Reg* § 1.469-1T(f)(2)(i)(A).

(n19)Footnote 575. *St Charles Investment Co v Commr*, 232 F 3d 773 (10th Cir 2000) , revg 110 TC 46 (1998) .

(n20)Footnote 576. *St Charles Investment Co v Commr*, 232 F 3d 773 (10th Cir 2000) , revg 110 TC 46 (1998) .

(n21)Footnote 577. *St Charles Investment Co v Commr*, 232 F3d 773 (10th Cir 2000) , revg 110 TC 46 (1998) .

(n22)Footnote 578. See *Golsen v Commr*, 54 TC 742 , *affd on other grounds* 445 F2d 985 (10th Cir 1971) , *cert denied* 404 US 940 (1971) .

(n23)Footnote 579. *Treas Reg* § 1.1398-1(a), (c).

(n24)Footnote 580. *Treas Reg* § 1.1398-1(d)(1).

(n25)Footnote 581. *Treas Reg* § 1.1398-1(d)(2).

(n26)Footnote 582. *Treas Reg* § 1.1398-1(e).

(n27)Footnote 583. *IRC* § 469(e)(2)(A). A similar rule applies to the corporation's passive activity credits. See § 13.08[5], above, for a discussion.

(n28)Footnote 584. *IRC* § 469(e)(2)(B); see *IRC* § 469(e)(1)(A); see § 13.06[2], above, for a discussion of these items.

(n29)Footnote 585. *IRC* § 469(e)(2).

(n30)Footnote 586. See [b], below, for a detailed discussion.

(n31)Footnote 587. *IRC* § 469(i)(1), (4); the restriction of the offset to only real estate rental activities has been upheld [*Schetzler v Commr*, *TC Memo* 1999-252 , *affd* 53 *Fed Appx* 397 (8th Cir 2003)].

(n32)Footnote 588. *IRC* § 469(i)(5)(A).

(n33)Footnote 589. *IRC* § 469(i)(1); see *IRC* § 469(j)(5) (deduction equivalent); see [f], below, for a discussion of the application of the offset against credits.

(n34)Footnote 590. *IRC* § 469(i)(3)(A).

(n35)Footnote 591. *IRC* § 469(i)(3)(F).

(n36)Footnote 592. See *IRC* § 86.

(n37)Footnote 593. See *IRC* §§ 135, 137.

(n38)Footnote 594. See *IRC* § 199.

(n39)Footnote 595. See *IRC* §§ 219, 221, 222.

(n40)Footnote 596. See *IRC* § 469(c)(7); see § 13.04[5], above, for a discussion.

(n41)Footnote 597. *IRC* § 469(i)(3)(A); *Paleveda v Commr*, *TC Memo* 1997-416 .

(n42)Footnote 598. *Opperwall v Commr*, 97-1 *USTC* P 50,160 (9th Cir 1997).

(n43)Footnote 599. *IRC* § 469(i)(1), (2), (3)(A).

(n44)Footnote 600. *IRC* § 469(i)(5).

(n45)Footnote 601. See *IRC* § 47.

(n46)Footnote 602. *IRC* § 469(i)(3)(B).

(n47)Footnote 603. See *IRC* § 42.

(n48)Footnote 604. *IRC* § 469(i)(3)(D).

(n49)Footnote 605. *IRC* § 469 (i)(3)(C); see *IRC* § 1400I.

(n50)Footnote 606. *IRC* § 469(i)(3)(E).

(n51)Footnote 607. See *IRC* § 469(i)(3)(C).

(n52)Footnote 608. See *IRC* § 469(i)(3)(C).

(n53)Footnote 609. See *IRC* § 469(i)(3)(B), (D).

(n54)Footnote 610. See *IRC* § 469(i)(3)(B).

(n55)Footnote 611. See *IRC* § 469(i)(3)(D).

(n56)Footnote 612. *IRC* § 469(i)(1).

(n57)Footnote 613. See *IRC* § 469(h), discussed in § 13.05, above.

(n58)Footnote 614. HR Rep No 3838, Pub Law No 99-514, 99th Cong, 2nd Sess 244 (1986).

(n59)Footnote 615. HR Rep No 3838, Pub Law No 99-514, 99th Cong, 2nd Sess 244 (1986).

(n60)Footnote 616. *Madler v Commr*, *TC Memo* 1998-112 .

(n61)Footnote 617. *IRC* § 469(i)(6)(A), (D).

(n62)Footnote 618. *IRC* § 469(i)(6)(D).

(n63)Footnote 619. See *IRC* § 42.

(n64)Footnote 620. See *IRC* § 47.

(n65)Footnote 621. See *IRC* § 1400I.

(n66)Footnote 622. *IRC* § 469(i)(6)(B).

- (n67)Footnote 623. *IRC § 469(i)(6)(C)*.
- (n68)Footnote 624. *IRC § 469(i)(1)*.
- (n69)Footnote 625. *IRC § 469(j)(5)*.
- (n70)Footnote 626. See *IRC § 1(i)(2)*.
- (n71)Footnote 627. See *IRC § 469(j)(5)*.
- (n72)Footnote 628. See *IRC § 47*.
- (n73)Footnote 629. *IRC § 469(i)(3)(B)*.
- (n74)Footnote 630. *IRC § 469(i)(3)(D)*; see *IRC § 42*.
- (n75)Footnote 631. *IRC § 469(i)(4)(A)*.
- (n76)Footnote 632. *IRC § 469(i)(4)(B)*.
- (n77)Footnote 633. *IRC § 469(k)(1)*.
- (n78)Footnote 634. See *IRC § 42*.
- (n79)Footnote 635. See *IRC § 47*.
- (n80)Footnote 636. See *IRC §§ 26(b), 469(j)(3)*.
- (n81)Footnote 637. *IRC § 469(k)(1)*.
- (n82)Footnote 638. *IRC § 469(f)(3)*.
- (n83)Footnote 639. *IRC § 469(f)(1)(A)*.
- (n84)Footnote 640. *IRC § 469(f)(1)(C)*.
- (n85)Footnote 641. See *IRC §§ 26(b), 469(j)(3)* (definition of regular tax liability).
- (n86)Footnote 642. *IRC § 469(f)(1)(B)*.
- (n87)Footnote 643. *IRC § 469(f)(1)(C)*.
- (n88)Footnote 644. See *IRC § 469(g)*.
- (n89)Footnote 645. *IRC § 469(f)*.

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.10

§ 13.10 Treatment of Passive Losses on Disposition of Passive Activity

[1] Passive Losses are Generally Allowed in the Year the Taxpayer Disposes of a Passive Activity

The tax treatment of suspended passive losses upon a taxpayer's disposition of an entire interest in a passive activity depends on the type of disposition (sale or exchange, transfer by death, gift), whether the disposition involves a related party, and whether the disposition is fully taxable. n646 For passive activity losses to be allowed, a disposition of a passive activity must meet three tests:

- the taxpayer's entire interest in the activity must be disposed of; n647
- the disposition must be fully taxable; n648 and
- the disposition must not be to a related party. n649

The requirements that the disposition be of the taxpayer's entire interest and be fully taxable are consistent with the concept of the passive activity limitations. The disposition ensures that the taxpayer will not recognize additional income from the passive activity. As a result, there is no justification for continuing to suspend the losses from that activity. The disposition of the taxpayer's entire interest guarantees there will be no future income produced, and a fully taxable transaction ensures that any inherent taxable gain is recognized currently.

The following are not fully taxable transactions and will not trigger recognition of losses: n650

- like-kind or involuntary exchanges; n651
- conversions to personal use;
- gifts; n652
- transfer to a corporation, partnership or LLC; n653
- transfers to an ex-spouse on divorce; n654 and

- installment sales. n655

If a taxpayer disposes of his entire interest in a passive activity in a fully taxable transaction, the loss attributable to that activity for the current year, which includes any carryover of disallowed losses from prior years, is allowed against other passive or active income without regard to the passive activity limitations. n656

The order in which the losses are allowed against various types of income is controlled by special rules. The effect of these rules is that net income or loss from the particular passive activity being disposed of is determined separately from other passive activities for the year. Any gain from the disposition is treated as passive income and any loss is treated as passive loss. Any losses relating to the passive activity in the year of sale (including suspended losses relating to the activity carried forward into the year of sale) are used to offset gain from the disposition of the passive activity. n656.1 Any net loss remaining is then used against any passive income from other activities. The balance is treated as a loss that is not from a passive activity. It is therefore fully deductible against non-passive income. n657

If property sold has been used in more than one activity during the 12-month period before the date of its disposition, the amount realized must be allocated among those different activities on a basis that reasonably reflects the use of that interest in the property during that period. n658

NOTE:

Other Code provisions, such as those limiting capital losses, n659 may limit whether a loss on the disposition of a passive activity may be recognized. n660

Practice Tip:

When the accumulated losses from a passive activity exceed the potential gain from its sale, or where a major portion of the gain will have to be recognized in any event, taxpayers should make certain that they meet the criteria for a complete and fully taxable disposition, so that they will be able to make full and immediate use of the suspended passive losses. n661 Otherwise, those losses may continue to be suspended and result in no current or subsequent tax benefit. For example, conveying a residential rental property with suspended passive losses to a related party who intends to use the property as a residence is generally not advisable. Any suspended passive losses will be deductible only when the related party sells the residence in a fully taxable transaction. n662 Given the mandatory application of *IRC Section 121* this may never occur, and the suspended losses will never become deductible. n663

Practice Tip:

The recognition of suspended passive losses is triggered only when the taxpayer's entire interest in the activity is disposed of. This disposition rule should be considered in deciding how to first group passive activities. A narrower grouping of activities will make disposition of an entire activity easier, and may thereby speed the recognition of losses. n664

[2] Partial Dispositions

Generally, a partial disposition of a taxpayer's interest in a passive activity does not allow the taxpayer to use any of the suspended passive losses from that activity. n665 A taxpayer may, however, elect to treat certain partial dispositions as a disposition of an entire passive activity. This is done by treating the part disposed of as a separate activity for the year of the disposition. To qualify for this treatment, the taxpayer must dispose of "substantially all" the activity in that year, however, and must establish the following with reasonable certainty: n666

- the amount of disallowed passive activity deductions and credits from prior years that are carried

over and allocable to the part of the passive activity that the taxpayer is treating as a separate activity; n667 and

- the amount of gross income and of any other deductions and credits allocable to that part of the passive activity for the taxable year.

[3] Dispositions to a Related Party

A taxpayer who disposes of an entire interest in a passive activity to a related party n668 cannot treat the suspended passive losses as non-passive until the taxable year in which the entire interest in the passive activity is acquired in a fully taxable transaction by an unrelated party. n669 Related parties for purposes of this rule include the following: n670

- members of a family (including brothers and sisters of whole or half blood), spouse, ancestors and lineal descendants); n671
- an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for that individual;
- two corporations that are members of the same controlled group (applied with a 50-percent ownership test); n672
- a grantor and a fiduciary of any trust;
- a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- a fiduciary of a trust and a beneficiary of that trust;
- a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- a person and certain exempt organizations n673 controlled directly or indirectly by that person or (if the person is an individual) by members of the family of that individual;
- a corporation and a partnership if the same persons own (1) more than 50 percent in value of the outstanding stock of the corporation, and (2) more than 50 percent of the capital interest, or the profits interest, in the partnership;
- an S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;
- an S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation;
- except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate;

- a partnership and a person owning directly or indirectly more than 50 percent of the capital or profits interest in the partnership; and

- two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital.

[4] Installment Sales

The normal rule--that accumulated passive losses are deductible in the year a passive activity is disposed of, without regard to the passive activity limitations--is modified when a taxpayer sells the entire interest in the passive activity in an installment sale. In that case, only a portion of the accumulated losses from the activity may be deducted in the year of sale without regard to the passive activity limitations. The portion of passive losses eligible is that which bears the same ratio that the gain recognized during the year bears to the gross profit on the installment sale that will be realized when payment is complete. n674 For example, if the gain recognized in the year of the sale is 10 percent of the gross profit that will be realized on the entire sale, 10 percent of the accumulated passive activity losses would be deductible in that year without regard to the passive activity limitations. The same rule would apply to each year of the installment period. n675

Example (1):

Cheryl disposes of a rental property in an installment sale. Her total gain of \$10,000 is to be reported over 5 years (\$2,000 each year). Her current and suspended passive losses attributable to this rental were \$30,000. The losses deductible are as follows: n676

Year 1 $(\$2,000/\$10,000 \times \$30,000) = \$6,000$

Year 2 $(\$2,000/\$8,000 \times \$24,000) = \$6,000$

Year 3 $(\$2,000/\$6,000 \times \$18,000) = \$6,000$

Year 4 $(\$2,000/\$4,000 \times \$12,000) = \$6,000$

Year 5 $(\$2,000/\$2,000 \times \$6,000) = \$6,000$

Example (2):

Paul disposes of a rental property in an installment sale. His total gain of \$50,000 is to be reported over 5 years (\$10,000 each year). His current and suspended losses attributable to this rental were \$30,000. The losses deductible are as follows n677

Year 1 \$10,000

Year 2 \$10,000

Year 3 \$10,000

Paul can further deduct losses from other passive activities to the extent of income recognized from the installment sale in years 4 and 5. When the gain recognized in the current year exceeds all of Paul's

current and carryforward losses, all of those losses would be deductible in that current year. n678

In applying this disposition rule to installment sales, several things must be kept in mind:

- Installment reporting may be used only to report gains, not losses. n679 Therefore, if the passive activity is disposed of at a loss, the installment sale rule does not apply, even though the selling price may not be received until a later year; n680
- Any gain attributable to depreciation recapture amounts on real or personal property must be recognized in the year of disposition. n681 This gain must be disregarded in computing the gross profit ratio for purposes of the above installment sale rule; n682 and
- The imputed-interest rules applicable to deferred-payment transactions may cause a recharacterization of selling price into interest income. This can dramatically reduce the gross profit on the installment sale, thereby changing the gross profit ratio. n683

Example:

Ellen Smith, an individual, sells her entire interest in a passive activity to an unrelated party for \$500, to be paid \$100 down and the balance 13 months later. The contract bears adequate stated interest. Ellen's adjusted basis in the activity is \$300, and the accumulated passive losses just before the sale are \$700. The effect on the tax treatment of the passive activity losses in the year of sale between reporting on the installment method and electing out are shown in the chart below. Ellen has available a much larger loss deduction in the year of sale by choosing to elect out of installment method n684 because the installment sale passive loss restriction will not apply, n685 and all of the suspended passive losses can be used to offset other income. n686 Using the installment method defers Ellen's recognition of the major portion of the gain on the sale until the following year, and also has the effect of postponing her deduction for most of the suspended passive activity losses. Which choice is more beneficial depends on the taxpayer's circumstances. n687

Reporting Choice	Gain	Percentage of Gain Recognized	Gain Recognized	Passive Loss Allowed	Net
Installment Method	\$200	20%	\$40	(\$140)	(\$100)
Election out	\$200	100%	\$200	(\$700)	(\$500)

[5] Dispositions by Passthrough Entities

Partnerships and S corporations engaged in a passive activity can accomplish a complete disposition under rules identical to those above; that is, by selling all interests and assets held by the entity that are associated with the passive activity. If a partnership or S corporation engages in more than one activity, it can dispose of those activities separately. n688 Whether the disposition of a passive activity by a passthrough entity allows the partners or shareholders to deduct suspended passive activity losses generally depends on whether the partner or shareholder holds any interest or assets in the same activity outside the entity. If so, then a complete disposition would not have occurred as to that partner or shareholder. n689

In this regard, an S corporation may carry forward from its C corporation years any passive activity losses that were suspended from its C corporation years. When the S corporation sells the properties used in passive activities, S corporation shareholders may take advantage of the losses at that time. n690

[6] Dispositions of Interest in a Passthrough Entity

In general, the disposition of an interest in a partnership or S corporation is treated as a disposition of an interest in each of the entity's activities. A holder's gain or loss from each activity in the passthrough entity must be aggregated. The net gain or loss is then allocated among the activities of the passthrough entity. The allocation is made in proportion to the amounts of gain or loss that would have been allocated to the holder by the passthrough entity, if the entity had sold its interests in each of its activities on the valuation date. Generally, the passthrough entity may select as the valuation date the beginning of the taxable year in which the holder's disposition occurs or the date of the disposition. n691

The gain from a holder's disposition of an interest in a passthrough entity that is allocated to a passive activity may be treated as gain that is not from a passive activity, under certain circumstances. The rule is designed to prevent taxpayers from using passthrough entities to structure dispositions of property to generate passive income, when the income would not be from a passive activity otherwise. n692

A special disposition rule applies for interests in publicly traded partnerships. A taxpayer is not treated as having disposed of an entire interest in an activity of a publicly traded partnership until the taxpayer completely disposes of his or her entire interest in the partnership. n693

[7] Dispositions by Gift

Taxpayers who dispose of an entire interest in a passive activity by gift cannot deduct any of the accumulated passive losses on the portion of the activity given away. n694 Instead, any accumulated losses are added to the basis of the property immediately before the transfer. This allows the donee to benefit from the increased basis in the transferred activity. n695 For the donor, any losses added to the donee's basis are permanently extinguished. When only a portion of the passive activity's assets is given away, an allocable portion of the accumulated losses is added to the basis of that property and is extinguished for the donor. n696

Note:

Although this rule sounds simple, in practice it can become very complex. For one thing, it theoretically requires a portion of the suspended passive activity loss allocated to the passive activity to be further allocated in even greater detail to the specific assets of that activity. There are no rules for accomplishing this allocation. Furthermore, the statutory rule that a taxpayer must dispose of all of an activity's assets to claim the accumulated passive activity losses now must be embellished with the additional rule that disposition by gift will have somewhat unpredictable and probably undesirable results regarding the disallowance of those losses. n697

Any gift of a passive activity's assets is subject to the extinguishment rule, n698 regardless of whether there is an intent to completely dispose of the activity. There is neither a de minimis exception nor an exception for cash gifts. Therefore, gifts to charities, for example, might create a charitable contribution deduction but also extinguish part or all of the accumulated losses by the amount allocable to the gift, which might significantly exceed the charitable contribution deduction. n699 If a taxpayer makes a partial gift of passive activity assets and retains the balance, the accumulated passive activity losses allocable to the retained portion continue to be suspended. The taxpayer's ability to deduct those losses in the future is based on the general rule that losses can be used to offset passive activity income and are fully allowed if the activity, or all the remaining assets from a discontinued activity, are disposed of in a fully taxable transaction. n700

For the donee, the basis of the gift property is increased by the amount of any suspended losses attributable to the property. n701 The donee recovers the basis of that property under the normal rules for basis recovery, such as depreciation. n702 Any deductions attributable to the increased basis do not have a passive activity taint, unless the

donee uses the property in a passive activity. As a result, the basis of gift property that the donee uses in an active business produces deductions that are not subject to the passive activity limitations. n703 If the donee uses the property in a passive activity, it produces passive activity deductions. In any event, however, the donee could benefit, within the limits of the tax basis rules, from the increased basis if the property is disposed of in a taxable transaction such as a sale. n704

[8] Disposition by Death

If a taxpayer engaged in a passive activity dies, that event is treated as a complete disposition of the activity. However, the passive activity taint to the suspended passive activity losses is not necessarily eliminated. n705 Under the tax rules governing estates, the basis of property passing through an estate is generally stepped up to its fair market value at the date of death. n706 This step-up in basis does not create taxable income. However, for purposes of the passive activity loss rules, any step-up in the basis of passive activity property results in a dollar-for-dollar reduction in the amount of any suspended losses attributable to that activity. As a result, that portion of any suspended losses is extinguished and is not available to the decedent, the estate, or the heirs. n707 The net effect is similar to taxing part of the step-up in basis. Any suspended passive activity losses in excess of the amount of the basis step-up are allowed without limitation on the decedent's final return. n708 The decedent's suspended passive losses are allowed only to the extent they exceed the amount by which the transferee's basis in the passive activity has been increased. If the increase in basis exceeds unused passive losses, no passive activity losses are deductible on the decedent's return. n709

Passive losses that are suspended during the period in which the estate holds the activity increase the basis of the property when the estate distributes the property. Those losses are not allowed as a deduction at any time. n710 This step-up/loss-extinguishment rule applies at the individual activity level rather than to the aggregate of the passive activities of the decedent. The result of this approach is that a decedent's passive activity losses may not be reduced by the full amount of the basis step-up. n711

Example:

Mike dies having four passive activities at the time of death, as follows:

Activity	Passive Activity Loss	Tax Basis	Fair Market Value	Step-up At Death	Passive Activity Loss Allowed By Reason of Death
1	(\$69)	(\$10)*	\$20	\$30	\$39
2	(\$81)	(\$15)*	\$10	\$25	(\$56)
3	-----	\$25	\$300	\$275	-----
4	-----	\$35	\$200	\$165	-----
Totals	(\$150)	\$35	\$530	\$495	(\$95)

* The negative tax basis for activities 1 and 2 results from the excess of Mike's share of partnership debt over the tax basis of the share of partnership assets.

The total amount of the basis step-up at Mike's death (\$495) far exceeds the suspended passive activity losses present at death (\$150). However, because the step-up/loss-extinguishment rule applies to each activity separately, \$95 of the \$150 passive losses are nevertheless allowed in the year of Mike's death. The balance is extinguished by the basis step-up on those activities. n712

[9] Distributions of Interests in Passive Activities by Estates or Trusts

If an estate or trust distributes an interest in a passive activity, no deduction is allowed for any passive activity losses allocable to that interest. Instead, the basis of the interest immediately before the distribution must be increased by the amount of any passive activity losses allocable to that interest. n713

[10] Transfer Pursuant to Divorce

The transfer of passive activities incident to a divorce is not considered a fully taxable transaction, and therefore, any suspended losses are not triggered on the transfer. n714 The reason is that any transfer of property incident to a divorce is treated as a gift for purposes of Subtitle A of the Code. n715 Because Treas Reg § 1.7701-2 is part of Subtitle A, the transfer of passive activities incident to a divorce would be treated as a gift, and the suspended losses of the "donor" spouse are added to the property's basis immediately before the transfer. n716

[11] Other Nonrecognition Dispositions

When a taxpayer disposes of passive activity property in a tax-free transaction other than by gift or death (such as a like-kind exchange, conversion to personal use, or tax-free transfer to an entity), the suspended losses of that activity are not affected, even if all the assets of the activity are transferred. Those losses continue to be treated as passive activity losses of the taxpayer and can be used to offset any passive activity income. n717 In all cases, the taxpayer will have received some asset or ownership interest in exchange for the passive activity property. When that asset or interest is subsequently completely disposed of in a fully taxable transaction, the original property is treated as completely disposed of, and any suspended losses for that property are allowed in full. n718

[12] Worthlessness of Stock as Disposition

If a taxpayer's investment in a passive activity is through ownership of stock, the entire interest in that activity is disposed of for purposes of *IRC Section 469(g)* whenever that stock becomes worthless. This occurs because under *IRC Section 165(g)*, the loss from the stock's worthlessness is treated as a loss from a sale or exchange. n718.1

FOOTNOTES:

(n1)Footnote 646. *IRC § 469(g)*.

(n2)Footnote 647. *IRC § 469(g)*; but see [2], below, for a discussion of partial dispositions.

(n3)Footnote 648. *IRC § 469(g)(1)(A)*.

(n4)Footnote 649. *IRC § 469(g)(1)(B)*; see [3], below, for discussion of related party issues.

(n5)Footnote 650. See *IRC § 469(g)(1)*.

(n6)Footnote 651. See *IRC §§ 1031, 1033*.

(n7)Footnote 652. See [7], below, for a discussion.

(n8)Footnote 653. See *IRC §§ 351, 721*.

(n9)Footnote 654. See *IRC § 1041(a), (b)*; see [10], below, for a discussion.

(n10)Footnote 655. See *IRC § 453*; see [4], below, for a discussion.

(n11)Footnote 656. *IRC § 469(g)(1)(A)*. *Lowe v Commr, TC Memo 2008-298* (suspended passive losses allowed on disposition of passive activity, but only to the extent they exceeded prior unreported gains from the activity).

(n12)Footnote 656.1. *Shiekh v Commr, TC Memo 2010-126 (2010)* .

(n13)Footnote 657. *IRC § 469(g)(1)(A)*.

(n14)Footnote 658. *Temp Treas Reg § 1.469-2T(c)(2)(ii)*; for de minimis amounts, the amount realized may be allocated entirely to the property's predominant use.

(n15)Footnote 659. See *IRC § 1211*.

(n16)Footnote 660. See *Treas Reg § 01.7701-3(c)(1)(v)(C)*, above, for a discussion.

(n17)Footnote 661. *IRC § 469(g)(1)*.

(n18)Footnote 662. See *IRC § 469(g)(1)(B)*.

(n19)Footnote 663. *IRC § 469(g)(1)(B)*; see *TAM 9739004* (involving subsequent disposition under former *IRC § 1034*).

(n20)Footnote 664. See *IRC § 469(g)*.

(n21)Footnote 665. See *IRC § 469(g)*.

(n22)Footnote 666. *Treas Reg § 1.469-4(g)*.

(n23)Footnote 667. See *Treas Reg § 1.469-1(f)(4)*.

(n24)Footnote 668. See *IRC §§ 267(b), 707(b)(1)*.

(n25)Footnote 669. *IRC § 469(g)(1)(B)*.

(n26)Footnote 670. *IRC §§ 267(b), 707(b)(1)*.

(n27)Footnote 671. See *IRC § 267(c)(4)*.

(n28)Footnote 672. See *IRC §§ 267(f), 1563(a)*.

(n29)Footnote 673. See *IRC § 501*.

(n30)Footnote 674. *IRC § 469(g)(3)*.

(n31)Footnote 675. *IRC § 469(g)(3)*.

(n32)Footnote 676. See *IRC § 469(g)(3)*.

(n33)Footnote 677. See *IRC § 469(g)(3)*.

(n34)Footnote 678. See *IRC § 469(g)(3)*.

(n35)Footnote 679. *IRC § 453(a)*.

(n36)Footnote 680. See *IRC § 469(g)(3)*.

(n37)Footnote 681. *IRC § 453(i)(1)(A)*.

(n38)Footnote 682. See *IRC § 453(g)(3)*.

(n39)Footnote 683. See *IRC* §§ 453(c), 483.

(n40)Footnote 684. See *IRC* § 453(d).

(n41)Footnote 685. See *IRC* § 469(g)(3).

(n42)Footnote 686. *IRC* § 469(g)(1).

(n43)Footnote 687. See *IRC* § 453(g)(3).

(n44)Footnote 688. *Temp Treas Reg* § 1.469-2T(c)(2)(i)(A).

(n45)Footnote 689. See *IRC* § 469(g)(1).

(n46)Footnote 690. *St Charles Investment Co v Commr*, 232 F 3d 773 (10th Cir 2000) , revg 110 TC 46 (1998) .
See § 13.10[2][b], above, for a discussion.

(n47)Footnote 691. *Temp Treas Reg* § 1.469-2T(e)(3)(ii).

(n48)Footnote 692. See *Temp Treas Reg* § 1.469-2T(e)(3)(iii).

(n49)Footnote 693. *IRC* § 469(k)(3).

(n50)Footnote 694. *IRC* § 469(j)(6)(B).

(n51)Footnote 695. *IRC* § 469(j)(6)(A).

(n52)Footnote 696. See *IRC* § 469(j)(6)(A).

(n53)Footnote 697. See *IRC* § 469(g)(1), (j)(6).

(n54)Footnote 698. See *IRC* § 469(g)(1).

(n55)Footnote 699. See *IRC* §§ 170, 469(j)(6).

(n56)Footnote 700. *IRC* § 469(b), (g)(1).

(n57)Footnote 701. *IRC* § 469(j)(6).

(n58)Footnote 702. See *IRC* § 168.

(n59)Footnote 703. *IRC* § 469.

(n60)Footnote 704. See *IRC* § 1001(a).

(n61)Footnote 705. See *IRC* § 469(g)(2).

(n62)Footnote 706. See *IRC* § 1014.

(n63)Footnote 707. *IRC* § 469(g)(2)(B).

(n64)Footnote 708. *IRC* § 469(g)(2)(A).

(n65)Footnote 709. See *IRC* § 469(g)(2).

(n66)Footnote 710. *IRC § 469(j)(12)*.

(n67)Footnote 711. See *IRC § 469(g)(2), (j)(12)*.

(n68)Footnote 712. See *IRC § 469(g)(2), (j)(12)*.

(n69)Footnote 713. *IRC § 469(j)(12)*.

(n70)Footnote 714. *IRC § 469(g)(1)*.

(n71)Footnote 715. *IRC § 1041(b)*.

(n72)Footnote 716. *IRC § 469(j)(6)(A)*; see [7], above, for a discussion of the treatment of dispositions by gift.

(n73)Footnote 717. See *IRC § 469(b), (g)(1)*.

(n74)Footnote 718. See *IRC § 469(g)(1)*.

(n75)Footnote 718.1. See *Bilthouse v US, 553 F3d 513 (7th Cir 2009)* .

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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.11

§ 13.11 At-Risk Limitation on the Deductibility of Losses

The at-risk rules present an additional limitation on the ability to currently use losses from most investments. The statutory at-risk rules limit the deductibility of losses to the amount a taxpayer has at risk in the activity at the close of a taxable year n719

[1] Taxpayers Subject to the At-Risk Limitation

Individuals and certain closely held C corporations are subject to the at-risk limitation. n720 Partnerships engaged in activities subject to the at-risk limitations apply the limitations at the partner level rather than the partnership level. Additionally, the at-risk rules apply to losses at the shareholder level rather than at the corporate level for S corporations. Corporations, unless they are an S corporation or a closely held company, are not subject to the at-risk limitation. This is true even when the corporation is a partner in a partnership that conducts an activity that is subject to the at-risk limitation.

Taxpayers subject to the at-risk limitation, may deduct losses from certain enumerated activities only to the extent they are at risk with respect to the activity at the end of their taxable year. n721 If the investor's taxable year differs from that of the partnership or S corporation, the at-risk limitation is applied at the end of the entity's taxable year.

[2] Activities Subject to the At-Risk Limitation

For real property acquired after 1986, the at-risk rules of *IRC Section 465* apply. Losses generated by property acquired before 1987 can be deducted without regard to the at-risk limitation. For partnerships, any partnership interest acquisition after 1986 subjects the partner's share of the partnership debt to the at-risk limitation, even if the partnership property was acquired before 1987.

Although TRA 1986 caused all real estate activities to be subject to the at-risk rules, it did grant the real estate industry a more liberal definition of the "at-risk amount" than is applicable to other industries. (See § 13.02[5][c], below.)

[3] Closely Held C Corporations

[a] Overview

Activities engaged in by closely held C corporations are subject to the at-risk limitation. n722 A closely held C corporation is one in which five or fewer individuals own, directly or indirectly (i.e., by attribution), more than 50 percent of the corporation's stock. However, for this purpose, there is no attribution of stock ownership from one partner to another. n723

[b] Actively Engaged in Leasing Activities

An exception to the at-risk limitation is provided for closely held C corporations that actively engage in equipment leasing. n724 The income from the leasing of Section 1245 equipment must constitute 50 percent or more of the corporation's gross receipts for the corporation to be considered actively engaged in equipment leasing. n725 In the case of a parent-subsidiary or brother-sister controlled group of corporations, the controlled group is to be considered as one corporation, for purposes of determining whether 50 percent or more of the group's combined gross receipts are attributable to equipment leasing. n726

[c] Engaged in a Qualified Business

Certain active, closely held C corporations are also exempt from the at-risk limitation. For tax years beginning after 1983, a closely held qualified C corporation will be exempt if it engages in a qualifying business. n727 For the corporation to be qualified it cannot be:

- (1) a personal holding company;
- (2) a foreign personal holding company; or
- (3) a personal-service corporation. n728

A "qualifying business" is an active business that satisfies three requirements. During the entire 12-month period, ending on the last day of the tax year, the corporation must have had:

- (1) substantially all the services of at least one full-time employee directed toward the active management of the business;
- (2) substantially all of the services of at least three full-time non-owner employees directly related to the business; and
- (3) deductions for business expenses attributable to the business allowable to the corporation for the tax year, and for contributions to certain employee benefit plans, exceeding 15 percent of the business' gross income.

In addition, the business must not be an excluded business (defined as (1) equipment leasing, or (2) any business involving the use, exploitation, sale, lease, or other disposition of master sound recordings, motion picture films, video tapes, or tangible or intangible assets associated with literary, artistic, musical, or similar properties). n729

In determining whether the deductions for business expenses exceed 15 percent of business income, the compensation deduction for personal services rendered by owner-employees (i.e., those who own more than 5 percent of the stock) or any member of the employee's family, is disregarded.

[4] Separation and Aggregation of Activities

The at-risk limitation is applied separately to each of the following activities: n730

- (1) film and video;
- (2) equipment leasing;
- (3) farming;
- (4) oil and gas;
- (5) geothermal; and
- (6) each other activity engaged in by the taxpayer in carrying on a trade or business, or for the production of income. n731

The definition of "activity" as it applies to real estate depends upon the type of real estate involved and the manner in which the taxpayer uses it. The Conference Report to TRA 1986 states that all real estate holdings that would have been exempt from the at-risk rules before TRA 1986 will be considered "the activity of holding real property." That would appear to mean that holding real estate will generally be considered to be a single activity of the taxpayer, and the at-risk limitation can be applied based on the aggregate of the taxpayer's equity interests in real property, including personal property used in hotel and rental apartment operations.

The clearest exception to that general rule would occur in the case of mineral property, since there is a specific exclusion provision in TRA 1986. Other exceptions would include any real property used by the taxpayer in any of the activities listed in (1) through (5), above, including real estate used in farming and in oil and gas production. Real property used in those specific categories is not considered part of the activity of holding real property because it was not exempt from the at-risk limitation under prior law. Real property not included within the scope of the activity of holding real property will be part of the specific activity in which it is used, i.e., farming, oil and gas, mineral, etc.

It is likely that real property, other than that described in the preceding paragraph, that is used by the taxpayer in a non-real estate trade or business will nonetheless be treated as part of the activity of holding real property. Thus, for at risk purposes, it would normally be a separate activity from the activity or activities constituting the trade or business in which it is used. However, the statute provides that separate activities may be aggregated and treated as one activity for at-risk purposes, if the activities are combined in a single trade or business of the taxpayer. The statutory aggregation rules do not apply to investment (as distinguished from trade or business) activities, nor do they apply to activities that are not combined in a single trade or business. Aggregation of activities that are not a single trade or business will be permitted only under future regulations.

For the activities that constitute a trade or business to be aggregated, the taxpayer must either: (1) actively participate in the management of the trade or business, or (2) the trade or business must be carried on by a partnership or S corporation that allocates 65 percent or more of its losses to the people who actively participate in the management of the business. n732 Active participation depends upon the facts and circumstances of each situation. Lack of active participation will be indicated if the taxpayer has authority only to discharge the manager of the business, or if the manager is an independent contractor rather than an employee.

Treasury has issued temporary regulations that allow a partner or an S corporation shareholder to aggregate similar activities conducted by the partnership or S corporation and treat them as a single activity, for purposes of applying the at-risk limitation.

Example:

A partnership (or S corporation) owns ten oil and gas properties on which it explores for or exploits oil and gas resources. The partnership (or S corporation) also owns two farms where it engages in farming activities. The partner (or shareholder) may aggregate the ten oil properties and treat them as one activity. The partner (or shareholder) can aggregate the two farms and treat them as one activity. However, the partner (or shareholder) cannot aggregate the farming activity with the oil and gas exploration activity. n733

The temporary regulations only to apply to those specific activities that would otherwise be treated on a property-by-property basis, namely those listed in categories (1) through (5), above. The temporary regulations, therefore, do not apply to real property except to the extent it is used in those specific activities. However, as discussed above, real estate holdings that are not in those specific categories, with the exception of mineral property, would be considered a single activity, without regard to any aggregation rules. As a result, even in the absence of regulations, all of the real property owned by a partnership or S corporation, that is not covered in categories (1) through (5) and is not mineral property, should be treated as a single activity.

Treasury has the authority to prescribe additional regulations regarding when activities are to be aggregated or separated. These regulations will most likely allow for aggregation of activities that are not tax shelters and separation of activities that have tax shelter characteristics. The tax shelter characteristics that Treasury may consider include:

The presence of accelerated deductions, mismatching of income and deductions, substantial non-recourse financing, novel financing techniques which do not conform to standard commercial practices, and the marketing of the activity to prospective investors as a tax shelter.

Until regulations are issued, different activities will be treated separately, unless (1) the activities are to be aggregated because the taxpayer actively participates in their management directly or on behalf of a partnership or S corporation, or (2) because they are similar activities that are conducted by a partnership or an S corporation.

[5] Amounts Considered At-Risk

[a] Overview

A taxpayer is generally considered at risk in an activity to the extent of cash and the adjusted basis of property contributed by the taxpayer to the activity. n734 In general, a taxpayer's amount at risk also includes any amounts borrowed for use in the activity if the taxpayer is personally liable for repayment or if property other than property used in the activity is pledged as security. n735 Amounts borrowed for use in an activity subject to *IRC Section 465* will not increase the borrower's amount at risk in the activity if the lender has an interest other than that of a creditor in the activity (a disqualifying interest) or if the lender is related to a person (other than the borrower) who has a disqualifying interest in the activity. n736 This rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity. The rule generally applies only to activities listed in the statute—generally those connected with motion pictures and video tapes, farming, leasing of *IRC Section 1245* property (generally non-real estate assets), and exploring for or exploiting oil, gas, and geothermal deposits. n737 The rule also applies to other activities, but only to the extent provided in regulations. n738

Regulations expand the rule of *IRC Section 465(b)(3)* to all new post-1978 activities, not just those described in *IRC Section 465(c)(1)*. n739 Thus, for all activities, amounts borrowed with respect to the activity will not increase the borrower's amount at risk in the activity if the lender has an interest in the activity other than that of a creditor, or if the lender is related to a person (other than the borrower) who has an interest in the activity other than that of a creditor. This rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity. n740

These amounts are treated in the same manner as borrowed amounts for which the taxpayer has no personal liability and for which no security is pledged. n741 Any amounts that are protected against loss, whether borrowed or not, are also treated in the same manner as borrowed amounts for which the taxpayer has no personal liability and for which no security is pledged. n742

For purposes of determining a corporation's amount at risk, an interest in the corporation as a shareholder is not an interest in any activity of the corporation. Thus, amounts borrowed by a corporation from a shareholder may increase the corporation's amount at risk. n743

Regulations clarify the treatment under the at-risk rules of financing connected with the holding of real property. For purposes of determining a taxpayer's amount at risk in an activity of holding real property, a taxpayer is treated at risk with respect to financing that is secured by real property used in the activity and is either (1) qualified nonrecourse financing, n744 or (2) financing that, if it were nonrecourse, would be qualified nonrecourse financing. n745

Regulations also clarify when a borrower that is personally liable for a loan is considered to have a non-creditor interest in an activity for purposes of apply the at-risk rule. A borrower that is personally liable for the repayment of a loan for use in an activity is considered to have an interest in the activity other than that of a creditor only if the borrower has either a capital interest in the activity or an interest in the net profits of the activity. n746 A capital interest in an activity is an interest in the assets of the activity that is distributable to the owner of the capital interest upon the liquidation of the activity. For example, the partners of a partnership and the shareholders of an S corporation are considered to have capital interests in the activities conducted by the partnership or S corporation. n747

An employee or independent contractor any part of whose compensation is determined with reference to the net profits of the activity is considered to have an interest in the net profits of the activity. It is not necessary for a person to have any incidents of ownership in the activity in order to have an interest in the net profits of the activity. n748 Compensation related to gross receipts from an activity, however, is not an interest in the net profits of an activity. n749

Final regulations also clarify when a person has a non-creditor interest in an activity when a non-recourse loan is made. The rules for nonrecourse loans vary, depending on whether or not the loan is secured by assets with a readily ascertainable fair market value. In the case of a nonrecourse loan for use in an activity where the loan is secured by property that has a readily ascertainable fair market value, a person is considered to have an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity, as described above. n750

In the case of a nonrecourse loan for use in an activity where the loan is secured by property which does not have a readily ascertainable fair market value, a person is considered to have an interest in the activity other than that of a creditor if the person stands to receive financial gain (other than interest) from the activity or from the sale of interests in the activity. Financial gain includes compensation for services rendered in connection with the organization or operation of the activity, or amounts received from the sale of interests in the activity. Generally, a promoter of an activity who organizes the activity or solicits potential investors will be deemed to receive financial gain and will have an interest in the activity other than that of a creditor. n751

Notwithstanding any other rule, a taxpayer is not considered to be at risk for any amount that is protected against loss through nonrecourse financing, stop-loss agreements, guarantees, or other similar arrangements. n752

The investor's at-risk investment is increased by additional contributions to the activity and by his share of taxable income generated by the activity. The at-risk amount is decreased by any subsequent withdrawals from the activity and by the investor's share of losses generated by the activity. n753

Example:

P purchases property for \$200,000, making a \$40,000 cash down payment and financing the balance of the purchase price through a nonrecourse loan, payable interest only for the first year. During the first year that *P* owns the property it is leased to an unrelated party, and the leasing activity generates a tax loss of \$15,000 and a \$2,000 cash flow (excess of rental income over operating expenses and interest payments on the \$160,000 loan). This investment is subject to the at-risk limitation. Initially, *P*'s amount at risk is equal to the down payment of \$40,000. At the end of the first year, *P*'s at-risk amount is reduced to \$23,000 (\$40,000 less losses of \$15,000 and cash distribution of \$2,000).

[b] Application of the At-Risk Limitations to Partners, LLC Members, and S Corporation Shareholders

Partnerships, LLCs, and S corporations are not subject to the at-risk limitation. However, the at-risk limitation does apply to the partners of the partnership, members of an LLC, or the shareholders of the S corporation. Computation of the at-risk limitation is generally the same for partners, LLC members, and shareholders of S corporations. Partners, LLC members, and S corporation shareholders compute their at-risk limitation based on their capital contribution to the partnership, LLC, or S corporation. The limitation is then adjusted according to the rules stated above. The amount that the partnership, LLC, or S corporation has at-risk in the activity is irrelevant for determining the individual investor's at-risk amount.

Some additional rules apply in determining a partner's or LLC member's amount at-risk that do not apply to S corporation shareholders. Although a guarantee of partnership debt does not increase a partner's at-risk amount, a partner increases his at-risk amount for his share of liabilities incurred by the partnership. A partner's at-risk amount increases only for those liabilities for which the partner may be held personally liable under an agreement or state law, and only to the extent that the partner is not protected against loss. ⁿ⁷⁵⁴ Relying on partnership law, the IRS has ruled that LLC members who guarantee lease payment liabilities of the LLC are also at risk only to the extent they have no right of reimbursement against any other LLC members. ⁿ⁷⁵⁵ In the case of a loan by a partner to a partnership, the lending partner increases his at-risk amount to the extent that his basis is increased under the partnership rules, but the amount at-risk of any other partners is not increased as a result of the loan. ⁿ⁷⁵⁶ Under the partnership regulations, a partner may get basis to the extent that he bears the ultimate economic responsibility for the repayment of the debt. ⁿ⁷⁵⁷

Several recent cases have attempted to clarify the rules in this area. *Pritchett v. Commissioner* ⁿ⁷⁵⁸ was the first case to address the effect of partnership borrowings on a limited partner's amount at-risk. The taxpayers in *Pritchett* were limited partners in similar oil and gas exploration partnerships. Each partnership was indebted to a drilling company as evidenced by non-interest-bearing recourse promissory notes with 15-year maturities. The principal of each note was payable from the net cash available to the partnership as a result of drilling operations. Only the general partners of each partnership were directly liable on the notes. However, the limited partners, by executing the partnership agreements, obligated themselves to make additional capital contributions if the notes were not paid in full by maturity.

The taxpayers' argument for including their future capital contribution commitment in their at-risk amount was that they were personally liable to the drilling companies through liability to the respective partnerships.

The majority of the Tax Court judges ruled against the taxpayers, finding that the limited partners' obligations were contingent upon:

- (1) whether the partnership would have sufficient funds to pay the notes when due; and
- (2) whether the general partners would exercise their discretion in favor of making the call for additional limited partner capital contributions. The majority cited the common law contract principle that a contingent debt does not reflect a present liability.

The Tax Court then went a step further and found that even if the drilling company could force the general partners to call upon the limited partners or could move directly against the limited partners without the general partner contribution calls, the limited partners would still not be at-risk for the years in question because the drilling contractor had no recourse against the limited partners at the end of the taxable year at issue. The Tax Court interpreted Section 465(b)(2)(A) to require fixed personal liability at the close of the taxable year.

On the other hand, in *Abramson v. Commissioner*, n759 the Tax Court held that the limited partners were at-risk since they had a direct contractual liability to a third-party seller of goods. The Tax Court differentiated its opinion from *Pritchett* by stating that the limited partners in *Pritchett* were not directly liable and had not borrowed any amount within the meaning of Section 465(b)(2).

In the appeal of *Pritchett*, the Ninth Circuit agreed with the Tax Court's reasoning in *Abramson* and stated that, if the limited partnership agreements created only contingent liabilities, it would affirm the lower court's decision to disallow the taxpayers' deductions. The Ninth Circuit concluded, however, that in *Pritchett*, the liability of the limited partners was unavoidable and thus *not* contingent. The Ninth Circuit cited *Melvin v. Commissioner*, n760 in which the Tax Court stated that, even though the partnership or other partners remain in the chain of liability, the at-risk amount of the parties who have *ultimate liability* will not be affected. The question is, according to the Ninth Circuit, who is the obligor of last resort? Using this line of reasoning, the court held that the limited partners, by virtue of their contractual obligations, have ultimate responsibility for the debt and therefore are at-risk for their pro-rata shares.

The Ninth Circuit dismissed the Tax Court's reasoning that it was not known at the end of each taxable year whether there would be enough partnership revenues to satisfy the notes before maturity. The Ninth Circuit stated that, if the notes required payments upon maturity, the limited partners' obligations to contribute additional funds would be certain and not contingent.

The Ninth Circuit also dismissed the fact that cash calls were contingent upon the general partners' election. Citing *Durkin v. Commissioner*, n761 the Ninth Circuit held that economic reality ensures that the general partners would exercise the calls.

The agreement of the taxpayers in *Pritchett* provided that the creditor would receive 20 percent of the gross sales if the partnership achieved certain profit levels. The Ninth Circuit remanded the issue of whether or not this interest would constitute "other than a financial interest" under Section 465(b)(3).

At the appellate level, the Service raised for the first time the issue of whether at-risk amounts should be allowed only for the present value of the note. The Ninth Circuit believed this issue had merit, but the court did not consider it because, as a general rule, issues raised for the first time on appeal are not considered.

The fact that a loan may be recourse in nature does not determine conclusively that an investor is at risk. In *Thornock v. Commissioner*, n762 a case involving a sequence of computer equipment sales and leasebacks, a limited partner was held to have no economic liability on the acquisition debt although the debt was recourse in nature. The court reasoned that due to the guarantees made by other participants in the transaction, the partner would never be required to pay off the debt. In addition, the underlying debt from the original purchase was nonrecourse. For these reasons, the partner was held not to be at risk.

A general conclusion can be drawn from these cases that, to determine if a limited partnership's borrowings affect a limited partner's amount at-risk, the following questions must be answered:

- (1) Can the partnership(s) creditors look to the limited partner for repayment of any portion of the loan in the case of partnership default?

(2) If the limited partner pays all or any portion of the partnership's loan, does the limited partner have any recourse against other parties for repayment?

If the answer to the first question is affirmative and the answer to the second question is negative, the limited partner should increase his amount at risk for the portion of the debt for which he is personally liable and not protected against loss by another party.

[c] Qualified Nonrecourse Financing

A taxpayer is generally not considered at-risk with respect to any amount protected against loss through nonrecourse financing, guarantees, stop loss agreements, or similar arrangements. n763 A taxpayer engaging in the activity of holding real property, however, is considered at-risk with respect to "qualified nonrecourse financing" secured by real property used in that activity, even though the taxpayer is not personally liable for repayment of the financing. n764 "Qualified nonrecourse financing" is any financing that meets all of the following requirements: n765

- it is borrowed by the taxpayer with respect to the activity of holding real property;
- it is borrowed by the taxpayer from a qualified person, or represents a loan from a government or government instrumentality, or is guaranteed by any federal, state, or local government;
- except to the extent provided by regulations, no person is personally liable for repayment; n766 and
- it is not convertible debt.

In general, only real property used in the activity of holding real property may secure qualified nonrecourse financing. For this purpose, however, the following property is disregarded: n767 (1) property that is incidental to the activity of holding real property; and (2) other property that is not real property or incidental to the activity of holding real property, provided that the aggregate gross fair market value of that property is less than 10 percent of the aggregate gross fair market value of all property securing the financing.

With respect to partnerships, a look-through rule applies regarding the property that may be used as security for qualified nonrecourse financing. A borrower is treated as owning directly its proportional share of the assets in a partnership in which the borrower owns (directly or indirectly through a chain of partnerships) an equity interest. n768

As noted above, no person may be personally liable for repayment of qualified nonrecourse financing, except to the extent provided in regulations. n769 Regulations provide a special rule with respect to partnership or tiered partnership nonrecourse financing. The rule also applies to LLCs and other entities that are disregarded for federal tax purposes. The personal liability of any partnership (or other disregarded entity) will be disregarded and, provided other requirements are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property if the following requirements are met: n770

- the only persons personally liable to repay the financing are partnerships;
- each partnership with personal liability holds only property that is permitted as security for qualified nonrecourse financing (applying a look-through rule for lower-tier partnerships); and
- in exercising its remedies to collect on the financing in a default or default-like situation, the lender may proceed only against property that is permitted as security for qualified nonrecourse financing and that is held by the partnership(s) (applying a look-through rule for lower-tier partnerships).

the activity of holding real property includes the holding of personal property and providing services that are incidental to making real property available as living accommodations. n771 The activity of holding real property does not, however, include the holding of mineral property. n772

A *qualified lender* is any person who is actively and regularly engaged in the business of lending money so long as that person is not: n773

- (1) the person from whom the property was acquired;
- (2) any person who receives a fee on the taxpayer's investment in the property (e.g., a promoter, or a person related to the promoter); or
- (3) a person related to the taxpayer, unless the financing from the related person is commercially reasonable and on substantially the same terms as a loan from an unrelated person. n774

Whether parties are related for this purpose is determined in accordance with *IRC Sections 267(b), 707(b)(1), and 52(a) and (b)*. However, these tests are modified so that a shareholder and a corporation will be related parties if the shareholder owns directly or indirectly more than 10 percent of the corporation's stock. n775

Nonrecourse financing between related parties will be deemed to be commercially reasonable if the financing is a written unconditional promise to pay on demand, or on a specified date, a specified sum, and the interest rate is a reasonable market rate of interest (taking into account the maturity of the obligation). Generally, an interest rate would not be considered commercially reasonable if it is significantly below the market rate on comparable loans between unrelated parties. On the other hand, an interest rate would not be considered commercially reasonable if it significantly exceeds the market rate on comparable loans by unrelated qualified persons. Nor would an interest rate be considered commercially reasonable if it were contingent. However, a variable interest rate will be commercially reasonable, provided that the interest is calculated on the basis of a market interest index such as the prime rate charged by a major commercial bank, LIBOR, the rate on government securities, or the applicable federal rate. The terms of the financing would also not be considered commercially reasonable if, for example, the term of the loan exceeds the useful life of the property, or if the right to foreclosure or collection on the debt is limited, except to the extent provided under applicable state law. n776

For non-real-estate activities, even a loan with full recourse is not generally treated as an at-risk amount if the lender has an interest in the activity other than as a creditor. However, for qualified nonrecourse real estate loans, the loan will not be disqualified solely because the lender has a noncreditor interest in the activity. n777

In real estate financing, the most common situation in which lenders will have an equity interest occurs when a partner makes a loan to his partnership. Although it is possible for the loan to meet the requirements of qualified nonrecourse financing, the existing partnership allocation regulations under *IRC Section 704(b)* may make the loan undesirable. (See Chapter 14 on partnerships.) In addition, a partner's at-risk amount with respect to the loan will be the same as his share of the debt determined under the general rules that govern the allocation of partnership debt for basis purposes. n778 Current regulations generally prevent the other partners from sharing in any nonrecourse partnership debt owed to a partner. n779

[d] Seller Financing

Although many typical real estate financing techniques will be considered as qualified nonrecourse financing, several common financing arrangements will not. Perhaps the most important of the nonqualified techniques is seller financing. As mentioned above, qualified nonrecourse financing cannot be obtained from the seller of the acquired property. n780

The prohibition on seller financing can create problems when debt obligations on distressed properties are being restructured, that is, in workout situations. Lenders frequently acquire title to the property (e.g., by foreclosure) in these situations before transferring it to a new owner. That chain of events causes the loan to become "seller" financing, even if the original loan was for cash and the owner assumes the old debt. On the other hand, the seller-financing taint can be avoided if the property is transferred directly from the prior owner to the new owner. In this regard, lenders and buyers have to be alert to the significance of the form as well as the substance of their transactions.

[e] Wrap-Around Financing

Wrap-around financing exists when the purchaser of a property issues a note payable to the seller in an amount at least equal to the seller's current underlying debt on the property. The seller remains liable on the underlying debt, and the purchaser does not assume liability for it. n781

When the purchaser issues a nonrecourse purchase money mortgage which wraps around a nonrecourse underlying debt, a question arises about whether the purchaser has any qualified nonrecourse financing. If the purchaser's purchase money mortgage is viewed as one note, qualified nonrecourse financing will not exist, since the loan was obtained from the seller. However, if the purchase-money-mortgage transaction is viewed, in substance, as taking the property subject to the seller's underlying indebtedness and a second mortgage loan from the seller for the remaining amount of the total debt, then, if the other qualifications are met, the purchase money mortgage should constitute qualified nonrecourse debt in an amount equal to the seller's first mortgage. A final determination on which alternative is the proper way to treat wrap-around financing will have to await further guidance from Treasury and the courts.

[6] Carryover of Disallowed Losses

[a] Overview

Losses disallowed under the at-risk limitation in a given tax year may be carried forward indefinitely. The loss may then be deducted to the extent the taxpayer has a sufficient at-risk amount at the end of a subsequent taxable year. n782 Except for the passive activity loss limitations, the at-risk provisions apply after all other loss limitation provisions; for example, the basis limitations on deducting partner losses.

[b] Characterization of Suspended Losses

The proposed regulations n783 require that allowable deductions be classified into four categories and charged against income in order of priority. Those classes, and their order of priority, are:

- (1) capital losses;
- (2) Section 1231 losses;
- (3) all other items of deduction except items of tax preference under *IRC Section 57*; and
- (4) items of tax preference under *IRC Section 57*.

Any deductions that are disallowed because of the application of the above rules are suspended and carried over to subsequent taxable years. The proposed regulations provide that the deductions retain their identity under the four classifications above when they are allowed in a subsequent tax year. It should also be noted that the at-risk limitations apply before the passive activity loss rules. Therefore, a loss that is limited by the at-risk provisions does not enter into the computation of the taxpayer's passive activity loss for that year. n784

Example:

A taxpayer has \$6,000 of income from an activity during the taxable year, and \$30,000 of deductions allocable to the activity. Of the \$30,000 of deductions, \$4,000 represent capital losses; there are no Section 1231 losses, all other deductions (except tax preferences) equal \$20,000, and items of tax preference equal \$6,000. The taxpayer's at-risk amount is \$20,000, at the beginning of the taxable year. Assuming no other events have occurred to effect the taxpayer's at-risk amount, the taxpayer is allowed \$26,000 of deductions, that is, the sum of the \$6,000 of income and the \$20,000 at-risk amount. The deductions allowed, in order of priority, are the capital losses deduction, the other items of deductions, and \$2,000 of tax preference items. The remaining \$4,000 of tax preference items are suspended and carried to the subsequent taxable year, in which they retain their character as tax preference items.

These rules present planning opportunities for a taxpayer who wishes to shift losses to a subsequent taxable year. The failure to satisfy the at-risk requirements automatically defers the loss.

Example:

Taxpayer *B* anticipates having losses from a nonrental activity in 1990 and 1991. *B* will not materially participate in the activity in 1990, but he expects to materially participate in 1991. If *B* is not at risk with respect to the activity in 1990, the losses will be deferred to 1991. If *B* is at risk in 1991, the 1990 passive losses will be "converted" to nonpassive losses in 1991.

The purpose of the ordering rules proposed is to retain the different character of the four classifications. Therefore, as a general rule, capital losses can be charged against ordinary income only to a limited extent. Section 1231 losses must first be netted against Section 1231 gains; and the computation of the minimum tax requires identification of tax preference items.

[7] Dispositions and Recapture of At-Risk Amounts

[a] Dispositions of At-Risk Investment

When a taxpayer invests in a real estate activity, either directly as a partner in a partnership or as a shareholder in an S corporation, his *tax basis* in the investment includes any related nonrecourse financing. To the extent losses are attributable to nonqualified nonrecourse financing, they are not currently deductible because the at-risk amount is not increased by nonqualified nonrecourse debt. However, these losses will reduce the tax basis of the investment. On the disposition of the real estate, the taxpayer's amount realized will not be less than the amount of any nonrecourse debt from which he is relieved. Any gain that is realized on the disposition will increase the taxpayer's at-risk basis and allow him to deduct the losses that were previously limited because of nonqualified financing. The net effect is that prior years' suspended losses are available to offset any gain that is attributable to nonqualified nonrecourse financing in the year of sale or other disposition of the real estate investment.

Example:

P acquires a partnership interest in exchange for a nonrecourse note of \$20,000. *P*'s allocable share of losses in the taxable year is \$20,000, but such losses are not allowable under the at-risk rules because the taxpayer has no amount at risk. *P*'s basis in his partnership interest is, however, reduced to zero since the at-risk rule does not affect basis. In the subsequent year, there is a foreclosure on the partnership interest by the lender. *P* realizes \$20,000 through discharge of the debt; thus, there is a gain of \$20,000. Recognition of the gain adds \$20,000 to the taxpayer's amount at risk which is offset by the suspended deduction of \$20,000 attributable to the amount disallowed in the previous year.

[b] Recapture of At-Risk Losses

A taxpayer must recapture previously allowed losses from an activity when the at-risk amount for that activity is reduced below zero. n785 This is accomplished by recognizing income to the extent that the at-risk amount is reduced below zero. n786 This recapture income is recognized at the end of the tax year in such a way that the at-risk amount as of the start of the next year is brought back to zero. The recapture income becomes a carryover at-risk deduction in the next tax year, and the taxpayer is allowed to deduct this recaptured amount in subsequent years to the extent his at-risk amount increases above zero. A taxpayer's at-risk basis cannot be reduced below zero because of deductions, but can be by any of the following:

- (1) distributions in excess of net income; or
- (2) reductions of qualified debt, which in the case of real estate would include qualified nonrecourse financing.

For activities other than the holding of real property, recapture of at-risk losses applies only to losses allowed in taxable years beginning after December 31, 1978. Thus, a taxpayer would only have to recapture losses incurred in 1979 and later years.

However, in the case of the activity of holding real property, the at-risk limitation is effective only for tax years beginning after 1986. As a result, recapture of real estate losses under the at-risk provision would only be required for losses allowed after the effective date, that is for tax years beginning on or after January 1, 1987. n787

FOOTNOTES:

(n1)Footnote 719. *IRC § 465(a)(1)*.

(n2)Footnote 720. *IRC § 465(a)*

(n3)Footnote 721. *Id.*

(n4)Footnote 722. *IRC § 465(a)(1)(B)*.

(n5)Footnote 723. *IRC §§ 465(a)(3)(A), 544(a)(2) and 542(a)(2)*.

(n6)Footnote 724. *IRC § 465(c)(4)(A)*.

(n7)Footnote 725. *IRC § 465(c)(4)(B)*.

(n8)Footnote 726. *IRC § 465(c)(4)(C)*.

(n9)Footnote 727. *IRC § 465(c)(7)(A)*.

(n10)Footnote 728. *IRC § 465(c)(7)(B)*.

(n11)Footnote 729. *IRC § 465(c)(7)(C)*.

(n12)Footnote 730. *IRC § 465(c)(2)*.

(n13)Footnote 731. *IRC § 465(c)*.

(n14)Footnote 732. *IRC § 465(c)(3)(B)*.

(n15)Footnote 733. *Temp Treas Reg § 1.465-1T(a)(4)* (aggregation of certain activities).

(n16)Footnote 734. *IRC § 465(b)(1)(A)*.

(n17)Footnote 735. *IRC § 465(b)(1)(B), (b)(2)*.

(n18)Footnote 736. *IRC § 465(b)(3)*; *Van Wyk v Commr, 113 TC 440 (1999)* (amount loaned by a shareholder to (January 2002) S corporation was not at risk because the shareholder had borrowed the loaned amounts from another shareholder in the S corporation).

(n19)Footnote 737. See *IRC § 465(c)(1)*.

(n20)Footnote 738. *IRC § 465(c)(3)(D)*.

(n21)Footnote 739. *Treas Reg § 1.465-8(a)(1)*, 1.465-20, effective for amounts borrowed after May 3, 2004.

(n22)Footnote 740. *Treas Reg § 1.465-8(a)(1)*.

(n23)Footnote 741. *Treas Reg § 1.465-20(a)(1)*.

(n24)Footnote 742. *Treas Reg § 1.465-20(a)(2)*; see *Treas Reg 1.465-6*.

(n25)Footnote 743. *Treas Reg § 1.465-8(a)(2)(i)*.

(n26)Footnote 744. See *IRC § 465(b)(6)(B)*, discussed in 13.02[5][c], below.

(n27)Footnote 745. *Treas Reg § 1.465-8(a)(2)(ii)*.

(n28)Footnote 746. *Treas Reg § 1.465-8(b)(1)*.

(n29)Footnote 747. *Treas Reg § 1.465-8(b)(2)*.

(n30)Footnote 748. *Treas Reg § 1.465-8(b)(3)*.

(n31)Footnote 749. *Treas Reg § 1.465-8(b)(4)*, Example 2.

(n32)Footnote 750. *Treas Reg § 1.465-8(c)(1)*.

(n33)Footnote 751. *Treas Reg § 1.465-8(d)*.

(n34)Footnote 752. *IRC § 465(b)(4)*

(n35)Footnote 753. *IRC § 465(b)(5)*.

(n36)Footnote 754. *Prop Treas Reg § 1.465-24(a)(2)(i)*; *Baird v Commr, 81 TC 821 (1983)* .

(n37)Footnote 755. *FSA 200025018* ; see *Prop Treas Reg § 1.465-24(a)(2)(i)*.

(n38)Footnote 756. *Prop Treas Reg § 1.465-7(a)*.

(n39)Footnote 757. See *Treas Reg § 1.752-2*.

(n40)Footnote 758. *85 TC 580 (1985)* , revd *827 F2d 644* , *87-2 USTC P 9517 (9th Cir 1987)*, on remand *TC Memo 1989-21* , *affd in unpublished opin* (Sept 23, 1991 9th Cir).

(n41)Footnote 759. *86 TC 360 (1986)* .

(n42)Footnote 760. *88 TC 63 (1987)* , *affd 894 F2d 1072 (9th Cir 1990)* .

(n43)Footnote 761. *87 TC 1329 (1986)* .

(n44)Footnote 762. *94 TC 439 (1990)* .

(n45)Footnote 763. *IRC § 465(b)(4)*.

(n46)Footnote 764. *IRC § 465(b)(6)(A)*.

(n47)Footnote 765. *IRC § 465(b)(6)(B)*; *Treas Reg § 1.465-27(b)(1)*.

(n48)Footnote 766. See *Treas Reg § 1.465-27(b)(3), (4), (5)*.

(n49)Footnote 767. *Treas Reg § 1.465-27(b)(2)(i)*.

(n50)Footnote 768. *Treas Reg § 1.465-27(b)(2)(ii)*.

(n51)Footnote 769. *IRC § 465(b)(6)(B)(iii)*.

(n52)Footnote 770. *Treas Reg § 1.465-27(b)(4), (5) Ltr Rul 200340024* (IRS rules that a limited partnership's proposed issuances and allocations of unsecured debt and line of credit advances would meet requirements of the qualified nonrecourse financing regulations).

(n53)Footnote 771. *IRC § 465(b)(6)(E)(i)*.

(n54)Footnote 772. *IRC § 465(b)(6)(E)(ii)*.

(n55)Footnote 773. *IRC §§ 465(b)(6)(D); 49(a)(1)(D)(iv)*.

(n56)Footnote 774. *Id.*

(n57)Footnote 775. *IRC § 465(b)(3)(C)*.

(n58)Footnote 776. Conf Rpt 99-841, Vol II (Pub L No 99-514), p II-135, 1986-3 CB Vol 4 135.

(n59)Footnote 777. *IRC §§ 465(b)(6)(A) and (B)* define qualified non-recourse financing. *IRC § 465(b)(6)(D)* defines a qualified person.

(n60)Footnote 778. See *IRC § 75* for a discussion of treatment of liabilities.

(n61)Footnote 779. *Treas Reg § 1.752-2(c)(1)*.

(n62)Footnote 780. *IRC §§ 49(a)(1)(D)(iv)(II), 465(b)(6)(B)(ii), (D)(i)*.

(n63)Footnote 781. See *Professional Equities, Inc v Commr*, *89 TC 165 (1987)* ; *Stonecrest Corp v Commr*, *24 TC 659 (1955)* .

(n64)Footnote 782. *IRC § 465(a)*.

(n65)Footnote 783. Prop *Treas Reg § 1.465-38*.

(n66)Footnote 784. *Temp Treas Reg § 1.469-2T(d)(6)* (providing that a loss disallowed by the at-risk rules is not a passive activity deduction for the year).

(n67)Footnote 785. *IRC § 465(e)(1)*.

(n68)Footnote 786. *IRC § 465(e)(2)*.

(n69)Footnote 787. *IRC § 465(e)*.

* Revised by Elsbeth Peshel, Esq. The author holds an LL.M in taxation from New York University School of Law.



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Federal Taxes Affecting Real Estate

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CHAPTER 13 Limitations on Losses From Real Estate *

1-13 Federal Taxes Affecting Real Estate § 13.12

§ 13.12 Limitation on Tax-Exempt Use Losses

[1] In General

An overall statutory limitation applies to limit deductions allocable to property used by governments or other tax-exempt entities. n788 Under the provision, a taxpayer who leases property to a tax-exempt entity (called "tax-exempt use property") cannot claim deductions for a taxable year from the lease transaction in excess of the taxpayer's gross income from the lease for that year. n789 The provision does not apply to certain transactions involving property with respect to which the low-income housing credit or the rehabilitation credit is allowable. n790

The limitation applies to deductions or losses related to a lease to a tax-exempt entity and the leased property. Any disallowed deductions are carried forward and treated as deductions related to the lease in the following taxable year, subject to the same limitations. n791 Under rules similar to those applicable to passive activity losses (including the treatment of dispositions of property in which less than all of the gain or loss from the disposition is recognized) n792 a taxpayer generally is permitted to deduct previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property. n793

[2] Tax-Exempt Use Property Defined

IRC Section 470 applies to losses from tax-exempt use property. n794 For this purpose, and subject to several modifications, "tax-exempt use property" has the same meaning as under *IRC Section 168(h)*. n795 With respect to real estate, it includes both nonresidential real property and residential rental property that is leased to a tax-exempt entity in a disqualified lease. n796 If only a portion of a property is leased to tax-exempt entities, the property is tax-exempt use property only if more than 35 percent of the property is leased to tax-exempt entities. n797

A disqualified lease is a lease to a tax-exempt entity, if any of the following is true: n798

- part or all of the property was financed with tax-exempt financing in which the tax-exempt entity or related entity participated;
- the lease contains a fixed or determinable price purchase or sale option (or an equivalent of one) that involves the tax-exempt entity or related entity;

- the lease has a term in excess of 20 years; or
- the lease occurs after a sale or other transfer of the property by, or the lease of the property from, the entity or related entity, and the property has been used by the entity or related entity before the sale or other transfer before that sale or other transfer or lease.

For purposes of *IRC Section 470*, there is no exception for tax-exempt use property for short-term leases. n799

Tax-exempt use property does not include any property that would be tax-exempt use property solely by reason of *IRC Section 168(h)(6)*. n799.1 Under that provision, if any property that is not otherwise tax-exempt use property is owned by a partnership that has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and any allocation to the tax-exempt entity of partnership items is not a qualified allocation, an amount equal to the tax-exempt entity's proportionate share of that property is treated as tax-exempt use property. n800 An allocation to a tax-exempt entity is a qualified allocation if the allocation: (1) is consistent with the allocation to the entity of the same distributive share of each item of income, gain, loss, deduction, credit and basis throughout the entire period that the entity is a partner in the partnership and (2) has substantial economic effect. n801 Similar rules apply for other pass-thru entities. n802 Tax-exempt use property does not include property otherwise subject to *IRC Section 168(h)(6)* if a low-income housing credit or rehabilitation credit is allowable with respect to the property. n803

Loss deferral under *IRC Section 470* may also be required if a partnership is recharacterized as a lease. Thus, if a partnership is recharacterized as a lease pursuant to *IRC Section 7701(e)*, and a provision of *IRC Section 168(h)* (other than *IRC Section 168(h)(6)*) applies to cause the property characterized as leased to be treated as tax-exempt use property, then the loss deferral rules of *IRC Section 470* apply. n803.1 In determining whether a partnership is treated as a lease, all relevant factors are taken into account, including whether or not: n803.2

- a tax-exempt partner maintains physical possession or control or holds the benefits and burdens of ownership with respect to the property;
- there is insignificant equity investment by any taxable partner;
- the transfer of the property to the partnership does not result in a change in use of that property;
- the property is necessary for the provision of government services;
- a disproportionately large portion of the deductions for depreciation with respect to the property are allocated to one or more taxable partners relative to that partner's risk of loss with respect to the property or to that partner's allocation of other partnership items; and
- amounts payable on behalf of the tax-exempt partner relating to the property are defeased or funded by set-asides or expected set-asides.

NOTE:

The provision relating to treating partnerships as leases for purposes of *IRC Section 470* n803.3 is effective generally for leases entered into after March 12, 2004. n803.4 The IRS has announced, however, that for partnership tax years beginning before 2007, it will not apply *IRC Section 470* to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of *IRC Section 168(h)(6)*. Abusive transactions involving partnerships and other pass-through entities, however, remain subject to IRS challenge under other provisions of the tax law for partnership taxable years beginning in 2004, 2005, and 2006. n804

[3] Tax-Exempt Leases Not Subject to the Limitation

[a] In General

A lease of property to a tax-exempt party is not subject to the deduction limitations of *IRC Section 470* if the lease satisfies all of the following requirements:

- the tax-exempt lessee does not monetize its lease obligations; n805
- the taxpayer makes and maintains a substantial equity investment in the leased property; n806
- the tax-exempt lessee does not bear more than a minimal risk of loss; n807 and
- the tax-exempt lessee generally does not have an option to purchase the leased property for any stated purchase price other than the fair market value of the property. n808

[b] Lessee Cannot Monetize Its Lease Obligations

In order for a lease of property to a tax-exempt party to avoid the deduction limits of *IRC Section 470*, the tax-exempt lessee cannot monetize its lease obligations beyond a specified amount. n809 The tax-exempt lessee may not monetize its lease obligations (including any purchase option) in an amount that exceeds 20 percent of the taxpayer's adjusted basis in the leased property at the time the lease is entered into. n810 Specifically, a lease does not satisfy this requirement if the tax-exempt lessee monetizes that excess amount pursuant to an arrangement, set-aside, or expected set-aside, that is to or for the benefit of the taxpayer or any lender, or is to or for the benefit of the tax-exempt lessee, in order to satisfy the lessee's obligations or options under the lease. n811

The Conference Report clarifies that this determination is made at all times during the lease term n811.1 and includes the amount of any interest or other income or gain earned on any amount set aside or subject to an arrangement described in this provision. For purposes of determining whether amounts have been set aside or are expected to be set aside, amounts are treated as set aside or expected to be set aside only if a reasonable person would conclude that the facts and circumstances indicate that those amounts are set aside or expected to be set aside. n812

The IRS may provide by regulations that a higher percentage is permitted in certain cases in which the creditworthiness of the tax-exempt lessee would not otherwise satisfy the taxpayer's customary underwriting standards. In no event, however, can the lessee's obligations be allowed to be monetized in excess of 50 percent of the taxpayer's adjusted basis in the property. n813

In addition, if the lease provides the tax-exempt lessee an option to purchase the property for a fixed purchase price (or for other than the fair market value of the property determined at the time of exercise of the option), any credit support at the time that the option may be exercised would not be permitted to exceed 50 percent of the purchase option price. n814

Certain lease arrangements that involve circular cash flows or insulation of the taxpayer's equity investment from the risk of loss fail this requirement without regard to the amount in which the tax-exempt lessee monetizes its lease obligations or options. n815 Thus, a lease does not satisfy this requirement if the tax-exempt lessee enters into an arrangement to monetize in any amount its lease obligations or options if the arrangement involves (1) a loan (other than an amount treated as a loan under *IRC Section 467* with respect to an *IRC Section 467* rental agreement) from the tax-exempt lessee to the taxpayer or a lender; (2) a deposit that is received, a letter of credit that is issued, or a payment undertaking agreement that is entered into by a lender otherwise involved in the transaction; or (3) in the case of a transaction that involves a lender, any credit support made available to the taxpayer in which the lender does not have a

claim that is senior to the taxpayer. n816

[c] Requirement of Substantial Equity Investment in Leased Property

In order for a lease of property to a tax-exempt party to avoid the deduction limits of *IRC Section 470*, the taxpayer/lessor must make and maintain a substantial equity investment in the leased property. n817 To meet this requirement, a taxpayer must generally meet the following requirements: n818

- At the time the lease is entered into, the taxpayer must initially make an unconditional at-risk equity investment in the property of at least 20 percent of the taxpayer's adjusted basis in the leased property at that time;
- The taxpayer must maintain that equity investment throughout the lease term; and
- At all times during the lease term, the fair market value of the property at the end of the lease term must be reasonably expected to be equal to at least 20 percent of that basis. For this purpose, the fair market value of the property at the end of the lease term is reduced to the extent that a person other than the taxpayer bears a risk of loss in the value of the property. n819

The above requirements do not apply to leases with lease terms of 5 years or less. n820

[d] Tax-Exempt Lessee Can Bear No More than Minimal Risk of Loss

In order for a lease of property to a tax-exempt party to avoid the deduction limits of *IRC Section 470*, the tax-exempt lessee generally may not assume or retain more than a minimal risk of loss, other than the obligation to pay rent and insurance premiums, to maintain the property, or other similar conventional obligations of a net lease. n821 This requirement is met if there is no arrangement under which the lessee bears (1) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than the leased property's reasonably expected fair market value at the time the lease is terminated; or (2) an aggregate loss that is greater than 50 percent of the loss that would occur if the fair market value of the leased property were zero at lease termination. n822

The IRS may provide by regulations that this requirement is not satisfied where the tax-exempt lessee otherwise retains or assumes more than a minimal risk of loss. n823

The provision regarding minimal risk for tax-exempt lessees does not apply to leases with lease terms of 5 years or less. n824

[e] Restriction on Tax-Exempt Lessee's Purchase Option Price

In order for a lease of property to a tax-exempt party to avoid the deduction limits of *IRC Section 470*, the tax-exempt lessee may not have an option to purchase the leased property for any stated purchase price other than the fair market value of the property (as determined at the time of exercise of the option). This requirement applies to all real estate. n825

[f] Coordination with Like-Kind Exchange and Involuntary Conversion Rules

Neither the like-kind exchange rules n826 nor the involuntary conversion rules n827 apply under *IRC Section 470* if either (1) the exchanged or converted property is tax-exempt use property subject to a lease that was entered into before March 13, 2004 and the lease would not have been able to avoid the *IRC Section 470* limitations n828 had they been in effect when the lease was entered into; or (2) the replacement property is tax-exempt use property subject to a lease that does not meet the requirements to avoid the *IRC Section 470* limitations. n829

[g] Other Rules

The limits of *IRC Section 470* apply throughout a lease term to property that initially was tax-exempt use property, even if the property ceases to be tax-exempt use property during the lease term. n830

IRC Section 470 is applied before the application of the passive activity loss rules under *IRC Section 469*. n831

FOOTNOTES:

(n1)Footnote 788. *IRC § 470*, effective generally for leases entered into after March 12, 2004.

(n2)Footnote 789. *IRC § 470(a), (c)(1)*.

(n3)Footnote 790. *IRC § 470(c)(2)*.

(n4)Footnote 791. *IRC § 470(b)*.

(n5)Footnote 792. See *IRC § 469(g)*.

(n6)Footnote 793. *IRC § 470(e)(2)*.

(n7)Footnote 794. *IRC § 470(a), (c)(1)*.

(n8)Footnote 795. *IRC § 470(c)(2)*.

(n9)Footnote 796. *IRC § 168(h)(1)(B)(i), (E)*.

(n10)Footnote 797. *IRC § 168(h)(1)(B)(iii)*. See Ltr Rul 200841003 (ruling determined that a new addition and renovation to an existing building were included as one property for purposes of applying the 35-percent test).

(n11)Footnote 798. *IRC § 168(h)(1)(B)(ii)*.

(n12)Footnote 799. *IRC § 470(c)(2)(A)*.

(n13)Footnote 799.1. *IRC § 470(c)(2)(B)*.

(n14)Footnote 800. *IRC § 168(h)(6)(A)*.

(n15)Footnote 801. *IRC § 168(h)(6)(B)*; see *IRC § 704(b)(2)* (substantial economic effect).

(n16)Footnote 802. *IRC § 168(h)(6)(E)*.

(n17)Footnote 803. *IRC § 470(c)(2)*; see *IRC §§ 42, 47*.

(n18)Footnote 803.1. *IRC §§ 470(c)(2)(B), (C), 7701(e)*.

(n19)Footnote 803.2. *IRC § 7701(e)(1), (2)*. See Joint Committee Conference Report on Pub Law No 110-172, JCX-119-07 (Dec 1, 2007).

(n20)Footnote 803.3. See *IRC §§ 470(c)(2)(C), 7701(e)*.

(n21)Footnote 803.4. Pub Law No 110-172, § 7(e)(1); Pub Law No 108-357, § 848(a), amended by Pub Law No 109-135, § 435(ff).

(n22)Footnote 804. See Notice 2005-29, 2005-13 IRB 796 ; Notice 2006-2, 2006-2 IRB 1 ; Notice 2007-4, 2007-1

IRB 260 .

(n23)Footnote 805. *IRC § 470(d)(1)*; see [b], below, for a discussion.

(n24)Footnote 806. *IRC § 470(d)(2)*; see [c], below, for a discussion.

(n25)Footnote 807. *IRC § 470(d)(3)*; see [d], below, for a discussion.

(n26)Footnote 808. *IRC § 470(d)(4)*; see [e], below, for a discussion.

(n27)Footnote 809. *IRC § 470(d)(1)*.

(n28)Footnote 810. *IRC § 470(d)(1)(A), (C)(i)*.

(n29)Footnote 811. *IRC § 470(d)(1)(A), (B)*.

(n30)Footnote 811.1. See *IRC § 470(d)(1)(A)*, imposing the same requirement.

(n31)Footnote 812. *IRC § 470(d)(1)(A)*.

(n32)Footnote 813. *IRC § 470(d)(1)(C)(ii)*.

(n33)Footnote 814. *IRC § 470(d)(1)(C)(iii)*.

(n34)Footnote 815. *IRC § 470(d)(1)(C)(iv)*.

(n35)Footnote 816. *IRC § 470(d)(1)(C)(iv)*.

(n36)Footnote 817. *IRC § 470(d)(2)*.

(n37)Footnote 818. *IRC § 470(d)(2)(A)*.

(n38)Footnote 819. *IRC § 470(d)(2)(B)*.

(n39)Footnote 820. *IRC § 470(d)(2)(C)*.

(n40)Footnote 821. *IRC § 470(d)(3)*.

(n41)Footnote 822. *IRC § 470(d)(3)(A)*.

(n42)Footnote 823. *IRC § 470(d)(3)(B)*; the Conference Report indicates that any regulations issued are to be prospective only.

(n43)Footnote 824. *IRC § 470(d)(2)(C)*.

(n44)Footnote 825. See *IRC § 470(d)(4)* (exceptions for certain non-real estate property).

(n45)Footnote 826. See *IRC § 1031*.

(n46)Footnote 827. See *IRC § 1033*.

(n47)Footnote 828. See *IRC § 470(d)*.

(n48)Footnote 829. *IRC § 470(e)(4)*.

(n49)Footnote 830. *IRC § 470(e)(1)*.

(n50)Footnote 831. *IRC § 470(e)(3)*.

* Revised by Elsbeth Peshel, Esq. The author holds an LL.M in taxation from New York University School of Law.



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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate 14.syn

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.01

§ 14.01 Overview

Over the past several decades, the partnership has probably been the most prevalent form of business organization used in the real estate industry. Ventures in which a developer raised funds from a group of passive investors were usually organized as limited partnerships; ventures in which all the members expected to be active in the business were frequently organized as general partnerships.

More recently, a new type of entity called a "limited liability company" (LLC) has become a popular alternative to the traditional partnership, and new ventures in which all, or most, of the members expect to be active in the business now are almost invariably organized as LLCs. Both partnerships and LLCs can be organized in a manner that enables them to avoid being taxable entities for federal income tax purposes. Instead, they are reporting vehicles that report items of income and deduction, and the members of the partnership or LLC individually include their respective distributive shares of these items on their income tax returns. Partnerships and LLCs are generally reporting vehicles for state, local and foreign income tax purposes as well, and the partners or members generally must report their shares of the entity's items of income and deduction for purposes of state, local and foreign income taxes, although in some cases a tax is also imposed by these jurisdictions on the entity itself.

The term "partnership" is defined in the Code to include a "syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not ... a corporation or a trust or estate." n1 The statutory definition is broader in scope than the common-law meaning of the term. Federal tax law, rather than local law, prescribes the test to be applied in determining the classification of a business organization for federal income tax purposes. n2

Regulations provide a regulatory framework in which unincorporated organizations can generally elect whether they will be treated as partnerships or as some other form of organization for federal income tax purposes. n3 Qualifying spouses may also elect to have a family joint venture not be treated as a partnership for tax purposes, and instead treat their interests in the venture as if they were sole proprietors. n4-6

FOOTNOTES:

(n1)Footnote 1. *IRC § 761(a)*.

(n2)Footnote 2. *Treas Reg §§ 301.7701-1 through 301.7701-6*.

(n3)Footnote 3. *Id.*

(n4)Footnote 4-6. *IRC § 761(f)*; see § 14.22, below, for a detailed discussion.

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.02

§ 14.02 Federal Entity Classification Rules

[1] In General

Entity classification regulations n7 allow eligible entities with more than one owner to elect their tax classification for federal purposes either as an association (taxable as a corporation) or as a partnership. Entities with only a single owner may elect either to be classified as a corporation or to be disregarded as an entity separate from their owner. n8 These "check-the-box" regulations replace former regulations that classified business organizations either as associations or partnerships, based on the presence or absence of the four corporate characteristics of: continuity of life, centralization of management, limited liability for debts of the enterprise, and free transferability of interests. n9-12

Courts have unanimously upheld the check the box regulations. n13 In one case, the taxpayer was the sole owner of several LLCs, and he had failed to elect under the regulations to have the LLCs treated as corporations. As a result, the LLCs were disregarded and treated as sole proprietorships for tax purposes, and the taxpayer was held personally liable for their unpaid employment taxes. n14 The other cases involved the same situation, but with just a single LLC. n14.1

[2] Determining Whether a Separate Entity Exists

The first step in the federal entity classification process is to determine whether there is an entity separate from its owners. This determination is a matter of federal law, not local law, and generally focuses on whether the participants jointly carry on a trade, business, financial operation or venture and divide the resulting profits. n15 For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and, in addition, provide services to the occupants directly or through an agent. n16 However, mere co-ownership of property that is maintained, kept in repair, or rented or leased, however, does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for cash rental or a share of the crops, they do not necessarily create a separate entity for tax purposes. n17 Similarly, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. n18

Because the determination of whether an entity exists is a matter of federal law, not local law, certain joint undertakings that are not entities under local law may be entities for federal tax purposes and, conversely, not all entities formed under local law will be recognized as separate entities for federal tax purposes. For example, if an LLC with a single individual owner elects to be disregarded as an entity separate from its owner under *Regulation Section 301.7701-3*, its individual owner is subject to federal tax as if the LLC's business were operated as a sole proprietorship. n19 However,

the LLC will still be treated as an entity for local law purposes, including the limitations on the liability of the owner for debts and liabilities of the entity.

[3] Classification of Separate Entities as Trusts or Business Entities

An organization that is recognized as a separate entity for federal tax purposes is classified as either a trustⁿ²⁰ or a business entity,ⁿ²¹ unless a separate provision of the Internal Revenue Code provides for special treatment, as it does for REMICs.ⁿ²² An organization is generally classified as a trust if the purpose of the arrangement is to vest in trustees the responsibility for the protection and conservation of property for beneficiaries and, therefore, it does not have associates or an objective to carry on a business for profit.ⁿ²³ An additional requirement, in the case of investment trusts, is that there be no power under the trust agreement to vary the investment of the certificateholders and that the trust not have multiple classes of ownership interests.ⁿ²⁴

[4] Automatic Classification of Certain Business Entities as Corporations

Certain business entities are automatically classified as corporations for federal tax purposes. An entity that is automatically classified as a corporation is sometimes referred to as a "per se" corporation. These entities are, therefore, ineligible to elect a different federal tax entity classification status pursuant to the entity classification regulations. The entities that are automatically classified as corporations include corporations denominated as such under applicable law, associations, joint-stock companies, insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, organizations that are taxable as corporations under a provision of the Internal Revenue Code other than Section 7701(a)(3), and certain organizations formed under the laws of specified foreign jurisdictions (including a US possession, territory, or commonwealth).ⁿ²⁵ Note that this is an unusual instance in which local law, rather than federal tax law, will be determinative of classification for federal income tax purposes.

A special grandfathering rule applies for specific listed foreign entities. Under the rule, a foreign entity described in the list of foreign entities treated as per se corporationsⁿ²⁶ will nevertheless be classified as something other than a corporation if certain conditions are met. These conditions generally require that the entity had been consistently treated as something other than a corporation for federal income tax purposes prior to the May 8, 1996, grandfathering date. The grandfathering rule also lists certain situations in which a grandfathered foreign business entity will lose its grandfathered status.ⁿ²⁷

Apart from the above rules, a single-owner eligible entity that is disregarded as an entity separate from its owner for any purpose, but regarded as a separate entity for certain excise tax purposes, is treated as a corporation for tax administration purposes related to those excise taxes.^{n27.1} A corresponding rule also applies with respect to the entity for employment taxes.^{n27.2}

[5] Eligible Entities May Choose Their Classification for Federal Tax Purposes

[a] In General

Any business entity that is not required to be treated as a corporation for federal tax purposesⁿ²⁸ is an "eligible entity."ⁿ²⁹ An eligible entity may choose its tax classification under rules set forth in the regulations. An eligible entity with at least two members may choose to be classified as either a partnership or an association (taxable as a corporation). An eligible entity with a single member may choose either to be disregarded as an entity separate from its owner, or to be classified as an association (taxable as a corporation).ⁿ³⁰ However, if the single owner of a business entity is a bank,ⁿ³¹ then the special rules applicable to banks will continue to apply to the single owner as if the wholly-owned entity were a separate entity.ⁿ³²

The IRS has ruled that if an eligible entity has two owners under local law, but one of the owners is, for federal tax purposes, disregarded as an entity separate from the other owner, then the eligible entity cannot be classified as a

partnership. Rather, it must either be disregarded as an entity separate from its owner or be treated as an association taxable as a corporation. n32.1

NOTE:

The IRS has issued a revenue procedure in which it specifies the conditions under which it will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property) is not an interest in a business entity for tax purposes. n32.2 The procedure details the guidelines for submitting ruling requests, the information to be submitted, and conditions for obtaining rulings. n32.3 The procedure applies to co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common. It should be noted that the guidelines provided are only issued for the purpose of assisting taxpayers in preparing ruling requests; they are not intended to be substantive rules, and are not to be used for audit purposes. n32.4

[b] Classification of Entity Owned as Community Property

The IRS has issued a revenue procedure regarding the classification of an entity that is owned solely by a husband and wife as community property. The procedure applies only if the following requirements are met: n32.5

- The business entity is owned by a husband and wife as community property under the laws of a state, foreign country, or possession of the U.S.;
- No person other than one or both of the spouses would be considered an owner for federal tax purposes; and
- The business is not treated as a corporation for federal tax purposes. n32.6

If the above requirements are met, the IRS will respect a taxpayer's treatment of the entity as either a disregarded entity or a partnership. If the entity and the husband and wife as community property owners treat the entity as a disregarded entity for federal tax purposes, the IRS will accept the position that the entity is a disregarded entity for federal tax purposes. n32.7 If the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. n32.8 A change in reporting position will be treated for federal tax purposes as a conversion of the entity. n32.9

If the entity and the husband and wife as community property owners treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the IRS will accept the position that the entity is a partnership for federal tax purposes. n32.10 A change in reporting position will be treated for federal tax purposes as a conversion of the entity. n32.11

[6] Default Classification Rules

In order to provide most eligible entities with the classification they would choose without requiring them to file an election, the entity classification regulations provide default classification rules that are intended to match taxpayers' expectations, and thus reduce the number of instances in which taxpayers will actually have to file elections. n33

The default classification for an entity existing on January 1, 1997, is the classification that the entity claimed immediately prior to January 1, 1997. An entity's default classification continues until the entity elects to change its classification by means of an affirmative election. n34 A change in classification is a potentially taxable event—it will be treated either as the liquidation of a corporation, generally taxable to the corporation and its shareholders, and the subsequent formation of a partnership or a sole proprietorship, or as the liquidation of a partnership (or termination of a

sole proprietorship) and the formation of a corporation. For domestic entities, a newly-formed eligible entity will be classified as a partnership under the default rules if it has at least two members, or it will be disregarded as an entity separate from its owner if it has a single owner. n35

For foreign entities, the default classification is determined by the extent to which the members are liable for debts or liabilities of the entity. A foreign eligible entity will be classified as an association (and taxable as a corporation) if none of the members has any liability for debts or obligations of entity. A foreign eligible entity will be classified as a partnership if it has two or more members and at least one member does not have limited liability; the entity will be disregarded as an entity separate from its owner if it has a single owner and that owner does not have limited liability. n36 A member is treated as not having limited liability for purposes of this rule if the member, by virtue of its membership in the foreign entity, has personal liability for all or any portion of the debts of the entity. n37 This determination is based *solely* on the provisions of the law under which the entity is organized (unless that law allows the entity to specify in its organizational documents whether or not the members will have limited liability), and it does not appear that the Service intends to impose any minimum net worth test for purposes of determining whether unlimited liability exists. n38

[7] How to Elect Entity Classification

[a] In General

An eligible entity n39 may affirmatively elect its classification (or may change its classification) on Form 8832, Entity Classification Election. n40 An affirmative election would ordinarily be necessary only for entities that are not satisfied with their default classification. The election must be signed by any officer, manager, or member of the entity who is authorized to make the election and who represents that it has that authorization under penalties of perjury, or must be consented to and signed by each person who is an owner of the entity at the time the election is made. The determination whether a person is authorized to make an election is based on local law. n41 If an election is made to change the classification of an entity, then each person who was an owner on the date that any of the deemed transactions resulting from an elective classification change occur must also sign the election. n41.1 The election will generally be effective on the date specified by the entity in making the election, but if an election is to be effective for any period prior to the date on which the election is made, each person who was an owner between the date on which the election is to be effective and the date the election is filed, and who is not an owner on the date the election is filed must also consent to the election. n42 An election will not be accepted unless it includes all of the required information, including the entity's taxpayer identifying number (TIN). n43

Taxpayers (including indirect owners of an entity) are required to attach a copy of the classification election to their tax returns. Failure to attach a copy of the classification election will not invalidate an otherwise valid election. However, since all members of an entity are required to file tax returns that are consistent with the entity's election, if a member that is itself a pass-through entity fails to attach the election form to its federal tax or information return, this failure may give rise to penalties against any of its members who file federal tax or information returns inconsistent with the lower-tier entity's election. n44

[b] S Corporation Election as Election to Be Taxed as Association

An entity that makes a timely election to be classified as an S corporation is deemed to have elected to be classified as an association taxable as a corporation for federal entity classification purposes. n44.1 If the eligible entity's election is not timely and valid, however, the default classification rules will apply to the entity unless the IRS provides late S corporation election relief or inadvertent invalid election relief. If the late or invalid election is not perfected, the default rules will maintain the passthrough taxation treatment by classifying the entity as a partnership or a disregarded entity. n44.2

If both the entity's S corporation election (Form 2553) and its entity classification election (Form 8832) are filed late, the above deemed election rule does not come into play. In that case, a taxpayer must generally apply for relief through a letter ruling. However, there are two revenue procedures that provide a simplified method for taxpayers to request relief for a late S corporation election and a late corporate classification election intended to be effective on the same date that the S corporation election was intended to be effective. Either procedure is in lieu of the letter ruling process ordinarily used, and avoids the user fees that ordinarily apply for letter rulings.

The first alternative is *Revenue Procedure 2007-62*. n44.3 To be eligible for relief under that revenue procedure, the following requirements must be met: n44.4

- it must be an eligible entity; n44.5
- the entity must have intended to be classified as a corporation as of the intended effective date of the S corporation status;
- the entity must fail to qualify as a corporation solely because Form 8832 was not timely filed n44.6 or was not deemed to have been filed; n44.7
- the entity must fail to qualify as an S corporation on the intended effective date of the S corporation status solely because the S corporation election was not timely filed; n44.8
- the entity must have reasonable cause for its failure to file a timely Form 2553 and a timely Form 8832;
- the entity must not have filed a tax return for the first taxable year in which the election was intended;
- the entity must file an application for relief under *Revenue Procedure 2007-62* no later than six months after the due date of the S corporation return (excluding extensions) of the entity seeking to make the election for the first taxable year in which the election was intended; and
- no taxpayer whose tax liability or tax return would be affected by the S corporation election (including all shareholders of the S corporation) has reported inconsistently with the S corporation election, on any affected return for the year the S corporation election was intended.

An entity that meets the above requirements may request relief for a late S corporation election and a late corporate classification election by filing a properly completed Form 2553, along with a Form 1120S, for the first taxable year the entity intended to be an S corporation. A properly completed Form 2553 includes a statement explaining the reason for the failure to file the S corporation election timely and a statement explaining the reason for the failure to file the entity classification election timely. The forms must be filed together no later than six months after the due date of the tax return (excluding extensions) of the entity for the first taxable year in which the S corporation election was intended. These items constitute the application requesting relief. n44.9 If the conditions are met and the forms properly filed, the entity will be treated as having made an election to be classified as an association taxable as a corporation n44.10 as of the effective date of the S corporation election. n44.11

An entity that does not qualify for relief under *Revenue Procedure 2007-62* may request relief under *Revenue Procedure 2004-48*. n44.12

To be eligible for relief, under *Revenue Procedure 2004-48* the entity must meet the following requirements: n44.13

- the entity must be an "eligible entity"; n44.14
- the entity must have intended to be classified as a corporation as of the intended effective date of the S corporation status;
- the entity must have failed to qualify as a corporation solely because Form 8832 was not timely filed or was not deemed to have been filed; n44.15
- the entity must have failed to qualify as an S corporation on the intended effective date of the S corporation status solely because the S corporation election was not filed timely; n44.16 and
- the entity must have reasonable cause for its failure to file timely the S corporation election and the entity classification election.

The revenue procedure sets out specific procedural requirements that must be complied with in order to obtain relief. Within 6 months after the due date for the tax return, excluding extensions, for the first year the entity intended to be an S corporation, the corporation must file a properly completed Form 2553 with the applicable service center. The Form 2553 must state at the top of the document " FILED PURSUANT TO REV. PROC. 2004-48 ." Attached to the Form 2553 must be a statement explaining the reason for the failure to file timely the S corporation election and a statement explaining the reason for the failure to file timely the entity classification election. n44.17

Upon receipt of a completed application requesting relief under the revenue procedure, the IRS will determine whether the requirements for granting additional time to file the elections have been satisfied and will notify the entity of the result of this determination. An entity receiving relief under this revenue procedure is treated as having made an election to be classified as an association taxable as a corporation under the regulations n44.18 as of the effective date of the S corporation election. n44.19

[8] Time for Making Election and Effective Date of Election

[a] In General

An entity classification election must generally be made at the beginning of the entity's taxable year. A special filing date applies to REITs. See *Section 14.01[12]*. The entity may specify the date on which an election will be effective, but an election cannot be effective more than 75 days prior to, or more than 12 months after, the date on which the election is filed. If no effective date is specified in the election, the effective date is the date of filing. If a purchasing corporation makes an election under *IRC Section 338* regarding an acquired subsidiary, an election for the acquired subsidiary can be effective no earlier than the day after the acquisition date. n45

[b] Late Classification Elections

Under a special revenue procedure, eligible entities may file a request for a late classification election within 3 years and 75 days of the requested effective date of the eligible entity's classification election. n45.1 The late entity classification relief is available both for initial classification elections and elections to change a classification. For eligible entities, relief under *Revenue Procedure 2009-41* is the exclusive means for obtaining relief for a late entity classification election; relief is not available under the regulatory letter ruling procedure under *Treasury Regulations Sections 301.9100-1 and 301.9100-3*. User fees do not apply in seeking relief under *Revenue Procedure 2009-14* . n45.2

An entity is eligible for relief under *Revenue Procedure 2009-41* only if the following requirements are met: n45.3

- The entity failed to obtain its requested classification (or requested change in classification) solely

because Form 8832 was not filed timely; n45.4

- The entity either (1) has not filed a federal tax or information return for the first year in which the election was intended because the due date has not passed for that year's return, or (2) the entity timely filed all required federal tax returns and information returns consistent with its requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the taxable years;
- The entity has reasonable cause for its failure to timely make the entity classification election; and
- 3 years and 75 days from the requested effective date of the eligible entity's classification election have not passed.

To take advantage of *Revenue Procedure 2009-41*, the taxpayer must, within 3 years and 75 days from the requested effective date of the entity's classification election, file with the proper IRS service center a completed and signed Form 8832. The Form 8832 must indicate that it is being filed pursuant to *Revenue Procedure 2009-41*, state that the elements of that procedure have been satisfied, include a reasonable cause statement explaining the reason for the failure to file a timely entity classification election, and include a signed declaration set forth in the procedure. n45.5 If the requirements are met and Form 8832 properly filed, the entity will be treated as having made a timely entity classification election as of the requested effective date of the election. n45.6

An entity that does not meet the requirements for obtaining relief under *Revenue Procedure 2009-41* may request an extension of time for making an entity classification election or change by letter ruling. The letter ruling request must include an affirmative representation regarding the timely filing of past tax returns or an explanation why the entity cannot make that affirmative representation. n45.7

[9] Multiple Classification Elections Restricted

Not more than one election to change an entity's classification may be made during any 60-month period. The Commissioner may waive this rule by letter ruling, but only if there has been more than a 50-percent ownership change in the entity. The 60-month limitation applies only to a change in classification by election; apparently, it does not apply if the organization's business is actually transferred to another entity, which as a separate entity would be entitled to make its own election. An election by a newly-formed eligible entity that is effective on the date of formation is not considered a change for purposes of the election restrictions. n46

[10] Entity Classification Rules Following Partnership Terminations and Divisions

A partnership is considered terminated if, within a 12-month period, there is a sale or exchange of at least 50 percent of the total interests in partnership capital and profits. n47 When a partnership is divided into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits interest of the prior partnership) are, for purposes of determining whether the prior partnership has terminated, all considered a continuation of the prior partnership. n48

For purposes of the entity classification rules, a partnership resulting from one of the above terminations or divisions is a partnership. n49 However, this rule does not apply for certain foreign entities whose entity status as a partnership was grandfathered under special rules. n50

[11] Changes in Number of Members of an Entity

The classification of an eligible entity as an association is not affected by any change in the number of members of the

entity. n50.1 An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member. A single-member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member. If an elective classification change is effective at the same time as a membership change, certain deemed transactions resulting from the elective change n50.2 pre-empt the transactions that would result from the change in membership. n50.3 Any change in the number of members of an entity does not result in the creation of a new entity for purposes of the 60-month limitation on elections. n50.4

The IRS has issued rulings describing the federal income tax consequences if one person purchases all of the ownership interests in an LLC that is treated as a partnership n50.5 or if a single-member LLC that is disregarded as an entity separate from its owner becomes an entity with more than one owner that is classified as a partnership for federal income tax purposes. n50.6

[12] Deemed Transactions Resulting From Elective Classification Change

[a] In General

Several different transactions are deemed to occur when an elective change in entity takes place. The particular deemed transactions vary, depending on the type of entity change involved. n50.7 The tax treatment of a change in classification of an entity is determined under all relevant tax provisions, including the step transaction doctrine. n50.8 For purposes of satisfying the statutory requirement of adopting a plan of liquidation, n50.9 a plan of liquidation is deemed adopted immediately before the deemed liquidation incident to an elective change in entity classification, unless a formal plan of liquidation that contemplates the filing of the elective change in entity classification is adopted on an earlier date. n50.10

If an entity that is treated as a partnership elects to be classified as an association, the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association; immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners. n50.10.1 If an entity that is treated as an association elects to be classified as a partnership, the association is deemed to distribute all of its assets and liabilities to its shareholders in liquidation of the association, and, immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly-formed partnership. n50.10.2

If an entity that is classified as an association elects to be disregarded as an entity separate from its owner, the association is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association. n50.11

If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to contribute all of the assets and liabilities of the entity to the association in exchange for the stock of the association. n50.12

[b] Timing of Election

An election changing the classification of an entity is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur as a result of the election n50.13 are treated as occurring immediately before the close of the day before the election is effective. n50.14 A special rule allows a purchasing corporation that makes a qualified stock purchase of a corporation to make an *IRC Section 338* election with respect to the purchase and also to make an election to change the classification of the target corporation. The transactions that are deemed to occur as a result of the election to change the classification of the target corporation n50.15 are treated as occurring immediately after the deemed asset purchase by the new target corporation under *IRC Section 338*. n50.16

If elections to change entity classifications for a series of tiered entities are effective on the same date, the eligible entities may specify the order of the election on Form 8832. If no order is specified for the elections, any transactions that are deemed to occur as a result of the change of entity classification will be treated as occurring first for the highest tier entity's classification, then for the next highest tier entity's change, and so forth down the chain of entities until all the transactions are deemed to have occurred. n50.17

[13] Special REIT Classification Election Rules

A special rule applies for real estate investment trusts (REITs). Although the entity classification election must generally be made at the beginning of the entity's tax year, because the election to be treated as a REIT must be made with the REIT's first tax return, to simplify filing requirements and to avoid timing problems, an election by an eligible entity to be a REIT will be treated as a deemed election to be classified as an association (taxable as a corporation), effective for the entire period during which REIT status is claimed. n51

[14] Transition Rule for Pre-1997 Periods for Entities in Existence Prior to January 1, 1997

A special transition rule applies for entities that were in existence prior to January 1, 1997. The Service will not challenge the prior classification of an existing eligible entity or an existing foreign entity described on the per se list n52 for periods prior to 1997 if the following conditions are met: n53

- (1) The entity had a reasonable basis (within the meaning of *IRC Section 6662*) for its claimed classification.
- (2) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the 60 months prior to January 1, 1997.
- (3) Neither the entity nor any member had been notified in writing on or before May 8, 1996, that the federal income tax classification of the entity was under examination.

FOOTNOTES:

(n1)Footnote 7. *Treas Reg §§ 301.7701-1 through 301.7701-6*; eff generally Jan 1, 1997 (*Reg § 301.7701-3(h)(1)*).

(n2)Footnote 8. *Treas Reg § 301.7701-3(a)*.

(n3)Footnote 9-12. See former *Treas Reg §§ 301.7701-2(a) through (e)*.

(n4)Footnote 13. *Littriello v United States*, 484 F3d 372 (6th Cir 2007) , cert denied 128 S Ct 1290 (2008) ; *McNamee v Dept of Treasury*, 488 F3d 100, 2007-1 USTC 50,515 (2d Cir 2007) ; *Kandi v US*, 2008-2 USTC P 50,599 (9th Cir 2008) (unpublished decision), affg 2006-1 USTC P 50,231 (DC Wa, 2006); *L & L Holding Co, LLC v US*, 2008-1 USTC P 50,324 (WD La 2008), 2008 US Dist LEXIS 35229 (WD La 2008) .

(n5)Footnote 14. *Littriello v US*, 484 F3d 372 (6th Cir 2007) , cert denied 128 S Ct 1290 (2008) .

(n6)Footnote 14.1. *McNamee v Dept of Treasury*, 488 F3d 100, 2007-1 USTC P 50,515 (2d Cir 2007); *Kandi v US*, 2008-2 USTC P 50,599 (9th Cir 2008) (unpublished decision), affg 2006-1 USTC P 50,231 (DC Wa, 2006); *Medical Practice Solutions, LLC v Commr*, 132 TC 125 (2009) , on appeal (1st Cir 2009). See also *Medical Practice Solutions, LLC v Commr*, TC Memo 2010-98 (2010) . Note that even if the IRS prevails on the merits of the employment tax liability issue in a case, it still must comply with mandatory collection procedures [see *IRC § 6330*]. If it does not, an individual owner of an LLC can demand that those procedures be complied with [*Medical Practice Solutions, LLC v Commr*, TC Memo 2009-214] .

- (n7)Footnote 15. *Treas Reg* § 301.7701-1(a)(1).
- (n8)Footnote 16. *Treas Reg* § 301.7701-1(a)(2).
- (n9)Footnote 17. *Treas Reg* § 301.7701-1(a)(2).
- (n10)Footnote 18. *Treas Reg* § 301.7701-1(a)(2).
- (n11)Footnote 19. *Treas Reg* § 301.7701-1(a)(4).
- (n12)Footnote 20. *Treas Reg* § 301.7701-4.
- (n13)Footnote 21. *Treas Reg* § 301.7701-2.
- (n14)Footnote 22. *Treas Reg* § 301.7701-1(b); see *IRC* § 860A (classification as REMICs).
- (n15)Footnote 23. *Treas Reg* § 301.7701-4.
- (n16)Footnote 24. *Treas Reg* § 301.7701-4(c)(1).
- (n17)Footnote 25. *Treas Reg* § 301.7701-2(b).
- (n18)Footnote 26. See *Treas Reg* § 301.7701-2(b)(8).
- (n19)Footnote 27. *Treas Reg* § 301.7701-2(d).
- (n20)Footnote 27.1. *Temp Treas Reg* § 301-7701-2T(c)(2)(v)(B), (C)(iv), (e)(6), effective Sept 14, 2009.
- (n21)Footnote 27.2. *Treas Reg* § 1.6031-1(a)(1), (e)(5), effective for wages paid on or after Sept 14, 2009.
- (n22)Footnote 28. See [4], above.
- (n23)Footnote 29. *Treas Reg* § 301.7701-3(a).
- (n24)Footnote 30. *Treas Reg* § 301.7701-3(a).
- (n25)Footnote 31. See *IRC* §§ 581-585.
- (n26)Footnote 32. *Treas Reg* § 301.7701-2(c)(2)(ii).
- (n27)Footnote 32.1. *Rev Rul* 2004-77, 2004-2 CB 119 .
- (n28)Footnote 32.2. *Rev Proc* 2002-22, 2002-1 CB 733 .
- (n29)Footnote 32.3. *Rev Proc* 2002-22 , §§ 4, 5, 6, 2002-1 CB 733 .
- (n30)Footnote 32.4. *Rev Proc* 2002-22 , § 3, 2002-1 CB 733 .
- (n31)Footnote 32.5. *Rev Proc* 2002-69 , § 3.02, 2002-2 CB 831 .
- (n32)Footnote 32.6. See *Treas Reg* § 1.7701-2.
- (n33)Footnote 32.7. *Rev Proc* 2002-69 , § 4.01, 2002-2 CB 831 .
- (n34)Footnote 32.8. See *Treas Reg* § 301.7701-2(a); see *Rev Proc* 2002-69 , § 2, 2002-2 CB 831 .

(n35)Footnote 32.9. *Rev Proc 2002-69* , § 4.03, 2002-2 CB 831 .

(n36)Footnote 32.10. *Rev Proc 2002-69* , § 4.02, 2002-2 CB 831 .

(n37)Footnote 32.11. *Rev Proc 2002-69* , § 4.03, 2002-2 CB 831 .

(n38)Footnote 33. *Treas Reg § 301.7701-3(b)*.

(n39)Footnote 34. *Treas Reg § 301.7701-3(b)(3)*.

(n40)Footnote 35. *Treas Reg § 301.7701-3(b)(1)*.

(n41)Footnote 36. *Treas Reg § 301.7701-3(b)(2)(i)*.

(n42)Footnote 37. *Treas Reg § 301.7701-3(b)(2)(ii)*.

(n43)Footnote 38. *Treas Reg § 301.7701-3(b)(2)(ii)* (second sentence).

(n44)Footnote 39. See [5], above.

(n45)Footnote 40. *Treas Reg § 301.7701-3(c)(1)(i)*.

(n46)Footnote 41. *Treas Reg § 301.7701-3(c)(2)(i)*.

(n47)Footnote 41.1. *Treas Reg § 1.6031-1(e)(2)*.

(n48)Footnote 42. *Treas Reg § 301.7701-3(c)(2)(ii)*.

(n49)Footnote 43. *Treas Reg § 301.7701-3(c)(1)(i)*.

(n50)Footnote 44. *Treas Reg § 301.7701-3(c)(1)(ii)*.

(n51)Footnote 44.1. *Treas Reg § 301.7701-3(c)(1)(v)(C)*.

(n52)Footnote 44.2. See *Treas Reg § 301.7701-3(b)*.

(n53)Footnote 44.3. *Rev Proc 2007-62*, 2007-41 IRB 786 .

(n54)Footnote 44.4. *Rev Proc 2007-62* , § 5.01, 2007-41 IRB 786 .

(n55)Footnote 44.5. See *Treas Reg § 301.7701-3(a)*.

(n56)Footnote 44.6. See *Treas Reg § 301.7701-3(c)(1)(i)*.

(n57)Footnote 44.7. See *Treas Reg § 01.7701-3(c)(1)(v)(C)*.

(n58)Footnote 44.8. See *IRC § 1362(b)*.

(n59)Footnote 44.9. *Rev Proc 2007-62* , § 5.02, 2007-41 IRB 786 .

(n60)Footnote 44.10. See *Treas Reg § 301.7701-3(c)*.

(n61)Footnote 44.11. *Rev Proc 2007-62* , § 5.03, 2007-41 IRB 786 .

(n62)Footnote 44.12. *Rev Proc 2007-62* , § 5.03, 2007-41 IRB 786 .

(n63)Footnote 44.13. *Rev Proc 2004-48* , § 4.01, 2004-2 CB 172 .

(n64)Footnote 44.14. See *Treas Reg § 301.7701-3(a)*.

(n65)Footnote 44.15. See *Treas Reg § 301.7701-3(c)(1)(v)(C)*.

(n66)Footnote 44.16. See *IRC § 1362(b)*.

(n67)Footnote 44.17. *Rev Proc 2004-48* , § 4.02, 2004-2 CB 172 .

(n68)Footnote 44.18. See *Treas Reg § 301.7701-3(c)*.

(n69)Footnote 44.19. *Rev Proc 2004-48* , § 4.03, 2004-2 CB 172 .

(n70)Footnote 45. *Treas Reg § 301.7701-3(c)(1)(iii)*.

(n71)Footnote 45.1. *Rev Proc 2009-41*, 2009-39 IRB 439 , effective generally Sept 28, 2009, with a transition rule for requests pending with the IRS on that date.

(n72)Footnote 45.2. *Rev Proc 2009-41* , § 3.01, 2009-39 IRB 439 .

(n73)Footnote 45.3. *Rev Proc 2009-41* , § 4.01, 2009-39 IRB 439 .

(n74)Footnote 45.4. See *Treas Reg § 301.7701-3(c)(1)(iii)*.

(n75)Footnote 45.5. *Rev Proc 2009-41* , § 4.02, 2009-39 IRB 439 .

(n76)Footnote 45.6. *Rev Proc 2009-41* , § 4.03, 2009-39 IRB 439 .

(n77)Footnote 45.7. See *Rev Proc 2009-41* , § 4.04, 2009-39 IRB 439 .

(n78)Footnote 46. *Treas Reg § 301.7701-3(c)(1)(iv)*.

(n79)Footnote 47. *IRC § 708(b)(1)(B)*.

(n80)Footnote 48. See *IRC § 708(b)(2)(B)*.

(n81)Footnote 49. *Treas Reg § 301.7701-3(e)*.

(n82)Footnote 50. *Treas Reg § 301.7701-3(e)*; see *Treas Reg § 301.7701-2(d)(3)*.

(n83)Footnote 50.1. *Treas Reg § 301.7701-3(f)(1)*.

(n84)Footnote 50.2. See *Treas Reg § 301.7701-3(g)*; see [12], below, for a discussion.

(n85)Footnote 50.3. *Treas Reg § 301.7701-3(f)(2)*.

(n86)Footnote 50.4. *Treas Reg § 301.7701-3(f)(3)*; see *Treas Reg § 301.7701-3(c)(1)(iv)* and [9], above, for a discussion of the 60-month limitation.

(n87)Footnote 50.5. See *Rev Rul 99-6*, 1999-1 CB 432 ; see § 14.19[2] for a discussion.

(n88)Footnote 50.6. See *Rev Rul 99-5*, 1999-1 CB 434 ; see § 14.19[2] for a discussion.

(n89)Footnote 50.7. *Treas Reg § 301.7701-3(g)*.

(n90)Footnote 50.8. *Treas Reg § 301.7701-3(g)(2)(i)*.

(n91)Footnote 50.9. See *IRC § 332(b)*.

(n92)Footnote 50.10. *Treas Reg § 301.7701-3(g)(2)(ii)*.

(n93)Footnote 50.10.1. *Treas Reg § 301.7701-3(g)(1)(i)*. *Rev Rul 2004-59, 2004-24 IRB 1050* (same deemed consequences when partnership converts into a state law corporation under a state "formless conversion statute," ie, a law that does not require an actual transfer of the unincorporated entity's assets or interests).

(n94)Footnote 50.10.2. *Treas Reg § 301.7701-3(g)(1)(ii)*.

(n95)Footnote 50.11. *Treas Reg § 301.7701-3(g)(1)(iii)*.

(n96)Footnote 50.12. *Treas Reg § 301.7701-3(g)(1)(iv)*.

(n97)Footnote 50.13. See [a], above, for a discussion.

(n98)Footnote 50.14. *Treas Reg § 301.7701-3(g)(3)(i)*.

(n99)Footnote 50.15. See [a], above.

(n100)Footnote 50.16. *Treas Reg § 301.7701-3(g)(3)(ii)*.

(n101)Footnote 50.17. *Treas Reg § 301.7701-3(g)(3)(iii)*.

(n102)Footnote 51. *Treas Reg § 301.7701-3(c)(1)(v)(B)*.

(n103)Footnote 52. See *Treas Reg § 301.7701-2(b)(8)*.

(n104)Footnote 53. *Treas Reg § 301.7701-3(h)(2)*.

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Federal Taxes Affecting Real Estate

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.03

§ 14.03 The Partnership Agreement

[1] Reasons for Having a Partnership Agreement

The importance of having a partnership agreement that sets forth the relationship among the partners cannot be over-emphasized. Even though, as a matter of local law, a partnership agreement can be an oral understanding, an informal handwritten document, or a formal typed contract, and even though an oral agreement may be as binding on the partners as a written agreement, many a dispute will be avoided by the simple expedient of having a written partnership agreement. A written agreement, signed by all partners, can prevent serious future misunderstandings among the parties. Moreover, a written agreement may be essential in proving the intent of the partners with respect to a partnership transaction should the tax return of the partnership be examined by the Service. n54

[2] Issues to be Addressed in a Partnership Agreement

The partnership agreement should cover all aspects of the formation, operation and dissolution of the partnership. The following is a list of some of the more important areas that should be covered in the partnership agreement:

- (1) purpose of the partnership;
- (2) term of the partnership;
- (3) management of the partnership;
- (4) capital contributions required;
- (5) allocation of profits and losses;
- (6) distribution of cash flow;
- (7) admission of new partners;
- (8) transfers of partnership interests;

- (9) consequences of retirement of a partner;
- (10) events causing a termination of the partnership;
- (11) liquidation rights and obligations;
- (12) method of determining value of partnership interest;
- (13) designation of tax matters partner (in the case of entities taxed as partnerships that are subject to the entity level partnership audit rules); n55 and
- (14) selection of entity status for federal tax purposes (presumably as a partnership). n56

[3] Tax Implications of the Partnership Agreement

The section of the agreement dealing with the purpose of the partnership can have substantial tax implications. For example, a partnership agreement that states that the purpose of the venture is to acquire property and hold it for resale could forfeit its right to capital gain treatment on the sale of the property, because such property would be deemed to be inventory. n57

The agreement may specify which tax elections, in addition to the entity classification election, are to be made by the partnership from time to time (such as an election to capitalize taxes and carrying charges, n58 or an election to adjust the basis of the partnership's assets upon the transfer of an interest in the partnership) n59 and identify the party who has the authority to determine when and which elections should be made. Additionally, the partnership agreement should contain provisions dealing with such concepts as the maintenance of the partners' capital accounts, the manner in which liquidating distributions are to be made, and whether or not partners have any obligation to restore deficit balances in their capital accounts. These requirements are discussed in greater detail in Section 14.11.

A partnership agreement can be as simple or as complex as the partners and the enterprise require. However, each partner should understand the tax and nontax aspects of all the provisions to which he or she has agreed.

FOOTNOTES:

(n1)Footnote 54. Note, however, that even if the parties execute a written partnership agreement, the terms of the agreement will not necessarily be determinative for federal income tax purposes. Allocations of income and loss set forth in the partnership agreement will be accepted by the Service only if the allocations have substantial economic effect or otherwise comply with the Regulations. *Treas Reg § 1.704-1(b)(1)*. In addition, *Treas Reg § 1.701-2*, is an anti-abuse rule that gives the IRS the power to recast a transaction involving the use of a partnership to reflect the underlying economic arrangement under subchapter K of the Code, or to prevent the use of a partnership to circumvent the intended purposes of any provision of the Code. This regulation appears to give the Service an enormous amount of authority to modify or even ignore the terms of a written partnership agreement in certain situations.

(n2)Footnote 55. "Small" partnerships are not subject to these rules. *IRC § 6231(a)(1)(B)*.

(n3)Footnote 56. *Treas Reg § 301.7701-3(a)*; see § 14.02, for a discussion of federal entity classification rules.

(n4)Footnote 57. *IRC § 1221(a)(1)*.

(n5)Footnote 58. *IRC § 266*.

(n6)Footnote 59. *IRC § 754*.

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.04

§ 14.04 Formation of a Partnership

Entities taxed as partnerships are very flexible business vehicles from the perspective of tax constraints on business transactions. As a general rule, assets can be transferred into and out of partnerships, and interests in partnerships can be shifted with much less of a concern about adverse federal income tax consequences than is the case with respect to any other form of business entity. Generally, no gain or loss is recognized on a contribution of property to a partnership made in exchange for an interest in the partnership. This rule applies whether the contribution is made to a partnership as part of the original formation or is made to a partnership that is already formed and operating, and does not depend on the contributor's holding a controlling interest in the partnership. n60 However, the difference, if any, between the fair market value and the tax basis of the assets contributed (i.e., built-in gains or losses) that are deferred at the time of contribution must generally be specially allocated to the contributing partner under *IRC Section 704(c)(1)(A)*. (The principles of this section are discussed in greater detail in Section 14.04[7].) The Taxpayer Relief Act of 1997 authorizes the Service to promulgate regulations providing that the non-recognition rule will not apply if the gain, if recognized, would be includible in the gross income of a foreign person, and also providing that intangibles transferred to a partnership may be treated as sold. n61

A contribution of property will not qualify for nonrecognition treatment if the partnership constitutes an "investment company." n62 For purposes of this provision, which generally will not be applicable to partnerships investing in real estate, the term "investment company" is defined by reference to *IRC Section 351(e)*, which imposes a similar limitation on the tax-free formation of a corporation. n63

For a contribution to qualify for nonrecognition of gain, the partner must be acting in its capacity as a partner, and not in a different capacity, such as that of a seller of property to the partnership. If the transfer of property by a partner to a partnership is followed shortly thereafter by a transfer to the contributing partner of money or other consideration, including a promissory obligation fixed in amount and time of payment, or if it is followed shortly by a transfer of money or other property by the partnership to another partner, the transaction will likely be treated as a sale or an exchange of the property, by the partner, to the partnership rather than as a contribution, and gain will, and loss may, be recognized. n64 A similar rule applies if a partner contributes property to a partnership and, within seven years of the contribution, the property is distributed to another partner: the transaction may be treated as an exchange of property and the nonrecognition provisions for the contribution of property may not apply. n65

The time elapsed between the transfers of property is an important factor in determining whether a valid contribution

and partnership distribution, rather than a sale or exchange of property, has occurred. Under *IRC Section 707(a)(2)(B)*, transfers between a partnership and a partner that are made within two years of each other are presumed to be part of a disguised sale or exchange of property, whereas transfers made more than two years apart are presumed to constitute a valid contribution and distribution. n66 These presumptions can only be rebutted by facts and circumstances that clearly establish the contrary. n67 A principal underlying issue in this facts and circumstances determination is the extent to which the capital represented by the transferred property has been subjected to the risks of the partnership between the time of its contribution and the associated distribution. A more rigorous standard is applied under *IRC Sections 704(c)(1)(B)* and 737; the time period prescribed by those provisions is five years and, effective with respect to property contributed to a partnership after June 8, 1997, is increased by the Taxpayer Relief Act of 1997 to seven years.

If a liability is incurred by a partner in anticipation of a transfer of property to a partnership, the portion of the liability shifted away from the transferor-partner to the partnership or other partners may be treated as consideration for the sale of such property. n68 The regulations establish a presumption that any liability incurred within two years prior to the transfer of the subject property will be considered to be made in anticipation of the transfer unless the facts and circumstances clearly establish otherwise. n69 However, acquisition and improvement debt and trade payables related to the transferred property are excluded from this treatment. n70

The nonrecognition provisions for property contributed to a partnership also cover transferred property that is subject to depreciation recapture. Thus, no gain is recognized on a contribution to a partnership of property having depreciation recapture potential. n71 However, if one of the exceptions applies to the general rule of nonrecognition of gain on a contribution to a partnership and gain is recognized, the depreciation recapture will be taken into account.

A contribution of property by a partner to a partnership may trigger investment credit recapture to the contributing partner. The regulations n72 provide that a contribution of property to a partnership is a "disposition" that triggers investment credit recapture, unless the following conditions are met:

- (1) The transfer constitutes merely a change in the form of conducting a trade or business.
- (2) The property continues to be eligible investment credit property in the trade or business.
- (3) Substantially all of the assets necessary to operate such trade or business are transferred to the partnership. n73
- (4) The basis of the assets in the hands of the partner is carried over to the partnership.
- (5) The partner retains a substantial interest in the trade or business.

[1] Transfer of Property Subject to a Liability

The assumption by a partnership of a partner's personal liabilities, or a decrease in a partner's share of liabilities is deemed to be a distribution of money by the partnership, to the partner. n74 For example, if a partner owns property subject to a liability and transfers that property to a partnership in which it has a 50 percent interest, the contributing partner may be deemed to have received a distribution of money equal to 50 percent of the liability of which it is relieved. To the extent the amount of this deemed distribution exceeds the basis of the partner's interest in the partnership immediately prior to the distribution, gain must be recognized by the partner. (This problem frequently arises with real estate partnerships because property transferred to partnerships is often subject to liabilities.) However, where the liabilities in question are nonrecourse liabilities, as is typically the case in a real estate partnership, this problem has been substantially ameliorated by the regulations that establish the rules for allocating liabilities among partners. These regulations provide that as a general rule, the contributing partner's share of nonrecourse liabilities will include the amount of any built-in gain that would be allocated to the contributing partner under *IRC Section 704(c)*.

n75 The liability to which the property is subject is treated as a liability of the partnership only to the extent of the fair market value of the property. n76

[2] Partnership Interest for Services

Another area in which the greater flexibility of a partnership can be demonstrated is in the context of the acquisition of a partnership interest in exchange for past or future services. A partner who receives an interest in partnership capital for services realizes income to the extent of the fair market value of that interest. n77 The partners of the partnership to which the services are provided may be entitled to a compensation deduction in respect of the transfer, but will also recognize gain to the extent that the partnership's tax basis for the deemed interest in partnership assets transferred is less than its fair market value. The tax treatment of a transfer of a capital interest in a partnership as compensation for services is thus similar to the treatment of a service provider to a corporation under similar circumstances. The corporation, however, has no gain recognition in respect of a transfer of its stock to a service provider as compensation for services. n78 The fair market value of the partnership interest may include the value of a pro rata share of appreciated property, even if the partnership itself has not yet realized the appreciation as gain for tax purposes.

The flexibility of the partnership demonstrates itself when the interest transferred to the service provider is merely an interest in future profits, not a current interest in the existing value of the assets of the partnership. As is set forth in the discussion of *Revenue Procedure 93-27* at the end of this section, the transfer of an interest in partnership profits will generally not be treated as a compensatory transfer to the service provider-recipient, and on the basis of the same analysis, should not result in either a current compensation deduction or a taxable asset disposition to the partnership. The tax analysis of the receipt of an interest in partnership profits in exchange for services has, thus, come full circle. For many years, it was thought that the receipt of an interest in a partnership's profits and losses in consideration of past or future services to the partnership was a nontaxable event. n79 This school of thought was given a rude awakening in 1971, when the Tax Court decided the fate of a taxpayer who had arranged financing for a real estate project and in return received a profits-only interest in the partnership. He sold the interest within four months. The Tax Court held that the taxpayer had to recognize ordinary income at the time he received the interest. n80 The case had an unusual fact pattern and was severely criticized by various commentators. n81 In fact, the court itself indicated that its ruling may not apply to other factual situations, particularly if the recipient of the profits interest was to provide future services.

In spite of the doubts that the Tax Court had expressed in the *Diamond* case, it did not back away from its compensation conclusions in subsequent cases. In *Campbell v. Commissioner*, n82 the Tax Court reaffirmed the principles established in *Diamond* in the context of *IRC Section 83* (pertaining to property transferred in connection with the performance of services.) In *Campbell*, the taxpayer organized hotel syndications; the court specifically held that *IRC Section 83* applies to the receipt of a profits interest in a partnership in connection with the performance of services. As a result, the court found that the new partner/service provider had to include in income an amount equal to the excess of the fair market value of the profits interest once it became substantially vested, over the amount, if any, contributed to capital.

In *Campbell*, the Tax Court determined the value of the service partner's interest in partnership profits largely by discounting the cash flows projected by the syndicator. The court included projected tax benefits in its calculation of total cash flow, even though most of the tax benefits were subsequently disallowed upon examination by the Service. Earlier court decisions had used a "liquidation approach" to value a partnership profits interest instead of *Campbell's* "valuation approach." The liquidation approach focuses on the amount the partner would receive on the recognition date if the partnership disposed of its assets at that time, paid its debts, and distributed the remaining proceeds (if any) to its partners in liquidation. n83

The Eighth Circuit Court of Appeals subsequently overturned the Tax Court's decision in *Campbell*. The appellate court discussed several grounds upon which it could have based its decision; however, it ultimately based its decision on its conclusion that the projections relied on by the Tax Court in valuing the profits interest were too speculative. Additional factors that the appellate court took into account in reaching this decision were the absence of an established "track

record" for the partnership, the restrictions on the transferability of the interest, and the taxpayer's lack of control over management of the partnership. n84

Since the Eighth Circuit's holding in this decision was based primarily on factual issues unique to the case, the door remained open for the Service to assert that similar but slightly different arrangements, nevertheless, resulted in current compensation income to the service provider. However, in a reversal of position, the Service announced in *Revenue Procedure 93-27* n85 that the receipt of a partnership profits interest in exchange for services rendered to, or for the benefit of, a partnership will generally not be treated as a taxable event for either the partnership or the receiving partner. However, this general rule will not apply in certain situations in which the value of the interest may be readily determinable, the services are rendered to certain entities other than the partnership in question, or the services are not rendered in the taxpayer's capacity as a partner.

Revenue Procedure 93-27 was clarified in *Revenue Procedure 2001-43* . n85.1 *Revenue Procedure 2001-43* provides that the determination of whether an interest granted to a service provider is a profits interest is under certain circumstances tested at the time the interest is granted, even if, at that time, the interest is substantially nonvested. Where a partnership grants a profits interest to a service provider in a transaction meeting the requirements of *Revenue Procedure 93-27* , the IRS will not treat the grant of the interest or the event that causes the interest to become substantially vested n85.2 as a taxable event for the partner or the partnership. For purposes of *Revenue Procedure 93-27* , where a partnership grants a partnership profits interest that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant provided that: n85.3

- (1) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;
- (2) upon the grant of the interest or at the time the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and
- (3) all other conditions of *Revenue Procedure 93-27* are satisfied.

An alternative basis on which a service provider can receive a partnership interest in respect of its services without any current income or gain recognition is to defer its admission to the partnership until it has created "property" that can be transferred to the partnership in exchange for an interest in capital, profits and losses without gain recognition. This technique will apply to some service providers but not to others. For example, in situations where intangible assets resulting from the performance of services are contributed to a partnership (eg, goodwill), the rules of *IRC Section 721* generally apply. Thus, for example, the contribution of a letter of intent by a partner in exchange for a partnership interest has been held to represent a nontaxable event. n86 However, in another case, a partner was unable to prove that "goodwill" purportedly transferred to a partnership represented a nontaxable contribution of property under *IRC Section 721(a)*. n87 Accordingly, a prospective partner whose service contribution may or may not result in the creation of "property" for purposes of *IRC Section 721* must choose whether to accept merely an interest in partnership profits and rely on *Revenue Procedure 93-27* , or receive an interest in partnership capital, as well, and attempt to rely on *Stafford* and avoid *Mark IV Pictures*.

[3] Basis of Contributed Property

The tax basis of property contributed to a partnership through a tax-free contribution by a partner is generally the same as the adjusted basis of the property in the hands of the partner immediately prior to the contribution. n88 When a

partner contributes nonbusiness property to a partnership that uses the property in its trade or business (e.g., a vacation home formerly used by a partner for personal use), the Tax Court has held that the basis of the property in the hands of the partnership is equal to the lower of the adjusted basis in the partner's hands or the fair market value at the date of contribution. n89

A special rule applies to built-in loss property that is contributed to a partnership. n89.1 The built-in loss may be taken into account only by the contributing partner and not by other partners. n89.2 Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated. n89.3 The "built-in loss" is the excess of the adjusted basis of the property over its fair market value at the time of contribution. n89.4

[4] Holding Period of Contributed Property

The holding period of contributed property in the hands of the partnership includes the holding period of the property in the hands of the contributing partner. n90 When a partnership acquires property in a transaction that is found to be a sale or taxable exchange, the partnership has a cost basis for the property, and the partnership's holding period for the property begins with the date of the sale or exchange.

[5] Character of Contributed Property

Generally, the character of income or loss from the disposition of property by a partnership is determined at the partnership level. Thus, the manner in which the property is used by the partnership generally governs its character, without regard to the character which it would have in the hands of the partners.

To prevent what was perceived to be an abuse that permitted a partner holding ordinary income property to contribute it to a partnership, which in turn would claim capital asset status for the contributed property, Congress enacted rules that cause certain property contributed to a partnership by a partner to retain the character that it possessed in the hands of the contributing partner for a specified period. If within five years of contribution, a partnership disposes of property that was inventory in the hands of the partner immediately before the contribution, any gain or loss recognized by the partnership is treated as ordinary gain or loss. n91 Gain or loss on the sale of unrealized receivables contributed by a partner is treated as ordinary gain or loss regardless of the disposition date. n92 The term "unrealized receivables" is defined by cross reference to *IRC Section 751(c)*, and has a far broader scope than the dictionary definition of that term. See *Section 14.13[2]* below. Similarly, built-in losses on capital assets retain their character as capital losses for five years after contribution, to the extent of precontribution unrealized losses.

[6] Distributions of Property Contributed to a Partnership

The value of property contributed to a partnership frequently differs from the contributing partner's adjusted basis. If that property is distributed by the partnership (other than to the contributing partner) within seven years of being contributed, precontribution appreciation or depreciation must be allocated solely to the contributing partner. n93

The above seven-year rule for distributed property applies only to the extent that a transaction is a distribution under *IRC Section 731*, i.e., a distribution to a partner acting in the capacity of a partner. n94 Thus, it should not apply to a transaction in which the property is transferred by the partnership in a like-kind exchange to a partner within the seven-year period. The amount of gain or loss resulting from a distribution of partnership property is determined as if the distributed property had been sold by the partnership to the distributee-partner. n95 As a result, if built-in loss property is distributed to a partner that holds a greater than 50-percent interest in partnership capital or profits, the built-in loss that otherwise would be recognized is disallowed. n96

If a partnership terminates as a result of a sale or exchange of at least 50 percent of the total interest in partnership capital and profits within a 12-month period, n97 property that was previously contributed by a partner to the partnership is subject to a new seven-year period under *IRC Section 704(c)(1)(B)*, n98 but only to the extent of any pre-termination gain or loss that would not have been allocated to a contributing partner under *IRC Section 704(c)(1)(A)* on a sale of contributed property immediately before the termination. n99

There are several exceptions to the statutory seven-year rule in the regulations. *IRC Section 704(c)(1)(B)* does not apply to any of the following:

- (1) property contributed to a partnership on or before October 3, 1989; n100
- (2) a distribution of an interest in *IRC Section 704(c)* property to a partner other than the contributing partner in a liquidation of the partnership if: (a) the contributing partner receives an interest in the *Section 704(c)* property contributed by that partner (and no other property), and (b) the built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to that partner on a sale of the contributed property to an unrelated party immediately before the distribution; n101
- (3) a deemed distribution of property caused by a termination under *IRC Section 708(b)(1)(B)*; n102
- (4) a nontaxable transfer by a partnership of all of its assets and liabilities to a second partnership pursuant to *IRC Section 721(a)* in exchange for a partnership interest, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan; n103
- (5) an incorporation of the partnership by any means (other than by a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction; n104 and
- (6) a distribution of an undivided interest in property to the extent that the distributed interest does not exceed the undivided interest contributed by the distributee partner. n105 The portion of the undivided interest in the property, if any, retained by the partnership after the distribution that is treated as having been contributed by the distributee partner is reduced to the extent of the undivided interest distributed to that partner.

There are several special rules under *IRC Section 704(c)*. First, property received by a partnership in a non-recognition transaction in exchange for *Section 704(c)* property is also treated as the *Section 704(c)* property for purposes of the seven-year rule. n106 Second, the transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of the seven-year rule to the extent of the share of built-in gain or loss allocated to the transferee partner. n107 Finally, a special rule applies with respect to distributions of like-kind property. If *IRC Section 704(c)* property is distributed to a partner other than the contributing partner, and like-kind property is distributed to the contributing partner no later than the earlier of (a) 180 days following the date of the distribution to the non-contributing partner, or (b) the due date (with extensions) of the contributing partner's return for the tax year of the distribution to the non-contributing partner, then the amount of gain or loss that otherwise would have been recognized on the distribution of the contributed property is reduced by the amount of the contributing partner's built-in gain or loss in the distributed like-kind property. n108 This rule is intended to treat the contributing partner as if the partner had exchanged the contributed property for like-kind property in a tax-free exchange outside of the partnership. This allows the contributing partner to avoid recognition of gain or loss under *IRC Section 704(c)(1)(B)* on the

distribution of the contributed property to another partner because the contributing partner is treated as having contributed the like-kind property and not the property that is actually distributed to the other partner. This like-kind exception applies only to the extent that the built-in gain or loss in the contributed property is preserved in the like-kind property distributed to the contributing partner. n109

There is a substantial degree of overlap in the tax policy behind *IRC Section 704(c)(1)(B)* and that behind *IRC Section 737*. The *IRC Section 704(c)* provisions deal with contributed property that is either retained by the partnership or distributed to another partner. The *IRC Section 737* provisions apply to distributions to a partner who has contributed property to the partnership. *IRC Section 737(a)* provides that, in the case of any distribution by a partnership to a partner, the partner is treated as recognizing gain in an amount equal to the lesser of (1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of the partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or (2) the net pre-contribution gain of the partner. *IRC Section 737(b)* defines the term "net pre-contribution gain." Both *IRC Sections 704(c)* and *737* require an allocation to the contributing partner of gain or loss attributable to the contributed property and regulations under both *IRC Sections 704* and *737* contain similar rules regarding distributions. n109.1

The IRS has issued a detailed ruling applying *IRC Sections 704(c)* and *737* in the context of an assets-over partnership merger with another partnership. The ruling determines a partner's distributive share of pre-contribution gain on property that was transferred to the partnership before the merger. The ruling holds that *IRC Section 704(c)(1)(B)* applies to newly created *IRC Section 704(c)* gain or loss in property contributed by a transferor partnership to the continuing partnership in an assets-over partnership merger, but does not apply to newly created reverse *IRC Section 704(c)* gain or loss resulting from a revaluation of property in the continuing partnership when the merger takes place. The ruling also holds that for purposes of *IRC Section 737(b)*, net pre-contribution gain includes newly created *IRC Section 704(c)* gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not include newly created reverse *IRC Section 704(c)* gain or loss resulting from a revaluation of property in the continuing partnership. n109.2

[7] Allocations Relating to Property Contributed to a Partnership

IRC Section 704(c)(1)(A) provides that income, gain, loss and deductions with respect to property contributed by a partner to a partnership must be allocated in a manner that takes into account any variations between the tax basis of the contributed property and its fair market value. These provisions are complemented by the provisions of *704(c)(1)(B)* and *737* discussed above. The regulations adopted under *IRC Section 704(c)(1)(A)* establish several alternative methods pursuant to which allocations may be made when a partnership has income, gain, loss, or deductions attributable to *Section 704(c)* property. Under the traditional method of allocation, the partnership must make appropriate allocations to partners to avoid shifting the tax consequences of the built-in gain or loss to non-contributing partners. A "ceiling rule" exists under the traditional method, pursuant to which the total income, gain, loss or deduction allocated to the partners for the taxable year with respect to a particular property cannot exceed the total partnership income, gain, loss or deduction with respect to that property for the taxable year. n110

To eliminate distortions caused by the ceiling rule, a partnership may either adopt the traditional method with curative allocations, or adopt the remedial allocation method for making allocations for *Section 704(c)* property. Under the traditional method with curative allocations, a partnership using the traditional method may make reasonable additional curative allocations to reduce or eliminate disparities between book and tax items of non-contributing partners. For example, if a non-contributing partner is allocated less tax depreciation than book depreciation with respect to an item of *IRC Section 704(c)* property, the partnership may make a curative allocation to that partner of depreciation from another item of partnership property to make up the difference. n111 Under the remedial allocation method, the partnership makes remedial allocations of income, gain, loss or deduction to the non-contributing partners equal to the full amount of the limitation caused by the ceiling rule, and offsets those allocations with remedial allocations of

deduction, loss, gain or income to the contributing partner. n112 The remedial allocation method can involve the creation of notional tax items by the partnership and is not dependent upon the actual tax items recognized by the partnership. The remedial items do not affect the partnership's computation of its taxable income and do not affect the partnership's adjusted tax basis in partnership property. Furthermore, the remedial items are created by the partnership solely for tax purposes, and do not affect the partnership's computation of its taxable income, its adjusted basis for its property, or the partners' book capital accounts. n113

NOTE:

Even if a partnership uses one of the above allocation methods, the IRS may recast any contribution of property or other transaction in order to avoid tax results that are inconsistent with the partnership tax provisions in the Code. One factor that may be considered by the IRS is the use of the remedial allocation method by related partners in which allocations of remedial items of income, gain, loss or deduction are made to one partner and the allocations of offsetting remedial items are made to a related partner. n113.01 In applying its transaction recasting authority, the IRS may do the following, among other things: n113.02

- disregard purported partnerships, in whole or part, so that partnership assets are treated as owned by the partner;
- disregard one or more contributions; or
- disregard one or more purported partners.

An additional allocation rule comes into play for built-in loss property that is contributed to a partnership. n113.1 The built-in loss may be taken into account only by the contributing partner and not by other partners. n113.2 Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated. n113.3 The "built-in loss" is the excess of the adjusted basis of the property over its fair market value at the time of contribution. n113.4

[8] Relevance of Basis of a Partner's Interest

A partner's basis in its partnership interest must be known in order to determine:

- (1) gain or loss on the sale, exchange, or liquidation of the interest;
- (2) the extent to which the partner may deduct losses in a particular year (since the basis may not fall below zero); n114
- (3) the amount of basis the partner may offset against distributed property; and
- (4) gain or loss, if any, in the case of certain cash and property distributions to the partner.

The determination of a partner's basis in its partnership interest is covered in *Sections 14.05 and 14.06 below*.

[9] Organization and Syndication Fees

At formation, the partnership may incur costs for organization expenses and syndication fees. These costs must be

capitalized, and cannot be deducted currently. n115 Capitalized organization fees, at the election of the partnership, may be amortized over a period of not less than 60 months. n116 Syndication costs are not amortizable or deductible. n117

Organization expenses are defined in *IRC Section 709(b)(2)* as expenses that are:

- (1) incident to the creation of the partnership;
- (2) chargeable to capital account; and
- (3) of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

Examples of organization expenses are legal fees for negotiating and preparing the partnership agreement, accounting fees for establishing a partnership accounting system, and necessary filing fees. n118

The Service has issued regulations that provide that the election must include a list of all expenses over ten dollars, a description of each item, the date incurred, the month the partnership began operations, and the number of months over which each item will be amortized. The election must be made with the original partnership return and filed no later than the extended due date. The election must be an affirmative statement attached to the return and contain the information noted above. n119

Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. For example, brokerage fees, registration fees, legal fees of the underwriter and the issuer, SEC costs, and legal fees incident to the preparation of the partnership prospectus are syndication fees. See *Section 3.01[1][c]* for further discussion.

FOOTNOTES:

(n1)Footnote 60. *IRC § 721(a); Treas Reg § 1.721-1(a).*

(n2)Footnote 61. *IRC § 721(c), (d).*

(n3)Footnote 62. *IRC § 721(b).*

(n4)Footnote 63. See *IRC § 351(e)(1).*

(n5)Footnote 64. *IRC Section 707(a)(2)(B); Treas Reg §§ 1.721-1(a), 1.731-1(c)(3); Jacobson v Commr, 96 TC 577 (1991) , affd per curiam 92-1 CCH USTC P 50,236 (8th Cir 1992) ; see Ltr Ruls 199915010 .*

(n6)Footnote 65. *IRC §§ 704(c)(1)(B), 737.*

(n7)Footnote 66. *Treas Reg §§ 1.707-3(c), (d).*

(n8)Footnote 67. *Treas Reg §§ 1.707-3(c), (d).*

(n9)Footnote 68. *Treas Reg § 1.707-5(a)(1).*

(n10)Footnote 69. *Treas Reg § 1.707-5(a)(7).*

(n11)Footnote 70. *Treas Reg § 1.707-5(a)(6).*

(n12)Footnote 71. *IRC § 1250(d)(3).*

(n13)Footnote 72. *Treas Reg § 1.47-3(f).*

(n14)Footnote 73. The Service acquiesced in the Tax Court decision *Loewen v Commr*, 76 TC 90 (1981) , acq 1983-2 CB 1 , holding that the taxpayer was not required to recapture investment credit because, although not all major properties were transferred, the taxpayer controlled substantially all of the property before and after the transfer. See Rev Rul 83-65, 1983-1 CB 10 . Compare with *Ramm v Commr*, 72 TC 671 (1979) .

(n15)Footnote 74. IRC § 752(b).

(n16)Footnote 75. Treas Reg § 1.752-3(a)(2).

(n17)Footnote 76. IRC § 752(c).

(n18)Footnote 77. Treas Reg § 1.721-1(b).

(n19)Footnote 78. IRC § 1032.

(n20)Footnote 79. Treas Reg § 1.721-1(b); see *Hale v Commr*, TC Memo 1965-274 .

(n21)Footnote 80. *Diamond v Commr*, 56 TC 530 (1971) , affd 492 F2d 286 (7th Cir 1974) .

(n22)Footnote 81. See Cowan, "Receipt of an Interest in Partnership Profits: The *Diamond* Case," 26 *Tax L Rev* 161 (1972); Lane, "Sol Diamond: The Tax Court Upsets the Service Partner," 46 *So Cal L Rev* 239 (1973); Lurie, "Diamond in the Rough," 169 *NYLJ* (1973).

(n23)Footnote 82. TC Memo 1990-162 , revd 943 F2d 815 (8th Cir 1991) . See generally *Mark IV Pictures, Inc v Commr*, TC Memo 1990-571 , affd 969 F2d 669 (8th Cir 1992) .

(n24)Footnote 83. See, eg, *Kenroy, Inc v Commr*, TC Memo 1984-232 .

(n25)Footnote 84. *Campbell v Commr*, 943 F2d 815 (8th Cir 1991) , revg TC Memo 1990-162 .

(n26)Footnote 85. 1993-2 CB 343 .

(n27)Footnote 85.1. Rev Proc 2001-43, 2001 -34 IRB191.

(n28)Footnote 85.2. See Treas Reg § 1.83-3(b) for when an interest is substantially vested.

(n29)Footnote 85.3. Rev Proc 2001-43, 2001 -34 IRB191.

(n30)Footnote 86. *Stafford v US*, 727 F2d 1043 (11th Cir 1984) .

(n31)Footnote 87. *Mark IV Pictures, Inc v Commr*, 969 F2d 669 (8th Cir 1992) .

(n32)Footnote 88. IRC § 722.

(n33)Footnote 89. *Au v Commr*, 40 TC 264 , affd per curiam 330 F2d 1008 (9th Cir 1964) , cert denied 379 US 960 . Note that if the date of conversion is different from the date of contribution, the fair market value is determined on the date of conversion. See also Treas Reg § 1.167(g)-1, wherein the same basis limitation holds for the purposes of computing depreciation deductions.

(n34)Footnote 89.1. IRC § 704(c)(1)(C), effective for contributions after Oct 22, 2004.

(n35)Footnote 89.2. IRC § 704(c)(1)(C)(i).

(n36)Footnote 89.3. IRC § 704(c)(1)(C)(ii).

(n37)Footnote 89.4. *IRC § 704(c)(1)(C)*.

(n38)Footnote 90. *IRC § 1223(2)*.

(n39)Footnote 91. *IRC § 724(b)*.

(n40)Footnote 92. *IRC § 724(a)*.

(n41)Footnote 93. *IRC § 704(c)(1)(B)*. See also *IRC § 737*. The former five-year period was extended to seven years by § 1063 of the Taxpayer Relief Act of 1997, HR 2014, effective with respect to property contributed to a partnership after June 8, 1997. The amount of gain or loss recognized is measured by the amount of gain or loss that would have been recognized and allocated to the contributing partner if the property had been sold by the partnership at fair market value at the time of its distribution.

(n42)Footnote 94. *Treas Reg § 1.704-4(a)(2)*.

(n43)Footnote 95. *Treas Reg § 1.704-4(a)(1)*.

(n44)Footnote 96. See *IRC § 707(b)(1)(A)*.

(n45)Footnote 97. See *IRC § 708(b)(1)(B)*.

(n46)Footnote 98. A prior five-year period was extended to a seven-year period effective with respect to property contributed to a partnership after June 8, 1997. The extended period does not apply to certain property contributed pursuant to a written binding contract in effect on June 8, 1997.

(n47)Footnote 99. *Treas Reg § 1.704-4(a)(4)(ii)*.

(n48)Footnote 100. *Treas Reg § 1.704-4(c)(1)*.

(n49)Footnote 101. *Treas Reg § 1.704-4(c)(2)*.

(n50)Footnote 102. *Treas Reg § 1.704-4(c)(3)*.

(n51)Footnote 103. *Treas Reg § 1.704-4(c)(4)*.

(n52)Footnote 104. *Treas Reg § 1.704-4(c)(5)*.

(n53)Footnote 105. *Treas Reg § 1.704-4(c)(6)*.

(n54)Footnote 106. *Treas Reg § 1.704-4(d)(1)*; see *Treas Reg § 1.704-3(a)(8)*.

(n55)Footnote 107. *Treas Reg § 1.704-4(d)(2)*.

(n56)Footnote 108. *Treas Reg § 1.704-4(d)(3)*.

(n57)Footnote 109. See *Treas Reg § 1.704-4(d)(3)*.

(n58)Footnote 109.1. Compare 1954 Internal Revenue Code and 1.737-2(a); *Treas Reg §§ 1.704-4(c)(4)* and 1.737-2(b); *Treas Reg §§ 1.704-4(c)(5)* and 1.737-2(c); *Treas Reg §§ 1.704-4(d)(1)* and 1.737-2(d)(3); *Treas Reg §§ 1.704-4(e)(3)* and 1.737-3(c)(4).

(n59)Footnote 109.2. *Rev Rul 2004-43, 2004-1 CB 843*.

(n60)Footnote 110. *Treas Reg § 1.704-3(b)(1)*.

(n61)Footnote 111. *Treas Reg § 1.704-3(c)*.

(n62)Footnote 112. *Treas Reg § 1.704-3(d)*.

(n63)Footnote 113. *Treas Reg § 1.704-3(d)(4)*

(n64)Footnote 113.01. *Treas Reg § 1.704-3(a)(1)*, effective for taxable years beginning after June 9, 2010, but no inference is to be drawn from this effective date with respect to prior law.

(n65)Footnote 113.02. See *Treas Reg §§ 1.701-2(b), (c)*. See TD 9485 .

(n66)Footnote 113.1. *IRC § 704(c)(1)(C)*, effective for contributions after Oct 22, 2004.

(n67)Footnote 113.2. *IRC § 704(c)(1)(C)(i)*.

(n68)Footnote 113.3. *IRC § 704(c)(1)(C)(ii)*.

(n69)Footnote 113.4. *IRC § 704(c)(1)(C)*.

(n70)Footnote 114. *Treas Reg § 1.704-1(d)*. A partner may not deduct losses from the partnership that exceed its adjusted basis of its interest in the partnership at the end of the partnership's taxable year in which the loss was incurred (determined before reduction for the current year's loss). Any losses allocated to a partner that are in excess of this amount may be carried forward indefinitely until the partner has sufficient basis available to permit the deduction. For example, a partner could generate additional basis by making a capital contribution to the partnership or by increasing its share of the partnership's liabilities.

(n71)Footnote 115. *IRC § 709(a)*.

(n72)Footnote 116. *IRC § 709(b)*.

(n73)Footnote 117. *Irc § 709(a); Treas Reg § 1.709-2(b)*.

(n74)Footnote 118. *Treas Reg § 1.709-2(a)*.

(n75)Footnote 119. *Id.*

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Federal Taxes Affecting Real Estate

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.05

§ 14.05 Basis of Partner's Interest: Initial Determination

When a partner acquires an interest in a real estate partnership by contributing money or property, the initial basis of the partnership interest is the sum of:

- (1) the money contributed;
- (2) the adjusted basis to the partner of the property contributed;
- (3) the partner's share of partnership liabilities; and
- (4) the amount (if any) of gain recognized by the contributing partner with respect to the transfer. n120
The determination of the partner's pro rata share of partnership liabilities is discussed in *Section 14.06* below.

If the partnership interest is acquired by purchase, the basis of the partnership interest is the cost to the buying partner. n121 If the interest is acquired by gift, there is generally a carryover basis from donor to donee. n122 In each case, the basis also includes the partner's pro rata share of partnership liabilities.

After the initial acquisition of a partnership interest, adjustment must be made to the basis of the interest to reflect the activity of the partner and the partnership. First, additional contributions of money or property by the partner increase the basis of the partnership interest. n122.1 Also, the following adjustments, which are generally made annually, increase the basis of the partner's partnership interest:

- (1) the partner's share of partnership taxable income; n123
- (2) the partner's share of partnership tax-exempt income; n124 and
- (3) the partner's share of any increase in partnership liabilities. n125

Adjustments must also be made to *decrease* the basis of a partner's interest. Partnership distributions of money and property will reduce the basis of the partner's interest in the partnership. The amount of the reduction is, in the case of a

distribution that is not in liquidation of the partner's interest, measured by the amount of money distributed and the basis of the property to the distributee partner. The partner's basis for its partnership interest will not be reduced below zero. The other decreasing adjustments are:

(1) the partner's share of a decrease in partnership liabilities and the amount of any liabilities of the partner that are assumed by the partnership (which are considered to be distributions of money to the partner); n126

(2) the partner's share of partnership losses; n127 and

(3) the partner's share of expenditures of the partnership which are not deductible in computing taxable income and which are not chargeable to capital. n128

Regulations provide basis adjustments when a partnership owns the stock of a corporate partner. The adjustments coordinate *IRC Sections 705* and *1032*, and prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock. n128.1

FOOTNOTES:

(n1)Footnote 120. *IRC §§ 752; 722.*

(n2)Footnote 121. *IRC § 1012(a).*

(n3)Footnote 122. *IRC § 1015(a).* Note, however, that the share of liabilities allocable to a transferee or donee will not necessarily be the same as the share of liabilities allocable to the transferor or donor. For example, if the transferor or donor were a guarantor of a nonrecourse liability of the partnership, but the transferee/donee did not also guarantee the debt, its share of the partnership's liabilities would be smaller than the share of the transferor/donor.

(n4)Footnote 122.1. *IRC § 722.*

(n5)Footnote 123. *IRC §§ 703; 705.*

(n6)Footnote 124. *IRC § 705(a)(1)(B).*

(n7)Footnote 125. *IRC § 752(a).*

(n8)Footnote 126. *IRC § 752(b).*

(n9)Footnote 127. A partner's allocable share of partnership losses must be adjusted where the loss-producing transaction is with a related party. *Rev Rul 96-10, 1996-1 CB 138*, provides detailed rules for determining the basis of partnership interests held by the partners of two related partnerships following the sale of property between the partnerships. The ruling deals with the interplay between the loss disallowance rules of *IRC §§ 267* and *707* and the basis determination rules of *IRC § 705*.

(n10)Footnote 128. *IRC § 705(a)(2).* A separate decrease (but not below zero) is made for the partner's deduction for depletion for any partnership oil and gas property to the extent it does not exceed the proportionate share of the adjusted basis of that property allocated to the partner (*IRC § 705(a)(3)*).

(n11)Footnote 128.1. *Treas Reg § 1.705-2.*

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Federal Taxes Affecting Real Estate

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.06

§ 14.06 Basis of Partner's Interest: Effect of Partnership Debt

A partner's share of partnership liabilities is included in the partner's basis for its partnership interest. n129 This result follows from the so-called "aggregate" approach to partnership taxation (under which each partner is treated as the owner of an undivided interest in the partnership's assets). Since each partner would generally be able to include the amount of such liabilities in the basis of the assets if such assets were owned directly by the partners, rather than by the partnership, their shares of liabilities are included in the basis of their interests in the partnership.

However, a partner can generally include only liabilities that create basis in a capitalizable asset, give rise to a current deduction, or result in a current nondeductible expense in the computation of the basis of its interest in the partnership. For example, accrued interest payable by a *cash-method* partnership would generally not give rise to additional basis, n130 nor would a contingent liability incurred by an accrual-method partnership.

Example:

Partner A contributes land encumbered by a \$50,000 mortgage to the AB Partnership. Before the contribution, Partner A was liable for \$50,000. After the contribution, Partner B assumed liability for half the debt. Since Partner A was economically relieved of \$25,000 of the liability, the tax law requires that his basis in the partnership interest be reduced by \$25,000. Thus, if his tax basis in the land was \$100,000 prior to the contribution, that basis would carry over as the basis of his partnership interest (reduced by the \$25,000 liability of which he was relieved), and his final basis would be \$75,000. Note: Partner B's basis in the partnership is increased by the \$25,000 for which she became liable as a result of Partner A's mortgage on the property.

Both recourse and nonrecourse liabilities must be taken into account in determining a partner's basis for its partnership interest. Because no partner bears the economic risk of loss with respect to "nonrecourse" liabilities, a partner may increase its basis in the partnership without affecting the extent of its personal liability by using nonrecourse debt.

In late 1988, responding to a Congressional directive contained in the 1984 Tax Legislation, n131 the Treasury released temporary regulations under *IRC Section 752* on the treatment of partnership liabilities. They dealt specifically with guarantees, assumptions, indemnity agreements, and similar arrangements, as well as loans from partners and parties related to partners. Final regulations were adopted in late 1991.

The Treasury simultaneously released regulations under *IRC Section 704(b)* that revise and expand the existing regulations dealing with the allocation of deductions attributable to nonrecourse debt. As there is significant interplay between these two sets of regulations, tax-planning decisions should not be made with respect to either set of rules without fully understanding the effect of the other. They contain some anomalies, and are not completely consistent.

[1] Recourse Liabilities

[a] General Rules

Under the final regulations, a partnership liability is considered to be "recourse" *to the extent* that any partner bears the economic risk of loss for repayment of that liability. n132 A partner is considered to bear economic risk of loss for a liability if that partner (or a person related to the partner) n132.1 could ultimately be required to make a "net payment" to a creditor or to make a contribution to the partnership in order to discharge the partnership liability. n133 This net-payment analysis takes into account any rights of reimbursement a partner may have from another partner, or from a person related to another partner. Nonrecourse debt owed to a partner or a party related to a partner generally represents a "recourse liability" for these purposes (except to the extent of any nonrecourse debt from an unrelated party that is "wrapped" by the nonrecourse debt from the partner or party related to the partner). n134

The regulations use a hypothetical "constructive liquidation" of the partnership to determine whether a net payment or contribution would be required. In a constructive liquidation, the following events are deemed to occur: n135

- The partnership's liabilities become due and payable in full.
- With the exception of property contributed to the partnership solely to secure a partnership liability, all the partnership's assets, including cash, have a value of zero;
- The partnership disposes of all its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership).
- The partnership allocates its items of income, loss, etc., for the year among the partners and then liquidates.
- The partnership liquidates.

If this analysis results in a partner having a negative book capital account that the partner is obligated to restore to the partnership, or being otherwise required to make a net payment to the creditor or a contribution to the partnership, either by agreement or operation of law, then that partner has an economic risk of loss with respect to the liability and would thus be allocated the liability for tax basis determination purposes. n136

The regulations also include an "anti-abuse rule." This rule provides that an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person if the facts and circumstances indicate that a principal purpose of an arrangement between the parties is: (1) to eliminate the partner's economic risk of loss with respect to that obligation; or (2) to create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. n137

[b] Guarantees and Nonrecourse Loans From Partners; Use of Partner's Assets as Collateral

The regulations also include special rules providing that a partner bears the economic risk of loss for a partnership liability to the extent of:

- (1) the value of a partner's assets put up as security for a partnership liability; (i.e. direct and indirect pledges of property). n138
- (2) a partner's contractual obligation that is tantamount to a guarantee; n139
- (3) a partner's direct or indirect guarantee of the payment of interest on an otherwise nonrecourse liability; n140
- (4) a partner's (or a related person's) nonrecourse loan to the partnership. n141 and
- (5) loss for a partnership liability based upon an obligation of a disregarded entity. n141.1

Notwithstanding these general rules, a partner is not considered to bear the economic risk of loss for any qualified nonrecourse financing loans that the partner makes to the partnership (as defined in *IRC Section 465(b)(6)*) if the lending partner's interest (including the interest of any person related to that partner) in *each* item of partnership income, gain, loss, deduction or credit is 10 percent or less. n142 The regulations expand this rule to include certain guarantees by partners or related persons. n143 Note, however, that although the basis rules will allow a partner to include in the calculation of its basis its pro rata share of a loan made by a partner or a partner's affiliate, if the lending partners in the partnership satisfy this *de minimis* test, there is no corresponding *de minimis* test in *Regulations Section 1.704-2*, dealing with the definitions of nonrecourse liabilities and partner nonrecourse debt. n144

[2] Nonrecourse Liabilities

A liability is considered nonrecourse to the extent that *no* partner (and *no* person related to a partner) bears the economic risk of loss for that liability. n145

Under the regulations, a three-tiered system applies for allocating nonrecourse liabilities. The three-tier system applies sequentially. n146

Under the first tier, a partner is allocated an amount of the liability equal to that partner's share of partnership minimum gain under *IRC Section 704(b)* and regulations. n147

Under the second tier, to the extent the entire liability has not been allocated under the first tier, a partner is allocated an amount of liability equal to the gain the partner would be allocated under *IRC Section 704(c)* if the partnership disposed of all partnership property in a taxable transaction subject to one or more nonrecourse liabilities in full satisfaction of the liabilities (*IRC Section 704(c)* minimum gain). n148 If a partnership has multiple properties subject to a single liability, for purposes of determining the amount of *IRC Section 704(c)* minimum gain in applying the second tier, the partnership may allocate to each property an amount of the liability that, when combined with any other liabilities allocated to the property, does not exceed the property's fair market value The portion of the liability allocated to each property is treated as a separate loan in determining the *IRC Section 704(c)* minimum gain attributable to the property. n149 Any reduction in the outstanding principal of a partnership liability must be allocated among multiple properties in the same proportion that the partnership liability was originally allocated to the properties. n149.1

Under the third tier, a partner is allocated any excess nonrecourse liabilities (i.e. nonrecourse liabilities in excess of the portion allocable under the first and second tiers) based on several methods that the partnership may choose. n150 Allowable methods of allocation include allocations according to the following: n150.1

- (1) a partner's share of profits;

(2) reasonably expected deductions attributable to nonrecourse liabilities; or

(3) excess *IRC Section 704(c)* gain or excess reverse *IRC Section 704(c)* gain (i.e. the excess of the amount of reverse *IRC Section 704(c)* gain attributable to an item of property over the *IRC Section 704(c)* minimum gain on that property) with respect to property that is subject to a nonrecourse liability.
n150.2

Example:

The AB partnership purchases depreciable property for a \$1,000 purchase money note that is a nonrecourse liability. Assume that this is the only nonrecourse liability of the partnership, and that no principal payments are due on the purchase money note for a year. The partnership agreement provides that all items of income, gain, loss, and deduction are allocated equally. Immediately after purchasing the depreciable property, the partners share the nonrecourse liability equally because they have equal interests in partnership profits. A and B are each treated as if they contributed \$500 to the partnership to reflect each partner's increase in his or her share of partnership liabilities (from \$0 to \$500). The minimum gain with respect to an item of partnership property subject to a nonrecourse liability equals the amount of gain that would be recognized if the partnership disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration. Therefore, if the partnership claims the depreciation deduction of \$200 for the depreciable property for the year it acquires that property, partnership minimum gain for the year will increase by \$200 (the excess of the \$1,000 nonrecourse liability over the \$800 adjusted tax basis of the property). A and B each have a \$100 share of partnership minimum gain at the end of that year because depreciation is allocated equally among them. Accordingly, at the end of that year, A and B are allocated \$100 each of the nonrecourse liability to match their share as a partnership minimum gain. The remaining \$800 of the nonrecourse liability will be allocated equally between A and B (\$400 each). n150.3

Special rules are provided for tiered partnerships and for debt that is part recourse and part nonrecourse. n151

FOOTNOTES:

(n1)Footnote 129. *IRC § 752(a)*.

(n2)Footnote 130. *Rev Rul 88-77, 1988-1 CB 128* .

(n3)Footnote 131. Pub L No 98-369, 98th Cong, 2d Sess § 79 (July 18, 1984).

(n4)Footnote 132. *Treas Reg § 1.752-1(a)(1)*.

(n5)Footnote 132.1. The term "related person" is defined in *Treas Reg § 1.752-4(b)* by cross reference to the rules of *IRC §§ 267(b)* and *707(b)(1)*, but substituting an "80% or more" relationship test for the "more than 50%" test contained in those provisions, and after making certain other adjustments. Accordingly, if an affiliate of a partner intends to provide nonrecourse financing to a partnership, the loan should be extended by a less than 80% owned affiliate.

(n6)Footnote 133. *Treas Reg § 1.752-2(b)(1)*.

(n7)Footnote 134. *Treas Reg § 1.752-2(c)(2)*.

(n8)Footnote 135. *Treas Reg § 1.752-2(b)(1)*.

(n9)Footnote 136. *Treas Reg § 1.752-2(b)(3)*.

(n10)Footnote 137. *Treas Reg § 1.752-2(j)(1)*.

(n11)Footnote 138. *Treas Reg* § 1.752-2(h).

(n12)Footnote 139. *Treas Reg* § 1.752-2(j)(2).

(n13)Footnote 140. *Treas Reg* § 1.752-2(e).

(n14)Footnote 141. *Treas Reg* § 1.752-2(c).

(n15)Footnote 141.1. *Treas Reg* § 1.752-2(k).

(n16)Footnote 142. *Treas Reg* § 1.752-2(d)(1).

(n17)Footnote 143. *Treas Reg* § 1.752-2(e)(4).

(n18)Footnote 144. *Treas Reg* § 1.704-2(b)(4).

(n19)Footnote 145. *Treas Reg* § 1.752-1(a)(2).

(n20)Footnote 146. *Treas Reg* § 1.752-3(a).

(n21)Footnote 147. *Treas Reg* § 1.752-3(a)(1); see *Treas Reg* § 1.704-2(g)(1).

(n22)Footnote 148. *Treas Reg* § 1.752-3(a)(2).

(n23)Footnote 149. *Treas Reg* § 1.752-3(b)(1) See Ltr Rul 200340024 (IRS applies the regulation in the context of proposed issuances and allocations of unsecured debt and line of credit advances by a limited partnership).

(n24)Footnote 149.1. *Treas Reg* § 1.752-3(b)(2). See Ltr Rul 200340024 (IRS rules on the tax effects of proposed issuances and allocations of unsecured debt and line of credit advances by a limited partnership).

(n25)Footnote 150. *Treas Reg* § 1.752-3(a)(3).

(n26)Footnote 150.1. *Treas Reg* § 1.752-3(a)(3).

(n27)Footnote 150.2. This final method does not apply for purposes of *Treas Reg* § 1.707-5(a)(2)(ii) (relating to a partner's share of nonrecourse liabilities under the disguised sale rules).

(n28)Footnote 150.3. *Treas Reg* § 1.752-3(c), Example 1; see *IRC* § 704(b); *Treas Reg* § 1.704-2(g)(1).

(n29)Footnote 151. *Treas Reg* §§ 1.752-1(i); 1.752-2(i).

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CHAPTER 14 Partnerships and Limited Liability Companies *

*1-14 Federal Taxes Affecting Real Estate § 14.07***§ 14.07 Basis of a Partner's Interest: Illustration**

The following example illustrates the foregoing rules regarding basis, liabilities and adjustments and shows how the computation of a partner's basis in a partnership interest is made.

Example:

Partner A acquires a 50 percent interest in the AB General Partnership by contributing cash of \$25,000 and land with a value and an adjusted basis to A of \$25,000. The land is subject to a \$20,000 mortgage which is assumed by the partnership. Thereafter, A contributed additional cash and property (with no attendant liabilities) having a value and basis of \$30,000 and has received distributions of cash from the partnership in the amount of \$20,000. The partnership has ordinary income in the amount of \$50,000 in year one, and has an ordinary loss of \$30,000 in the second year. At the beginning of the third year, the partnership obtains a recourse loan of \$5,000, secured by the partnership property, to improve the properties. Partner A's basis is determined as follows:

Initial contribution:

Cash		\$25,000
Land	\$ 25,000	
Less--(1/2 of \$20,000 liability relieved)	(10,000)	15,000
		40,000

Adjustments:

Subsequent contribution	\$ 30,000	
Distributions	(20,000)	
Profit (1/2 of \$50,000)	25,000	
Loss (1/2 of \$30,000)	(15,000)	
Recourse debt (1/2 of \$5,000)	2,500	22,500
Adjusted Basis		\$62,500

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.08

§ 14.08 Taxable Year

The Code imposes some limits on the ability of a partnership to choose its fiscal year--unlike a "C" corporation, a newly organized partnership cannot simply adopt any taxable year it chooses. Generally, a partnership may not have a tax year other than the tax year of the partners owning a majority interest in the capital and profits of the partnership. Such a taxable year is known as the "majority interest taxable year." n152 If there is no taxable year that is shared by partners owning a majority of the partnership's capital and profits, the partnership must adopt the same tax year as all of its principal partners. n153 A "principal partner" is a partner having a 5 percent or greater interest in partnership profits **OR** capital. n153.1 If there is no majority interest taxable year and the principal partners do not have the same year, the partnership must adopt a calendar year, unless regulations provide for another period. n154 The regulations generally require the adoption of the taxable year that results in the least amount of tax deferral to the partners. n155

A partnership may have a taxable year other than the one required above if it establishes, to the satisfaction of the Treasury, a business purpose for the different taxable year. Not surprisingly, deferral of income to partners is not treated as a business purpose. n156 Despite the forgoing limitations on the ability of a partnership to select its taxable year, under *IRC Section 444*, partnerships, under certain circumstances, may elect to have a taxable year other than the taxable year required by *IRC Section 706*. n157 (See Chapter 4 for further discussion.)

[1] Year in Which Partnership Income Is Included

In determining its taxable income for any taxable year, a partner is required to include its distributive share of income or loss for any partnership year ending with or within that taxable year. n158

Example:

If a calendar-year taxpayer is a member of a partnership with a taxable year-end of May 31, the partner would include its share of partnership items for the partnership year ended May 31, 1997, in its calendar year 1997 income tax return. Thus, the partner would not include its share of partnership income and deductions for the period beginning June 1 and ending December 31, 1997, until 1998. The result would be the same whether or not cash flow attributable to the post-May 31, 1997 period was distributed to the partner during calendar-year 1997.

[2] Closing of a Partnership Year

As a general rule, the taxable year of a partnership will not terminate before its normal taxable year-end, except upon termination of the partnership. Likewise, the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership will not close the taxable year of the partnership. n159

However, the sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 12-month period will cause the partnership to terminate for tax purposes, thereby closing the partnership's year. n160 If a partnership is terminated, its taxable year closes with respect to all of its partners on the termination date. This is either the date of final winding up of business, or the date on which the critical sale or exchange occurs. n160.1

A partnership that terminates under *IRC Section 708(b)(1)(B)* must file a short-year final return for the taxable year ending with the date of its termination. If a new partnership (for tax purposes) is formed to continue the business it is required to file a return for its taxable year beginning after the date of termination of the terminated partnership. n160.2

No special problems exist in terminating a partnership that has actually quit doing business, but a constructive termination requires a complementary constructive formation. If a partnership is constructively liquidated because of the sale or exchange of interests, the following is deemed to occur: (1) the partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and (2) immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. n160.3 Thus, the exact consequences of a constructive termination will differ in every case. A constructive termination should be avoided if at all possible, for the accounting expense alone. Sometimes it will be possible to defer sales of partnership interests to avoid the triggering number of sales within a 12-month period. n160.4

In addition, the taxable year of the partnership will close with respect to the partner involved if the partner's entire interest in the partnership terminates (whether by death, liquidation or otherwise). n161 The closing of the taxable year of a partnership for a particular partner who sells or exchanges its entire interest in the partnership or whose interest is liquidated will not cause the partnership year to close for all partners. n162

Example:

The *DEF* Partnership has a taxable year ending March 31st. Partner *D*, who reports on a calendar-year basis, sells its entire interest in *DEF* Partnership on November 30, 1995. *D* must include its pro rata share of the income of *DEF* Partnership for the period from April 1, 1995, through November 30, 1995, on its 1995 income tax return. The rules for determining the partner's pro rata share under these circumstances are set forth in *IRC Section 706(d)* and the regulations thereunder. This bunching of income can be avoided if Partner *D* sells less than its entire interest in *DEF* Partnership, because the partnership year will not close for a partner who disposes of less than its entire interest in the partnership.

FOOTNOTES:

(n1)Footnote 152. *IRC § 706(b)(1)(B)(i)*.

(n2)Footnote 153. *IRC § 706(b)(1)(B)(ii)*.

(n3)Footnote 153.1. *IRC § 706(b)(3)*.

(n4)Footnote 154. *IRC § 706(b)(1)(B)(iii)*.

(n5)Footnote 155. *Treas Reg § 1.706-1(b)(2)(i)*.

(n6)Footnote 156. *IRC § 706(b)(1)(C)*.

(n7)Footnote 157. *IRC § 444.*

(n8)Footnote 158. *IRC § 706(a).*

(n9)Footnote 159. *IRC § 706(c).*

(n10)Footnote 160. *IRC § 708(b)(1)(B).*

(n11)Footnote 160.1. *Treas Reg § 1.708-1(b)(3).*

(n12)Footnote 160.2. *Notice 2001-5, 2001-3 IRB 327 ; see IRC §§ 443(a)(2), 6031(a).*

(n13)Footnote 160.3. *Treas Reg § 1.708-1(b)(4).*

(n14)Footnote 160.4. *See IRC § 708(b)(1)(B).*

(n15)Footnote 161. *IRC § 706(c)(2).*

(n16)Footnote 162. *IRC § 706(c)(2)*

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.09

§ 14.09 Transactions Between the Partnership and a Partner

As a general rule, the Code provides that "if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided ... be considered as occurring between the partnership and one who is not a partner." n163 For example, if an accountant who is a partner in a real estate partnership is hired to prepare the partnership's tax return, the partnership's payment to the accountant will be treated by both the partner and the partnership as a payment for accounting services, not a partnership allocation and distribution. This rule recognizes that the partnership is an entity separate and distinct from its owners. Of the two most common types of transaction between a partner and a real estate partnership, namely, the transfer of property by a partner to the partnership and the rendering of services by a partner to a partnership, the latter transactions are, by far, the most difficult to evaluate in the context of whether or not the transaction is in the partner's capacity as a member of the partnership. The principal issue with respect to transfers of property, on the other hand, is generally not whether the transfer is by a partner in its capacity as a partner, but rather, whether the transfer is a contribution eligible for non-recognition treatment, or is a disguised sale.

[1] Transfers of Property

IRC Section 707(a)(2) authorizes the Secretary to prescribe regulations for purposes of determining whether transfers of property by a partner to a partnership should more properly be characterized as a transaction occurring between the partnership and a partner acting other than in its capacity as a member of the partnership, and/or as a sale or exchange of the property. The Secretary has exercised this authority. n164

The regulations provide that a transfer of property by a partner to a partnership will be characterized as a sale of property if there is a related transfer of money or other consideration (including the assumption of, or taking subject to, a liability) by the partnership and if, based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of the property and, in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. n165 The facts and circumstances include:

- (1) whether the timing and amount of a subsequent transfer are determinable with reasonable certainty;
- (2) whether the transferor has a legally enforceable right to the subsequent transfer;

- (3) whether that right is secured in any manner;
- (4) whether any person has made, or is obligated to make, contributions or loans to the partnership or whether the partnership is obligated to borrow, in order to make the subsequent payment;
- (5) whether the partnership has sufficient liquid assets to make the subsequent payment; and
- (6) whether the partnership distribution provisions are designed to result in a transfer of the benefits and burdens of ownership away from the transferring partner. n166

The regulations provide that if the two transfers occur within a two-year period, the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale. n167

The regulations also require that partners and partnerships make disclosures to the Internal Revenue Service of transfers made within a two-year period that are not treated as a sale for federal income tax purposes. n168 Transfers that are more than two years apart are correspondingly presumed not to be a sale, unless the facts and circumstances clearly establish that the transfers do, in fact, constitute a sale. n169

An alternative manner in which to structure a transfer of property by a partner to a partnership would be to provide the transferor partner with a "guaranteed payment" or preferred return with respect to the transferred property. Treasury Regulations set forth the circumstances in which such a transaction will and will not be treated as a disguised sale. n170 The regulations provide that, notwithstanding the presumption set forth in *Regulations Section 1.707-3(c)* (relating to transfers made within two years of each other), a guaranteed payment that is determined without regard to the income of the partnership and is reasonable will not be treated as a sale unless the facts and circumstances clearly establish that the transaction should be treated as a sale. A similar rule applies to reasonable preferred returns. n171 Whether or not the amount of a guaranteed payment or preferred return is reasonable is determined by reference to a safe harbor interest rate equal to 150 percent of the highest applicable federal rate in effect at the time that the right to the preferred return or guaranteed payment is first established pursuant to a binding written agreement among the partners. n172

Once a transaction has been determined to be a sale or exchange between the partnership and a partner, additional rules come into play in determining the character and allowability of any gain or loss recognized on the sale. If the transaction is between the partnership and its controlling partner, between two partnerships under common control, or between the partnership and a party related to its controlling partner, any loss on the sale of property will not be recognized for tax purposes. For this purpose, control is defined as the ownership of more than 50 percent of the capital interests or profits interests in the partnership. n173 If the property is subsequently resold by the transferee at a gain, the gain will be taxable only to the extent that it exceeds the disallowed loss. n174

Example:

A owns a 60 percent interest in the capital and profits of both the AB No. 1 and AB No. 2 Partnerships. AB No. 1 sells a piece of land with an adjusted basis of \$15,000 to AB No. 2 for \$10,000. AB No. 1 will not be allowed to recognize the \$5,000 loss on this sale for tax purposes, since A owns more than 50 percent of the capital or profits of both partnerships. However, if AB No. 2 subsequently sells the property to an unrelated third party for \$16,000, it will only recognize a \$1,000 gain (\$6,000 gain realized, less the previously disallowed \$5,000 loss). The loss would also have been disallowed if A had owned 11 percent of AB No. 1 and 49 percent of AB No. 2, and B had owned 49 percent of AB No. 1 and 11 percent of AB No. 2.

The character of income or gain realized on a sale of property by a partner to a partnership is also affected by the

partner's degree of ownership of the partnership. Gain on the sale or exchange of property between a partner and a controlled partnership (i.e., where the partner owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in the partnership) or between two controlled partnerships, is treated as ordinary income if the property: (1) is not a capital asset in the hands of the transferee; or (2) is depreciable in the hands of the transferee. n175 The ordinary income characterization of gain realized on the transfer of depreciable property is *not* limited to depreciation recapture in the hands of the transferor partner.

Example:

X, who has an 85 percent capital and 50 percent profit-and-loss interest in the XY Partnership, sells a building constructed on a 50-year ground lease to the XY Partnership at a gain of \$15,000. Since X has more than a 50 percent interest in the capital of XY and the partnership intends to hold the building as rental property, X's gain will be taxable as ordinary income.

Planning Note:

The special rules are applicable only if the partner or partners involved have a greater than 50 percent interest in capital or profits. Accordingly, the capital and profits interest of the partners should be determined accurately. The accounting records of the partnership, as well as the partnership agreement, should be carefully reviewed before a major sale or exchange between "related persons." A guaranteed payment does not constitute an interest in partnership profits for purposes of *IRC Section 707(b)*. n176 However, a partner's right to receive a preferred or priority return may cause that partner to have a greater interest in the partnership's profits than its residual percentage interest in partnership profits, and a partner who is also a lender to a partnership may have a greater than anticipated interest in partnership capital if the loan is recharacterized as an equity investment under traditional "debt versus equity" principles.

[2] Payments to Partners for Services

Amounts received by a partner who is also rendering services to the partnership can similarly be characterized either as:

- (1) payments to a partner in a capacity other than as a partner;
- (2) guaranteed payments to a partner for services rendered as a partner; or
- (3) a distribution of partnership cash and a corresponding allocation of profits.

The determination of the category into which the amount received by a partner providing services to the partnership fits will affect the timing and character of the partner's income recognition as well as the timing and character of the partnership's tax accounting for the item. A partner who receives a payment for services rendered to the partnership in a non-partner capacity realizes ordinary income, and accounts for that ordinary income on the basis of its own accounting method. n177 Accordingly, a cash method partner does not include such amounts in income until actually or constructively received. Conversely, a partner rendering services to a partnership in its capacity as a partner that receives a guaranteed payment for those services must include the payment as ordinary income for its taxable year within or with which ends the partnership taxable year in which the partnership deducted (or capitalized) such payments as paid or accrued under its method of accounting. n178

Guaranteed payments made to a partner, and direct payments made to a partner who engages in a transaction with the partnership in a capacity other than as a partner, are similarly treated as payments made to a nonpartner (that is, the payments are capitalized, amortized or deducted by the partnership). n179 The timing of the partnership's deduction or accrual is affected both by its accounting method and by the rules relating to deferred payments for the use of property

or services. n180 On the other hand, *allocations* of income to a partner are generally not susceptible to capitalization, and the character of the amount allocated to the partner is determined by the character of the amounts received by the partnership. Accordingly, if a partner is providing services to a partnership in its capacity as a partner, and receives an allocation of partnership income and gain, the partner will recognize its pro rata share (based on the allocation) of the partnership's ordinary income, tax-exempt income, or capital gain. This provides a substantial tax incentive for the general partner of a partnership investing in real estate that expects to receive a substantial portion of its economic return in the form of long-term capital gains on the ultimate disposition of its real estate, to structure its share of the partnership's economic profits as an allocation, rather than as a guaranteed payment.

However, if a partner performs services for, or transfers property to, a partnership and receives a "related direct or indirect" allocation and distribution, the transaction may be treated as a transaction between the partnership and someone who is not a partner. n181 Therefore, if a direct payment for the property or services would be a capital expenditure by the partnership, it receives the same treatment even though the payment is in the form of an allocation of partnership income and distribution of partnership cash flow. The purported allocation to the partner performing the services or transferring property is also disregarded in determining the partner's share of partnership taxable income or loss.

Guaranteed payments are payments to a partner for services or for the use of capital which are determined without regard to the income of the partnership. In *Pratt v United States*, n182 the Court of Appeals held that payments based on a percentage of *gross* income were made *with* regard to partnership income and, therefore, were not guaranteed payments. However, the Service has since ruled that payments based on a percentage of gross income, as were involved in *Pratt*, **do** constitute guaranteed payments. n183 A guaranteed payment would be ordinary income to the partner receiving the payment, even if the partnership's only income was long term capital gains. Guaranteed payments are treated as payments made to a third party for purposes of determining the partner recipient's gross income and the partnership's trade or business expenses. n184 For all other purposes, guaranteed payments are treated as a partner's distributive share of ordinary income of the partnership. Thus, guaranteed payments for services are not subject to wage withholding, are not eligible for exclusion on the basis of the disability provisions of the Code, are not treated as wages for purposes of the deferred compensation provisions of the Code, etc. n185

Example:

Assume X is a 1 percent general partner in a limited partnership. X syndicates the partnership and provides certain services that normally would have resulted in considerable syndication costs. The partnership agreement provides that X is allocated the first \$200,000 of partnership gross income and is to be distributed \$200,000 of cash. In 1995, the partnership has \$600,000 of gross income and \$1 million of deductions, including depreciation, resulting in a net loss of \$400,000. If the allocation of \$200,000 of gross income to X is treated as such, the loss available to the limited partners would be increased by \$200,000.

	X	Limited Partners	X and Limited Partners
Gross income--	\$200,000	\$.....	\$.....
.....specially		--	..200,000
.....allocated			
Gross income--	4,000	396,000	400,000
.... remaining			
Deductions	(10,000)	(990,000)	(1,000,000)
	\$194,000	\$ (594,000)	\$.....
			..(400,000)

Therefore, although the net loss of the partnership is still \$400,000, by allocating \$200,000 of gross income to *X*, the loss allocated among the limited partners is increased to \$594,000. This is the same result that would have been reached if the \$200,000 could have been deducted by the partnership, although no such deduction is allowable because the payment is for nondeductible expenses. n186

However, because of the relationship of the \$200,000 allocation and the \$200,000 distribution to the services performed by *X*, the \$200,000 gross income allocation to *X* is treated in the same way as a direct payment to *X*. Therefore, the partners are allocated a net loss of only \$400,000, and the partnership is treated as having made a \$200,000 nondeductible payment for syndication.

A transfer of partnership property in satisfaction of a partnership's obligation to make a guaranteed payment is treated as a sale or exchange, n186.1 rather than a partnership distribution to the partner under *IRC Section 731*. Accordingly, the partnership must recognize gain or loss on the transfer, and the nonrecognition rule for partnership distributions n186.2 does not apply to the transfer. n186.3

Example:

X Partnership purchased Blackacre for \$500x. *A*, a partner in *X* Partnership, is entitled to a guaranteed payment of \$800x. Subsequently, when the fair market value of Blackacre is \$800x and *X* Partnership's adjusted basis in Blackacre is \$500x, the partnership transfers Blackacre to *A* in satisfaction of the guaranteed payment. *X* Partnership realizes a \$300x gain on the transfer, the difference between its adjusted basis in the property (\$500x) and the property's fair market value (\$800x). n186.4

FOOTNOTES:

(n1)Footnote 163. *IRC § 707(a); Treas Reg § 1.707-1(a)*.

(n2)Footnote 164. *Treas Reg §§ 1.707-0 through-9*.

(n3)Footnote 165. *Treas Reg § 1.707-3(b)(1)*.

(n4)Footnote 166. *Treas Reg § 1.707-3(b)(2)*.

(n5)Footnote 167. *Treas Reg § 1.707-3(c)*.

(n6)Footnote 168. *Treas Reg § 1.707-3(c)(2)*.

(n7)Footnote 169. *Treas Reg § 1.707-3(d)*.

(n8)Footnote 170. *Treas Reg § 1.707-4*.

(n9)Footnote 171. *Treas Reg §§ 1.707-4(a)(1)(ii); (2)*.

(n10)Footnote 172. *Treas Reg § 1.707-4(a)(3)*.

(n11)Footnote 173. *IRC § 707(b)(1)*.

(n12)Footnote 174. *IRC § 707(b)(1)(last sentence)*.

(n13)Footnote 175. *IRC §§ 707(b)(2); § 1239*. The reference in *Treas Reg § 1.707-1(b)(2)* to a "more than 80% interest" reflects the Code provisions as they existed prior to 1986.

(n14)Footnote 176. *Treas Reg* § 1.707-1(c).

(n15)Footnote 177. *US v Pratt*, 550 F2d 1023 (5th Cir 1977) ; *Treas Reg* § 1.707-1(a).

(n16)Footnote 178. *Treas Reg* § 1.707-1(c).

(n17)Footnote 179. *IRC* § 707(c).

(n18)Footnote 180. *IRC* §§ 706, 467.

(n19)Footnote 181. *IRC* § 707(a)(2)(A).

(n20)Footnote 182. 550 F2d 1023 (5th Cir 1977) .

(n21)Footnote 183. *Rev Rul* 81-300, 1991-2 CB 143 . See also *Rev Rul* 81-301, 1982-2 CB 144 . In these revenue rulings, the Service indicated its disagreement with the *Pratt* court's conclusion on the guaranteed payments issued.

(n22)Footnote 184. *IRC* §§ 706(a); 707(c).

(n23)Footnote 185. *Treas Reg* § 1.707-1(c).

(n24)Footnote 186. *IRC* § 709(a).

(n25)Footnote 186.1. See *IRC* § 1001.

(n26)Footnote 186.2. See *IRC* § 731(b).

(n27)Footnote 186.3. *Rev Rul* 2007-40, 2007-25 IRB 1426 .

(n28)Footnote 186.4. *Rev Rul* 2007-40, 2007-25 IRB 1426 .

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.10

§ 14.10 Computation of Partnership Income, Reporting of Partnership Items by Partners, and Filing of Return

The partnership itself is not a taxable entity for federal income tax purposes; however, it does file an informational tax return on which it must account for various categories of income, gain, loss, deduction or credit, and must compute taxable income or loss exclusive of those items that must be accounted for separately. n187

Income of a partnership is computed in the same manner as that for an individual, n188 except that certain deductions allowed to individuals are excluded from the computation of partnership taxable income. Additionally, *IRC Section 448* restricts the use of the cash method of accounting for partnerships. Partnerships that have a C corporation partner (other than qualified service corporations, such as medical, legal, engineering and accounting firms) must use the accrual method of accounting. Exceptions are made for partnerships that have average annual gross receipts for all prior taxable years of not more than \$5 million. n189 The following deductions available to individuals are not allowed in the computation of partnership income: n190

- deduction for personal exemptions;
- deduction for taxes paid to foreign countries and possessions of the United States;
- deduction for charitable contributions;
- net operating loss deduction;
- deduction for medical expenses, expenses for production of income, alimony payments, etc.; and
- depletion deduction.

Although the above deductions are not allowed in the computation of partnership taxable income, the deduction for foreign taxes and charitable contributions n190.1 are taken into account separately, and each partner reports his distributive share of each item on his individual income tax return. The following items are also to be taken into account separately by the partners when computing their taxable incomes: n191

- short-term capital gains and losses;

- long-term capital gains and losses;
- gains and losses from sales of property used in a trade or business or involved in an involuntary conversion;
- dividends that are eligible for capital gains treatment under *IRC Section 1(h)(11)*, or dividends to which the statutory dividends-received deduction provisions apply; n191.1 and
- other items that are specially allocated or must be taken into account separately by the partners. n192

Each partner reports his distributive share of the above items as if they were paid or earned individually; therefore, each item retains the same character in the hands of the partner as that item had in the hands of the partnership. These rules prevent a taxpayer from using the partnership to claim a deduction in excess of the amount allowable on his individual return. n193 Partners are taxable on their distributive share of partnership income whether or not that income is distributed to them. n193.1 Partners are also taxable on their distributive shares of partnership income when realized by the partnership, despite a dispute among the partners as to their respective distributive shares. n193.2

Since the character of income and deductions is determined at the partnership level, if a real estate dealer invests in a partnership with several other partners to purchase land as an investment and hold it for capital appreciation, the gain on the sale of the land is determined at the partnership level and is capital gain to the partner. Accordingly, using partnerships allows an individual with several different types of business activities to segregate them so as to maximize its ability to claim appropriate tax benefits. Likewise, interest paid on debts incurred by the partnership to carry on this investment would be characterized as investment interest expense instead of interest incurred in an active trade or business. n194

The partnership must file an informational return of income within three and one-half months after the close of its taxable year, unless it is granted an extension of time to file. n195 No federal income tax is payable with a partnership return. If a partnership fails to file a timely return (with regard to extensions) or files a return that fails to show required information, n195.1 in addition to any other penalties under *IRC Section 7203* (relating to willful failure to file a return), the partnership is liable for a monthly penalty for each month (not exceeding 12 months) that the failure continues, unless that failure is due to reasonable cause. n195.2 The monthly penalty is \$195 multiplied by the number of persons who were partners in the partnership during any part of the taxable year. n195.3 The penalty is imposed against the partnership, n196 but as a partnership liability will be a personal liability of any partners who are personally liable for debts of the partnership. Partnerships with ten or fewer partners will not be subject to this penalty where each partner files a detailed statement of his or her share of partnership income and deductions with his or her own return. This exception will only be available if the partnership can establish that all partners have fully reported their shares of the income, deductions and credits of the partnership on their timely filed income tax returns. n197

Procedures for the audit of partnerships and partners are set forth in *IRC Sections 6221-6233*. Generally, these rules require that a partner must file a tax return that is in agreement with the information furnished on Form K-1. n198 Further, the procedures provide for a single proceeding at the partnership level to determine the correct tax characterization of partnership items. Certain large partnerships are not subject to these requirements. n199

Individuals, closely-held corporations, personal service corporations and certain other taxpayers engaged in a trade or business in which they do not materially participate, in rental activity, or in some other passive activity, are subject to the passive loss limitation rules of *IRC Section 469*. In essence, passive activity losses generally cannot offset nonpassive income; rather, such losses offset passive activity income instead. For a discussion of the passive activity loss rules, see Chapter 13.

Due to the pass-through nature of partnerships, partners are generally subject to the passive loss rules. The holder of a limited partnership interest generally is deemed not to materially participate in the limited partnership activities. n200 In the case of publicly-traded partnerships that are not treated as corporations under *IRC Section 7704*, the passive loss rules are applied separately for the items attributable to each publicly-traded partnership. n201

FOOTNOTES:

(n1)Footnote 187. *IRC §§ 701, 702, 703; Treas Reg § 1.6031-1(a)(1)*.

(n2)Footnote 188. *IRC § 703(a)*.

(n3)Footnote 189. *IRC § 448(b)(3); Temp Treas Reg § 1.448-1T(f)*.

(n4)Footnote 190. *IRC § 703(a)(2)*.

(n5)Footnote 190.1. *IRC § 702(a)(4), (6)*.

(n6)Footnote 191. *IRC § 702(a)*.

(n7)Footnote 191.1. See *IRC §§ 243-249*.

(n8)Footnote 192. *IRC §§ 702(a)(7), (8); Treas Reg §§ 1.702-1(a)(8), (9)*.

(n9)Footnote 193. *IRC § 702(b)*.

(n10)Footnote 193.1. *IRC § 702(c); Treas Reg § 1.702-1(a); US v Basye, 410 US 441 (1973) ; Cipparone v Commr, TC Memo 1985-234 ; Chama v Commr, TC Memo 2001-253* (taxpayer had to include in gross income her share of proceeds from the sale of real estate by a partnership in which she was a partner, even though the partnership did not distribute the proceeds to the partners).

(n11)Footnote 193.2. *De Cousser v Commr, 16 TC 65 (1951) ; Burke v Commr, TC Memo 2005-297* .

(n12)Footnote 194. *IRC § 163(d)*.

(n13)Footnote 195. *Treas Reg § 1.6031-1(e)(2)*.

(n14)Footnote 195.1. See *IRC § 6031*.

(n15)Footnote 195.2. *IRC § 6698(a)*. A similar penalty is imposed on S corporations [*IRC § 6699*].

(n16)Footnote 195.3. *IRC § 6698(b)*, effective for returns for taxable years beginning after Dec 31, 2009 [Pub Law No 111-92, § 16(b)]; for returns required to be filed after Dec 31, 2008 for taxable years beginning before Jan 1, 2010, the penalty is \$89 multiplied by the number of persons who were partners in the partnership during any part of the taxable year [*IRC § 6698(b), before amendment by Pub Law No 111-92*; see Pub Law No 110-458, § 127(b) (effective date)], and for earlier returns, the penalty is \$85 multiplied by the number of persons who were partners in the partnership during any part of the taxable year [*IRC § 6698, before amendment by Pub Law 110-458*].

(n17)Footnote 196. *IRC § 6698(c)*.

(n18)Footnote 197. *Rev Proc 84-35, 1984-1 CB 509 ; IRC § 6231(a)(1)(B)*.

(n19)Footnote 198. *IRC § 6222*.

(n20)Footnote 199. *IRC § 6223(b)*.

(n21)Footnote 200. *IRC § 469(h)(2)*.

(n22)Footnote 201. *IRC § 469(k)*.

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CHAPTER 14 Partnerships and Limited Liability Companies *

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§ 14.11 Allocations of Partnership Income and Deductions

One of the principal advantages of the partnership form of organization is the flexibility that the partners enjoy in sharing the profits, losses, cash flow and ultimate gains from the sale of the partnership property. For example, the partnership agreement may provide for certain otherwise equal partners to receive a greater share of current cash distributions in return for a smaller share in the ultimate appreciation of the partnership property, or for other otherwise equal partners to bear a greater risk of economic loss from partnership operations while enjoying a greater share of the economic profits.

The general rule is that partners can allocate income or loss, including certain specific items of income, gain or loss, in whatever manner they wish, as long as the allocation has "substantial economic effect." n201.1 What is substantial economic effect? Under the Treasury regulations, taxable income or loss of a partnership must be allocated in the same manner in which the partners have agreed to share the corresponding economic benefits and burdens. As a general matter, partners cannot agree to make an allocation for tax purposes only, n202 although in the case of certain credits, such as low income housing tax credits, such an allocation is, in effect, permitted. n203 As a general rule, the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received, independent of tax consequences. n203.1 Even if the allocation affects substantially the dollar amounts, the economic effect of the allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to those consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to those consequences if the allocation (or allocations) were not contained in the partnership agreement. n203.2

For example, assume that Partner A and Partner B each contribute \$50,000 to partnership AB for it to use as a down payment for the purchase of a building. The balance of the purchase price will be borrowed on a nonrecourse basis. Although AB is intended to be essentially a 50-50 partnership, assume that Partner A wants to be allocated all the depreciation on the property for the first four years, which will be \$100,000. As long as the burden of the first \$100,000 of economic depreciation is charged to that partner, the special allocation would generally be respected. At the end of four years, the capital accounts of the partnership will appear as follows (assuming no other activity):

A	B	Total

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Original contribution			
	.	.	\$100,000
	\$50,000	\$50,000	
Depreciation	(100,000)	--	(100,000)
Balance	[50,000)	\$50,000	--

If the partnership then sold the building at its net book value of \$50,000, there would be no gain to be allocated to the partners and no cash to be distributed to them (the cash proceeds from the sale would be paid over to the lender). In order for the special allocation of the depreciation to have substantial economic effect, Partner A would have to have an obligation to contribute \$50,000 to the partnership in satisfaction of its negative capital account. The proceeds of this contribution, in turn, would be distributed to Partner B *in respect of its positive capital account balance*. Accordingly, the final capital accounts of the partnership will be:

	A	B	Total
Prior balance	(\$50,000)	\$50,000	\$.....
			--
Contribution	50,000	\$.....	50,000
		--	
Distribution		(50,000)	(50,000)
	..--		
Final balance	--	--	--

In summary, A bears the economic burden for the entire \$100,000 of depreciation deduction that was incurred by the partnership and specially allocated to A.

Partner A may be willing to undertake an obligation to contribute to the partnership to satisfy its negative capital account because, it is hoped, that the property will appreciate in value. If it does, Partner A can be allocated the first sufficient portion of the gain from the sale of the property in order to recoup the depreciation losses and eliminate the capital account disparity. If the gain is capital in nature, A has successfully converted an ordinary loss to a capital gain. This is often the motivation for agreeing to accept the risk of claiming the depreciation expense. Assume that the partnership does realize a \$200,000 gain on the sale of the property; the capital accounts may be summarized as follows:

	A	B	Total
Balance before sale	(\$50,000)	50,000	\$.....
			--
Special allocation of gain to Partner A	100,000	--	100,000
Remaining gain	50,000	50,000	100,000
Cash distribution	(100,000)	(100,000)	(200,000)
Final balance	--	--	--

If an allocation does not have substantial economic effect (or if the partnership agreement makes no provision for

allocating the items in question), it will be shared in accordance with the partners' respective interests in the partnership, which are determined by taking into account all "facts and circumstances." n204 Relevant facts and circumstances include a partner's interest in cash flow and its right to distribution of capital upon liquidation.

The Service has issued regulations under *IRC Section 704(b)*, defining "substantial economic effect." n205 Generally, these rules require that a partner's capital account reflect the economic realities of transactions; that deficits be made up; and that liquidation and distribution rights follow the capital accounts. The Service has also provided specific rules for allocations of losses funded by nonrecourse debt. n206 These rules are complex and require an annual comparison of the principal balance of the nonrecourse debt with the adjusted basis of the property, in order to confirm that the allocations remain within the amount of gain that would be recognized by the partnership if it sold the assets encumbered by the nonrecourse liability for no consideration (other than the deemed consideration attributable to the liability).

The Service has also issued regulations providing guidance as to the proper method of allocating depreciation recapture among partners. n207 The new regulations seek to insure, to the extent possible, that a partner recognizes recapture on the disposition of depreciable property in an amount equal to the depreciation or amortization deductions from the property previously taken by that partner.

[1] Retroactive Allocations

Partnership income, gains, losses, deductions, and credits for a year must be prorated among partners according to the length of time during the year for which they held their partnership interests. n208 This rule prevents partnerships from admitting a new partner toward the end of the taxable year and then allocating a full share of the partnership losses to the partner for the entire year.

The Code provides rules pursuant to which the partnership items of income shall be allocated pursuant to the "varying interest" rule. These rules require that, in general, cash basis items such as interest, taxes and payments for services or for the use of property must be apportioned over the days in the partnership's taxable year to which they are attributable, with the portion attributable to each day then being allocated among the partners in proportion to their interests in the partnership at the close of that day. n209 The Code also applies rules for the allocation of cash basis items attributable to periods not within the taxable year, including items attributable to prior periods and provides that, in general, a partner in an upper tier partnership shall receive allocations of items generated by a lower tier partnership by first allocating the items of the lower tier partnership to the upper tier partnership in accordance with the upper tier partnership's varying interest in the lower tier partnership and then reallocating those items to the partners in the upper tier partnership using similar principles. n210

This "varying interest" rule applies only if a shift occurs in the capital interests of the partners. Such a shift may occur, for example, after a new partner is admitted to the partnership. If there is no shift in the capital interests during the year, the partnership agreement may be amended at the end of the year and profits and losses may be reallocated, at least in the case of partners who have been members of the partnership for the entire taxable year. The amendment must be made on or before the due date (unextended) of the partnership's tax return for the year. n211

However, where a change occurs in a partner's capital interest in a partnership, the distributive shares of the partners are determined by either: (1) prorating partnership items over the year as if they were earned or incurred ratably; or (2) allocating such items through an interim closing of the partnership's books, in which the items of income and deduction are allocated to different segments of the year under the partnership's regular method of accounting. n212

When a partnership interest is owned by another partnership, a "tiered" arrangement exists. A tiered arrangement is frequently used in a real estate partnership either to create an entity through which several general partners will hold their interests, so that reallocations and decisions involving the general partner interests can be made without involving

the limited partners, or to form a vehicle pursuant to which a group of investors can invest in a larger real estate fund, again to provide them with a mechanism through which they can make decisions about their partnership interests without needing to obtain the agreement of the larger entity. This arrangement could easily lend itself to abuse. For example, if a change occurred in the ownership of the upper-tier partnership, the ownership of the lower-tier partnership would be unaffected, and the change would not be subject to *IRC Section 706(d)*. To prevent this type of abuse from occurring, the Code provides that when a change occurs in a partner's interest in an upper-tier partnership, the distributive shares of the partners in the upper-tier partnership attributable to a lower-tier partnership must be determined on a per-partner, per-day basis. n213

[2] COD Income Allocations

A problem frequently encountered by an unsuccessful real estate venture is the need to restructure the partnership's ownership, indebtedness and operations in a way that enables the venture to remain viable, provides equitable allocations of values as between lenders and owners, and yet still allows the partners in the owning partnership to avoid the severe tax burdens that would result from an actual disposition of the partnership's property through a foreclosure or deed-in-lieu-of-foreclosure. One way in which this problem is sometimes addressed is for there to be an agreement between the partnership borrower and its lenders pursuant to which a portion of the partnership's indebtedness is canceled, generally in connection with the lender's acquiring an equity interest in the partnership. The cancellation of indebtedness may result in taxable cancellation of indebtedness (COD) income to the partnership and its partners. n214 The exceptions to the COD income rules for debt cancellation that occurs when a taxpayer is bankrupt or insolvent are applied at the partner level, not the partnership level. n215 Accordingly, the manner in which the COD income realized by the partnership is allocated among the partners may have a material effect on the overall amount of tax that will be paid by the partners with respect to the debt cancellation. Accordingly, if the partner's desire is to allocate COD income in a manner that varies from the partner's allocable shares of overall partnership profits (i.e., an allocation to a partner of a share of the partnership's COD income that differs from the partner's share of canceled debt under *IRC Section 752(b)*), it is necessary to determine whether such an allocation will be respected as having "substantial economic effect."

Example:

Assume that *A* contributes \$100 and *B* contributes \$900 to form *AB*, a general partnership. The partners' shares of the partnership's losses are 10 percent and 90 percent, respectively, and their shares of the partnership's income are 50 percent each. The partnership maintains capital accounts in accordance with the rules under the *IRC Section 704(b)* regulations, and the partners agree to liquidate partnership assets according to positive capital account balances. *A* and *B* do not agree to an unconditional deficit restoration obligation. However, both partners agree to a qualified income offset and are treated as having a limited obligation to restore their deficit capital accounts by reason of their liability to the partnership's creditors.

AB purchases property for \$10,000 from an unrelated seller, paying \$1,000 in cash and borrowing \$9,000 from an unrelated bank. The note is a recourse obligation of the partnership, the principal of which is due and payable in six years. The property generates \$2,000 of depreciation each year for five years. All other partnership deductions equal partnership income so that at the end of five years, the partnership has cumulative losses of \$10,000, allocated \$1,000 to partner *A* and \$9,000 to partner *B*. The losses reduce *A*'s capital account to negative \$900 and *B*'s capital account to negative \$8,100. At the beginning of year 6, after the fair market value of *AB*'s property has substantially decreased, the creditor cancels the debt and takes the building in exchange as part of a workout arrangement. Because the debt has been canceled, *A* and *B* are no longer treated as being obligated to restore their negative capital accounts.

The allocation of COD income of \$9,000 in a 50/50 ratio would result in *A*'s having a capital account of

\$3,600 and B's having a negative capital account of \$3,600 (allocation of \$4,500 to each partner). This allocation of income cannot have substantial economic effect even though the partners maintain capital accounts and liquidate according to positive capital accounts. This is because the cancellation of indebtedness eliminates justification for treating the partners as being obligated to restore their negative capital accounts and creates a situation in which neither partner has an independent deficit restoration obligation that can require a cash contribution to satisfy the other partner's positive capital account. Because of the lack of an independent deficit restoration obligation, A cannot enjoy the economic benefit of an allocation of COD income exceeding its negative capital account of \$900. Absent a deficit restoration obligation that can be invoked to satisfy another partner's positive capital account, the above allocation will not have economic effect unless COD income is allocated \$900 to A and \$8,100 to B; the same as the losses were originally allocated. n216

FOOTNOTES:

(n1)Footnote 201.1. *IRC § 704(b)(2)*.

(n2)Footnote 202. *Treas Reg § 1.704-1(b)*.

(n3)Footnote 203. *Treas Reg § 1.704-1(b)(4)(ii)*.

(n4)Footnote 203.1. *Treas Reg § 1.704-1(b)(2)(iii)*.

(n5)Footnote 203.2. See *Treas Reg § 1.704-1(b)(2)(iii)*.

(n6)Footnote 204. *IRC § 704(b)*.

(n7)Footnote 205. *Treas Reg § 1.704-1(b)*.

(n8)Footnote 206. *Treas Reg § 1.704-2*.

(n9)Footnote 207. *Treas Reg §§ 1.704-3(a)11; 1.1245-1(e)(2)(i)*.

(n10)Footnote 208. *IRC § 706(d)(1)*.

(n11)Footnote 209. *IRC § 706(d)(2)*.

(n12)Footnote 210. *IRC §§ 706(d)(2)(C), (D); (3)*.

(n13)Footnote 211. *IRC §§ 704(a), 761(c)*. See also the Conference Report on the Deficit Reduction Act of 1984 (PL 98-369, HR Rep No 98-861), 98th Cong 2nd Sess 858 (June 23, 1984).

(n14)Footnote 212. *Treas Reg § 1.706-1(c)(4)*.

(n15)Footnote 213. *IRC § 706(d)(3)*.

(n16)Footnote 214. *IRC §§ 61(a)(12), 108*.

(n17)Footnote 215. *IRC § 108(d)(6)*.

(n18)Footnote 216. *Rev Rul 92-97, 1992-2 CB 124*.

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.12

§ 14.12 Partnership Distributions

Distributions from a partnership are characterized for tax purposes either as "current" or "liquidating" distributions. These two different types of distributions can have different tax consequences; therefore, before attempting to determine the tax consequences of a distribution, it is necessary to determine the type of distribution involved. A liquidating distribution is one distribution, or a series of distributions, that terminates a partner's interest in a partnership. A current distribution includes any distribution other than a liquidating distribution. n217

Generally, current and liquidating distributions of partnership property, other than money, do not result in taxable gain to the receiving partner. Therefore, the partner will not recognize any gain with respect to the distributed property until the property is sold by him. However, to the extent that distributions of money exceed a partner's basis in the partnership, the partner will realize a gain. n218 Distributions of marketable securities, and liabilities of the partnership of which the partner is relieved are treated as distributions of money for this purpose. n219 Marketable securities are taken into account at their fair market value on the date of the distribution. n219.1 For example, if a partner has a tax basis in its partnership interest of \$10,000 and receives a cash distribution of \$9,000, together with property (not consisting of marketable securities) having a fair market value of \$6,000, no gain is recognized by the partner, since the cash did not exceed the basis of its partnership interest. If \$13,000 in cash had been distributed, the partner would recognize a gain of \$3,000 (\$13,000 cash received, less \$10,000 basis in the partnership interest). n219.2 When property is distributed, its basis to the receiving partner will normally be adjusted. The basis of the distributed property is also affected by the determination whether the distribution is a distribution in liquidation of a partner's interest, or is a non-liquidating distribution. n219.3 (See *Section 14.12[1]*, below, for a discussion of the basis of property received.)

A partner recognizes loss on a distribution only when the distribution is in liquidation of the partner's entire interest in the partnership, and then only in certain instances. Generally, no loss will be recognized on a current distribution. A loss can be recognized only when money, unrealized receivables, and appreciated inventory are the only properties distributed and the distribution is in complete liquidation of a partner's interest in the partnership. In such case, the loss is equal to the amount by which the basis of the partner's interest in the partnership exceeds the amount of money distributed, plus the basis to the partner of unrealized receivables and appreciated inventory distributed. n220

Example:

Partnership A distributes \$5,000 in cash, unrealized receivables and appreciated inventory to X in complete liquidation of its partnership interest. The unrealized receivables and appreciated inventory

have a basis to X of \$7,000. X's basis in the partnership is \$20,000 before the distribution. X's loss is computed as follows:

Basis in Partnership		\$20,000
A		
Cash received	\$5,000	
Basis in unrealized receivables and appreciated inventory	7,000	(12,000)
X's recognized loss		\$8,000

If a partner receives property other than money, unrealized receivables, or inventory items in a distribution, no loss is recognized even in a distribution in complete liquidation of a partnership interest. n221

Distributions made by a partnership in complete liquidation of a partner's interest can be made in a series of distributions. n222 When such a series of distributions is made, however, it is often difficult to distinguish between a current distribution, upon which no loss could be recognized, and one of a series of distributions in liquidation of the partner's entire interest. As a practical matter, making a distinction between the two will often be aided by the execution of a written agreement among the partners, setting forth the nature (and amounts) of the distributions to be made.

As a general rule, the partnership will not recognize any gain or loss on distributions of money or other property to the partners. n223 However, exceptions to this rule operate when the partnership makes certain payments to a retiring partner or a deceased partner's successor in interest, or, in some cases, when the partnership has unrealized receivables or substantially appreciated inventory. n224 In addition, a transfer of partnership property in satisfaction of a partnership's obligation to make a guaranteed payment under *IRC Section 707(c)* is a sale or exchange, n224.1 rather than a distribution within the meaning of *IRC Section 731*. Accordingly, the partnership must recognize gain or loss on the transfer, and the nonrecognition rule for partnership distributions n224.2 does not apply to the transfer. n224.3

[1] Basis of Property Distributed Other Than Money

[a] In General

The basis of property received by a partner in a distribution by a partnership is determined according to the type of distribution involved (i.e., current or liquidating). In a current distribution, the basis of the property received will be the adjusted basis of the property in the hands of the partnership. The total basis of all property received by a partner is limited, however, to the partner's adjusted basis in his partnership interest, reduced by any money received in the transaction. n225

Example:

Assume that a partner has an adjusted basis of \$10,000 for its partnership interest. The partner receives a current distribution of property with an adjusted basis to the partnership of \$8,000 and cash of \$4,000. The basis of the distributed property to the partner would be \$6,000 (\$10,000 basis in its partnership interest, less \$4,000 cash received). If the partner's adjusted basis in its partnership interest was \$20,000 immediately before the distribution, his adjusted basis for the property would be \$8,000 (the adjusted basis of the property in the hands of the partnership). n225.1

The basis of the property received by a partner in liquidation of its entire interest in a partnership is equal to the adjusted

basis of its interest in the partnership, reduced by the amount of money received by the partner in the same transaction. n226 When more than one item of property is distributed in liquidation of a partner's entire interest in the partnership, the partner's adjusted basis in its partnership interest must be allocated among the various items of property. Basis is allocated first to any unrealized receivables (as defined in *IRC Section 751(c)*) and inventory property, and then to any other property distributed by the partnership. To the extent that the basis to be allocated is less than the sum of the adjusted bases of the unrealized receivables and inventory items, then the required decrease in basis is allocated first to assets with unrealized depreciation in proportion to their respective amounts of unrealized depreciation, and then in proportion to the adjusted basis of those properties. n226.1 To the extent that the basis remaining after the allocation of basis required with respect to unrealized receivables and inventory requires an increase in the basis of the partnership's properties, the increase is allocated first to properties with unrealized appreciation, in proportion to the respective amounts of unrealized depreciation, and thereafter to the properties in accordance with their fair market values. n227

Example:

Assume that Partnership A distributes to X \$2,000 in cash, unrealized receivables with a basis to the partnership of \$8,000 and a fair market value of \$10,000, a parcel of undeveloped land with a basis to the partnership of \$12,000 (and a fair market value of \$9,000), and marketable securities with a basis to the partnership of \$6,000 (and a fair market value of \$3,000), in complete liquidation of X's partnership interest. Before the distribution, X had a \$22,000 tax basis in its partnership interest. X's basis in the items distributed is computed as follows: n227.1

X's basis in Partnership A	\$22,000
Less--Money received	(2,000)
Basis to be allocated	20,000
Less--Basis of unrealized receivables	(8,000)
Basis to be allocated between undeveloped land and marketable securities	\$12,000

Basis of Land and Marketable Securities

Partner's Basis for Partnership Interest	Partnership Basis for Assets	Unrealized Depre- ciation	Allocated Decrease	Partners's Basis for Assets
	Land.....	\$3,000	\$3,000	\$9,000
	\$12,000			
	Secur- ity.....\$6, 000	\$3,000	\$3,000	\$3,000
\$12,000	\$18,000	\$6,000	\$6,000	\$12,000

A partner who acquires a partnership interest with respect to which an *IRC Section 754* election is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within two years, may elect to treat as the adjusted partnership basis of that property the adjusted basis the property would have if the optional adjustment to partnership property under *IRC Section 743(b)* were in effect with respect to partnership property. n227.2 An adjustment under this special basis rule is required for a distribution to a partner if, at the time of the partner's acquisition of the transferred interest, all of the following are met: n227.3

- the fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership;
- an allocation of basis under *IRC Section 732(c)* upon a liquidation of the partner's interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion or amortization, to property subject to such an allowance; and
- a basis adjustment under *IRC Section 743(b)* (relating to optional adjustments to the basis of partnership property upon the transfer of an interest in the partnership) would change the basis to the transferee partner of the property actually distributed.

The partnership must provide transferees with information necessary for them to compute basis adjustments under *IRC Section 732(d)*. The information must be provided if a transferee notifies the partnership that it plans to make the election under *IRC Section 732(d)* or if the partnership makes a distribution requiring mandatory application of *IRC Section 732(d)*. n227.4

[b] Distributions by a Partnership to a Corporate Partner of Stock in Another Corporation

If a partnership distributes to a corporate partner the stock of another corporation as part of a distribution, the corporate partner may have to reduce the basis in the assets of the corporation whose stock it received. The basis reduction is specified by statute and is required if, after the distribution, the corporate partner controls the distributed corporation, and the partnership's adjusted basis in the stock immediately before the distribution exceeded the corporate partner's adjusted basis in the stock after the distribution. n227.5 The determination of whether a corporate partner has control of a distributed corporation for this purpose is made by applying the consolidated group aggregate stock ownership rules. n227.5.1

The amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of: (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution. n227.6 The amount of the basis reduction is limited in two respects. First, the amount of the basis reduction may not exceed the amount by which: (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. n227.7

Example:

The stock of corporation D is distributed to corporate partner C. D has cash of \$300 and other property with a basis of \$600, and C's basis in the stock of the D is \$400. The basis reduction cannot exceed \$500 (i.e., [\$300 + \$600] - \$400). n227.8

Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation cannot be reduced below zero under the provision, even though the total amount of the basis reduction would otherwise be greater. n227.9

The basis reduction is allocated among assets of the controlled corporation in accordance with the rules provided under *IRC Section 732(c)*. n227.10 The reduction in basis is applied to any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has that control. n227.11 The basis reduction is not made to any distribution in which the corporate partner does not have control of the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control. n227.12

If a corporation acquires (other than in a distribution from a partnership) stock, the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to *IRC Sections 732(a)(2)* or *732(b)*, then the corporation is treated as receiving a distribution of stock from a partnership. n227.13

Example (1):

P, a partnership, distributes real estate to a corporate partner C. C contributes the real estate to another corporation, D, in an *IRC Section 351* transaction. The stock which C receives in the *IRC Section 351* transaction is not treated as distributed by P, and the basis reduction under *IRC Section 732(f)* is not done. n227.14

Example (2):

P, a partnership, distributes stock of corporation C to two corporate partners, R and S, neither of which has control of C. R and S merge, and the survivor obtains control of C. The stock of C, which is acquired as a result of the merger, is treated as received in a partnership distribution; the basis reduction rule of the *IRC Section 732(f)* therefore applies. n227.15

In the case of tiered corporations, a special rule applies. If the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, then the basis of the property of that controlled corporation is reduced. The provision is also reapplied to any property of any controlled corporation that is stock in a corporation that it controls. n227.16

In addition, the corporate partner receiving the stock in the distribution must recognize long-term capital gain to the extent that the amount of the basis reduction exceeds the basis of the property (other than money) of the distributed corporation. The corporate partner's adjusted basis in the stock distributed is increased in the same amount. n227.17 As used here, the term "control" means ownership of stock meeting the requirements of *Internal Revenue Code Section 1504(a)(2)* (generally, an 80-percent vote and value requirement). n227.18

[2] Gain or Loss on Disposition of Distributed Property

The nature of gain or loss (capital vs. ordinary) on a partner's disposition of distributed property is generally determined by reference to the character of the property in the hands of the distributee partner. The holding period to be used in determining the gain or loss includes the partnership's holding period with respect to that property. n228 Thus, a partner with a short-term holding period for its partnership interest will recognize a long-term capital gain on the sale of a capital asset distributed by the partnership to the partner, if the partnership has a long-term holding period for that asset.

A sale by a partner of inventory items (as defined in *IRC Section 751(d)*) acquired in a distribution from a partnership results in ordinary gain or loss if sold or exchanged by the distributee partner within five years from the date of the

distribution, regardless of the character of the property in such partner's hands. n229 After the inventory items have been held by the partner for a period of five years, gain on the sale of the items is determined by the character of the items in the hands of the partner. Thus, if a real estate partnership engaged in a condominium conversion distributes condominium units to its partners, the sale of the condominium unit by the distributee partner within five years after the date of distribution would produce ordinary income to the distributee partner, even if it held the condominium as a capital asset, because the condominium unit constituted inventory in the hands of the partnership. However, if the distributee partner uses the condominium as his or her principal residence, gain on a subsequent sale of the condominium within the five-year period might be eligible for the exclusion provided in *IRC Section 121*.

When a partner disposes of property in a nonrecognition transaction, if his basis carries over to the new owner (e.g., in a gift situation), the income or loss character of the property also carries over to the new owner. Additionally, the character of any property received by the partner in a nonrecognition transaction, except for stock in a regular corporation, carries over. n230

[3] Distributions of Marketable Securities

Non-pro rata distributions of marketable securities are generally treated as distributions of cash. n231 As a result, such distributions generally result in the recognition of taxable gain to the distributee to the extent that the fair market value of such distributions exceeds the basis of such partner's interest in the partnership. This provision was enacted to prevent partners from being able to convert an illiquid, high value but low basis interest in a partnership into liquid marketable securities without recognizing the built-in gain.

FOOTNOTES:

(n1)Footnote 217. *IRC §§ 731(a), 761(d)*.

(n2)Footnote 218. *IRC § 731(a)(1)*.

(n3)Footnote 219. *IRC §§ 731(c)(1)(A), 752(b)*.

(n4)Footnote 219.1. *IRC § 731(c)(1)(B)*.

(n5)Footnote 219.2. *IRC § 731(a)(1)*.

(n6)Footnote 219.3. *IRC § 732(a), (b)*.

(n7)Footnote 220. *IRC § 731(a)(2)*.

(n8)Footnote 221. *See id.*

(n9)Footnote 222. *IRC § 761(d)*.

(n10)Footnote 223. *IRC § 731(b)*.

(n11)Footnote 224. *IRC § 731(d)*.

(n12)Footnote 224.1. *See IRC § 1001*.

(n13)Footnote 224.2. *See IRC § 731(b)*.

(n14)Footnote 224.3. *Rev Rul 2007-40, 2007-25 IRB 1426*.

(n15)Footnote 225. *IRC § 732(a)*.

(n16)Footnote 225.1. *IRC § 732(a); Treas Reg § 1.732-1(a).*

(n17)Footnote 226. *IRC § 732(b).*

(n18)Footnote 226.1. *IRC § 732(c)(1)(A).*

(n19)Footnote 227. *IRC § 732(c)(2).*

(n20)Footnote 227.1. *IRC § 732(c); Treas Reg § 1.732-1(c)(1), (2).*

(n21)Footnote 227.2. *IRC § 732(d);* if an *IRC Section 754* election is in effect, optional basis adjustments under *IRC § 743(b)* are made; see § 14.14 for a discussion.

(n22)Footnote 227.3. *IRC § 732(d)*, in effect for distributions occurring after December 15, 1999; *Treas Reg § 1.732-1(d)(4).*

(n23)Footnote 227.4. *Treas Reg § 1.732-1(d)(5).*

(n24)Footnote 227.5. *IRC § 732(f)*, eff generally for distributions made after July 14, 1999 (Pub L No 106-170, § 538(b)).

(n25)Footnote 227.5.1. *Treas Reg § 1.732-3; see Treas Reg § 1.1502-34.*

(n26)Footnote 227.6. *IRC § 732(f)(1).*

(n27)Footnote 227.7. *IRC § 732(f)(3)(A).*

(n28)Footnote 227.8. *IRC § 732(f)(3)(A).*

(n29)Footnote 227.9. *IRC § 732(f)(3)(B).*

(n30)Footnote 227.10. *IRC § 732(f)(1)*

(n31)Footnote 227.11. *IRC § 732(f)(1).*

(n32)Footnote 227.12. *IRC § 732(f)(2).*

(n33)Footnote 227.13. *IRC § 732(f)(6).*

(n34)Footnote 227.14. *IRC § 732(f).*

(n35)Footnote 227.15. See *IRC § 732(f).*

(n36)Footnote 227.16. *IRC § 732(f)(7).*

(n37)Footnote 227.17. *IRC § 732(f)(4).*

(n38)Footnote 227.18. *IRC § 732(f)(5).*

(n39)Footnote 228. *IRC § 735(b).*

(n40)Footnote 229. *IRC § 735(a).*

(n41)Footnote 230. *IRC § 735(c).*

(n42)Footnote 231. *IRC* § 731(c).

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Federal Taxes Affecting Real Estate

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CHAPTER 14 Partnerships and Limited Liability Companies *

*1-14 Federal Taxes Affecting Real Estate § 14.13***§ 14.13 Sale or Exchange of a Partnership Interest****[1] In General**

The measure of gain or loss on the sale of a partnership interest is the difference between the amount realized by the partner and the partner's adjusted basis in the partnership. n232 The character of the gain or loss is generally capital. The exception to this rule occurs when the partnership holds "Section 751 assets," such as unrealized receivables and substantially appreciated inventory. Money or other property received for these items are considered to be amounts realized from the sale or exchange of property other than a capital asset. n232.1 The income or loss realized by a partner on the sale or exchange of its interest in Section 751 property is the amount of income or loss from Section 751 property (including any remedial allocations) n232.2 that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of that property. This fair market value, however, cannot be less than the amount of any nonrecourse indebtedness to which the property is subject. n232.3 The difference between the amount of capital gain or loss that the partner would realize in the absence of *IRC Section 751* and the amount of ordinary income or loss determined under this rule is the transferor's capital gain or loss on the sale of its partnership interest. n232.4

Example:

A buys Y's interest in personal service partnership XY for \$17,000 when the balance sheet of the partnership (which uses the cash receipts and disbursements method of accounting) is as follows:

Assets	Adjusted Basis	Fair Market Value
Cash	\$5,000	\$5,000
Loans receivable	10,000	10,000
Other noninventory assets	7,000	11,000
Unrealized receivables	--	10,000
	--	--

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	\$22,000_	\$36,000_
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
Liabilities and capital--		
Liabilities	\$2,000	\$2,000
Capital--		
Partner X	10,000	17,000
Partner Y	10,000_____	17,000_____
	_____	_____
	\$22,000_____	\$36,000_____
	_____	_____
	_____	_____
	_____	_____

The total amount realized by Partner Y is \$18,000, consisting of the purchase price (\$17,000) plus \$1,000, Partner Y's share of the partnership liabilities assumed by A. Partner Y's basis in his partnership interest is \$11,000 (\$10,000 capital account, plus \$1,000, Y's share of partnership liabilities). Therefore, Y has realized a \$7,000 gain (\$18,000 received, less \$11,000 basis) on the sale of his partnership interest.

The character of this gain will be determined under *IRC Section 751* because the partnership holds unrealized receivables. *IRC Section 751* states that the amount of money (or property) received in exchange for a partnership interest and attributable to unrealized receivables must be treated as ordinary income instead of capital gain. In this example, a portion of the purchase price was paid in exchange for Y's one-half interest in the unrealized receivables. Therefore, \$5,000 (one-half of the \$10,000 of unrealized receivables) of Y's gain will be ordinary income, and \$2,000 will be capital gain.

Several types of distributions of partnership property to a partner can be treated as a sale or exchange of the distributed property between the partner and the partnership. First, a sale occurs when a distributee partner receives "*IRC Section 751* property" (e.g., unrealized receivables and substantially appreciated inventory) in "exchange" for the partner's interest in the partnership. Similarly, a deemed sale occurs when a distributee partner receives cash, capital assets or property used in the trade or business in "exchange" for the partner's interest in "*IRC Section 751* property." n233 The distribution by a partnership of a lower tier partnership interest constitutes an exchange of that partnership interest for purposes of determining whether there has been a termination of the low tier partnership. See *Section 14.08[2]* above.

These rules do not apply if there are no *IRC Section 751* assets or if the distributee partner receives only its pro rata share of each category of assets of the partnership. The character of the gain or loss, as between the distributee partner and the partnership, depends on the nature of the assets distributed. Partnerships must file a separate information return for each *IRC Section 751(a)* exchange of an interest in that partnership. n234

Under certain circumstances, if a partnership distribution has the effect of reducing or eliminating built-in gain (i.e., the property had a fair market value that was greater than its tax basis in the hands of the contributing partner) associated with property contributed to the partnership, or causes a shifting of the built-in gain to partners other than the

contributing partner or to assets other than the contributed property, some or all of such built-in gain may become taxable at the time of the distribution. These rules most commonly apply to so-called "mixing-bowl transactions," where economic ownership of one asset is, in substance, exchanged for another asset through a series of partner/partnership transactions. One example of a mixing-bowl transaction would be a situation where low-basis, built-in gain property is contributed by one partner and cash is contributed by another partner. The low-basis property is subsequently distributed by the partnership to the partner who contributed cash, or the partnership distributes cash to the partner who contributed the property. Because of the general nonrecognition rules governing partnership contributions and distributions, this exchange of property rights through a series of partner/partnership transactions could generally occur tax-free. Accordingly, Congress enacted *IRC Section 704(c)(1)(B)* and *IRC Section 737* to prevent such perceived abuses of the partnership rules.

Under *IRC Section 704(c)(1)(B)*, if property is contributed to a partnership by one partner and distributed to another partner within seven years of the contribution, any built-in gain associated with such property is recognized at the time of the distribution (but only to the extent the gain would have been recognized under *IRC Section 704(c)* if the partnership had sold the property for its fair market value at the time of distribution).

In 1992, Congress recognized that *IRC Section 704(c)(1)(B)* could be subverted by simply structuring a transaction so that low-basis property would remain in the partnership and high-basis property would be distributed to the partner contributing low-basis property (accomplishing the same economic exchange of property rights). As a result, Congress enacted *IRC Section 737*, which provides that a distribution of property (other than a distribution of the property that was contributed by the distributee) within seven years of the contribution will trigger the recognition of built-in gain on the property contributed by the distributee partner to the extent of the lesser of:

- (1) the amount that would have been recognized under *IRC Section 704(c)(1)(B)* if the property that was contributed by the distributee partner had been distributed to another partner; or
- (2) the excess of the value of the distributed property (other than cash) over the tax basis of the distributee partner's interest in the partnership at the time of the distribution.

IRC Section 737 does not apply to constructive distributions caused by the technical termination of a partnership under *IRC Section 708(b)(1)(B)*.ⁿ²³⁵ In addition, neither *IRC Section 704(c)(1)(B)* nor *737* applies to an incorporation of a partnership by any method of incorporation (other than pursuant to a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction.ⁿ²³⁶ Consequently, care should be exercised in structuring the incorporation of a partnership in situations where property has been contributed to the partnership within the preceding seven years, to ensure that an improper incorporation method does not prevent the achievement of the nonrecognition goals.

IRC Section 737 applies only to the extent that a transaction is a distribution under *IRC Section 731*. It does not apply, however, to the extent that the distribution is treated as a sale or exchange under *IRC Section 751(b)*.ⁿ²³⁷ The regulations also set forth additional transactions to which *IRC Section 737* does not apply;ⁿ²³⁸ clarify the manner of determining the amount of the excess distribution,ⁿ²³⁹ the amount of the net pre-contribution gain,ⁿ²⁴⁰ and the character of the gain recognized by the distributee partner under *IRC Section 737*,ⁿ²⁴¹ and specify the basis adjustments that must be made when *IRC Section 737* applies to a distribution.ⁿ²⁴²

There are many similarities between the types of situations where *IRC Section 704(c)(1)(B)* or *IRC Section 737* apply and situations where the disguised-sale rules apply, because both types of transactions involve transfers of property to a partnership that are linked in some manner to transfers of property from a partnership. In determining which set of rules applies to a particular transaction, all of the relevant facts and circumstances must be analyzed. As discussed above, if the transfers are so inextricably linked that they lack the economic substance of bona fide partner/partnership

transactions, the disguised-sale rules of *IRC Section 707(a)(2)(B)*, rather than *IRC Section 704(c)(1)(B)* or *IRC Section 737*, would apply. This result presumably would occur regardless of the amount of time that passes between the transactions. If instead, the contributing partner bears significant entrepreneurial risks of ownership during the period of time between the "contribution" and "distribution," and the transfers occur within a seven-year time period, the disguised sale rules would probably *not* apply, but *IRC Section 704(c)(1)(B)* or *IRC Section 737* would potentially apply.

The effect of being subject to the disguised-sale rules rather than *IRC Section 704(c)(1)(B)* or *IRC Section 737* can be significant. Under *IRC Section 707(a)(2)(B)*, no deferral in the recognition of the built-in gain associated with the "contributed" property is generally permitted because the sale is considered to occur at the time of the purported contribution of the property to the partnership (unless the transaction, when viewed as a whole, resembles an installment sale and qualifies for installment sale treatment). Under *IRC Section 704(c)(1)(B)* and *IRC Section 737*, on the other hand, some deferral may occur because the built-in gain is not recognized until the "triggering distribution event" occurs. Moreover, if the value of the contributed property declines below the *IRC Section 704(b)* book value of the asset during the intervening period, the amount of the built-in gain triggered under *IRC Section 704(c)(1)(B)* or *IRC Section 737* would generally be reduced or eliminated accordingly.

However, it should also be noted that *IRC Section 704(c)(1)(B)* and *IRC Section 737* are somewhat less forgiving than *IRC Section 707(a)(2)(B)* in certain situations. For example, if a partner contributes built-in gain property to a partnership, and the partnership is subsequently incorporated by distributing the partnership's assets in liquidation of the partners' interests therein followed by a contribution of such assets to a corporation in exchange for stock in an *IRC Section 351* transaction within seven years of the original property contribution, *IRC Section 737* automatically treats the transaction as a taxable event. A different result would be obtained under the disguised-sale rules because *IRC Section 707(a)(2)(B)* merely disregards the form of the purported partner/partnership transactions and reconstitutes the transaction based on its economic substance, whether it be a sale, exchange or tax-free contribution (i.e., in this case, the transaction may have merely been recharacterized as a "disguised *IRC Section 351* exchange" rather than a taxable event if only *IRC Section 707* applied to the transaction).

[2] Section 751 Assets

Judicial decisions before the enactment of the 1954 Internal Revenue Code allowed capital gains treatment on the sale or exchange of a partnership interest, regardless of the presence or absence of assets that, if sold by the partnership, would yield ordinary income. This position led to a concern that "collapsible partnerships" would rival "collapsible corporations" as tax avoidance devices. Congress responded in 1954 by enacting *IRC Section 751*. The basic goal underlying this section is the prevention of the conversion of ordinary income into capital gain.

A typical example of a collapsible entity is a partnership created to develop a tract of houses. The completed houses represent the partnership's inventory. However, before the houses are sold, the partners could sell their partnership interests and attempt to obtain capital gain treatment on the sale. In essence, the partners would receive capital gain treatment for selling inventory which, when otherwise sold, would have resulted in ordinary income. This technique was effectively eliminated by the enactment of *IRC Section 751*.

The terms "unrealized receivables" and "inventory" or "substantially appreciated inventory," as used throughout this chapter, are used with reference to *IRC Section 751* assets. Under *IRC Section 751*, these terms generally include all assets that have ordinary income potential. As such, the words are terms of art and include many items not generally associated with the normal meanings of receivables and inventory.

"Unrealized receivables" are amounts receivable for goods delivered or services performed, to the extent that they have not been previously included in income by the partnership. A typical example is the accounts receivable of a cash-basis partnership. However, the term "unrealized receivables" also includes potential depreciation recapture on real and

personal property (*IRC Sections 1250 and 1245*) computed as if the assets were sold by the partnership at their fair market value. There are also several other items described as "unrealized receivables," but they will not be discussed in this chapter since they are not generally applicable to real estate partnerships. n243

The term "inventory items" means: (1) property of the partnership of the kind described in *IRC Section 1221(a)(1)*, any other property of the partnership that is not a capital asset or an asset used in a trade or business within the meaning of *IRC Section 1231* and any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in the three preceding provisions. n244

Basically, "substantially appreciated inventory" is inventory items of the partnership (as described above) with a fair market value that exceeds 120 percent of the partnership's basis in the inventory. This mathematical test can be easily made once the "substantially appreciated inventory" items have been identified. n245

In determining whether partnership property is inventory, property that is not inventory to the partnership, but would be inventory in the hands of the selling or distributee partner, will be considered inventory of the partnership. n246

Under *IRC Section 751(a)*, the amount of money, or the fair market value of any property received by a transferor partner in exchange for all or part of its interest in a partnership, that is attributable to *IRC Section 751* assets produces ordinary income. Similarly, *IRC Section 751(b)* provides that if a partner receives a non-pro rata distribution of unrealized receivables or substantially appreciated inventory or receives a non-pro rata distribution of other property, such that the economic effect of the transaction as between the distributee partner and the partnership is an exchange of an interest in the other property for an interest in the unrealized receivables and substantially appreciated inventory, the transaction is treated as a taxable sale or exchange and produces ordinary income.

[3] Look-Through Capital Gain Under *IRC Section 1(h)*

IRC § 1(h) can come into play when a partnership interest is sold. That section provides maximum capital gains rates in three categories. For tax years ending on or after May 6, 2003, and before January 1, 2009, n246.1 the lowest capital gains tax rate is 15 percent (5 percent for taxpayers in the 15-percent regular income tax bracket). n246.2 For tax years beginning after December 31, 2007 and before January 1, 2009, a 0 percent capital gains rate applies for taxpayers in the 15 percent regular income tax bracket (*IRC Section 1(h)(1)(B)*). For taxable years that include May 6, 2003, the 15-percent (or 5-percent) rate applies only to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect of applying the lower rates to sales or exchanges of a partnership interest (and installment payments received) on or after May 6, 2003. n246.3 For tax years ending before May 6, 2003 and beginning after December 31, 2008, the lowest capital gains tax rate is 20 percent, or 10 percent for taxpayers in the 15-percent regular tax bracket. n246.4

If one of the above lowest capital gains rates does not apply, a 25-percent n246.5 or 28-percent rate n246.6 applies.

Capital gain attributable to the sale or exchange of an interest in a pass-thru entity held for more than one year generally is in the 15-percent rate category. There can be a look-through capital gain from the sale of a partnership interest. Look through capital gain includes the share of *IRC Section 1250* capital gain that is allocable to an interest in a partnership. n246.7 *IRC Section 1250* capital gain for this purpose means the capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if *IRC Section 1250(b)(1)* included all depreciation and the applicable percentage under *IRC Section 1250(a)* were 100 percent. n246.8 In determining whether a partnership has *IRC Section 1250* capital gain, the partnership is treated as owning its proportionate share of the *IRC Section 1250* property of any partnership in which it owns an interest, either directly or indirectly through a chain of partnerships. n246.9

When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there is taken into account in determining the partner's unrecaptured *IRC Section 1250* gain n246.10

the amount of *IRC Section 1250* capital gain that would be allocated, taking into account any remedial allocation n246.11 to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its *IRC Section 1250* property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology applies to determine the *IRC Section 1250* capital gain recognized by the transferor, except that the partnership is treated as transferring only a proportionate amount of each *IRC Section 1250* property determined as a fraction. The fraction is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. n246.12

[4] Limitation With Respect to Net *IRC Section 1231* Gain

In determining a transferor partner's net *IRC Section 1231* gain n246.13 for purposes of *IRC Section 1(h)(6)(B)*, the transferor partner's allocable share of *IRC Section 1250* capital gain in partnership property is not treated as *IRC Section 1231* gain, regardless of whether the partnership property is used in the trade or business. *IRC Section 1(h)(6)(B)* limits the amount of unrecaptured *IRC Section 1250* gain recognized as a consequence of sales, exchanges, and conversions described in *IRC Section 1231(a)(3)(A)* to the taxpayer's net *IRC Section 1231* gain n246.13.1 for the taxable year.

Treasury believes that because the transfer of an interest in a partnership is not described in *IRC Section 1231(a)(3)(A)*, the limitation provided in *IRC Section 1(h)(6)(B)* regarding *IRC Section 1231* property is not applicable with respect to those transfers. Accordingly, regulations require that where a partner sells an interest in a partnership, the partner must take into account the entire allocable share of *IRC Section 1250* capital gain in determining the unrecaptured *IRC Section 1250* gain under *IRC Section 1(h)(6)(A)*, without regard to the limitation set forth in *IRC Section 1(h)(6)(B)*. n246.13.2

[5] Residual Long-Term Capital Gain or Loss

The amount of residual long-term capital gain or loss recognized by a partner on account of the sale or exchange of an interest in a partnership equals the amount of long-term capital gain or loss that the partner would recognize under *IRC Section 741* (pre-look-through long-term capital gain or loss) minus the amount of look-through capital gain determined as discussed above. n246.14

[6] Sale of Partnership Interest With Divided Holding Period

If a partner sells or exchanges the partner's entire interest in a partnership, any capital gain or loss recognized is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less. n246.15

A selling partner is permitted to identify the portion of a partnership interest sold with its holding period if the following requirements are met: n246.16

- The partnership is a publicly traded partnership; n246.17
- The partnership interest is divided into identifiable units with ascertainable holding periods;
- The selling partner can identify the portion of the interest transferred; and
- The selling partner elects to use the identification method for all sales and exchanges of interests in the partnership after September 21, 2000. The election is made by the selling partner's using the actual

holding period of the portion of the partner's interest in the partnership first transferred after September 21, 2000 in reporting the transaction for federal income tax purposes.

If a partner has a divided holding period in a partnership interest, and sells a portion of it, and the above provision regarding publicly traded partnerships does not apply, then the holding period of the transferred interest is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the transferor partner would realize if the entire interest in the partnership were transferred in a fully taxable transaction immediately before the actual transfer. n246.18

[7] Holding Period for Partnership Interests

A gain or loss on the sale or exchange of a partnership interest is generally capital in nature. Whether the gain or loss is short-term or long-term depends on whether the partnership interest has been held by the transferor for at least one year. n246.19 The holding period of a partnership interest is measured from the date of acquisition of the partnership interest itself, and not from the dates of acquisition by the partnership of specific partnership properties. n246.20 There may be a divided holding period with respect to an interest in a partnership. The holding period of a partnership interest will be divided if a partner acquires portions of an interest at different times or if an interest is acquired in a single transaction that gives rise to different holding periods. n246.21 The holding period of a portion of a partnership interest generally is determined based on a fraction. The numerator is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator is the fair market value of the entire partnership interest (determined immediately after the acquisition). n246.22 Special rules apply to determine the holding period when a partner has made cash contributions to the partnership and receives cash contributions from the partnership. n246.23 Adjustments are also made with respect to contributed *IRC Section 751* assets (unrealized receivables and inventory items). n246.24

[8] Admission of New Partners

In Revenue Ruling 84-102, n246.25 the Service concluded that, upon the admission of a new partner into an existing partnership having unrealized receivables and outstanding liabilities, the original partners were required to recognize ordinary income to the extent that their interests in partnership liabilities were correspondingly reduced. The ruling was based on the fact that the new partner received a pro rata interest in the partnership's receivables and liabilities. Since there was a decrease in the existing partners' shares of liabilities of the partnership, this decrease was treated as a constructive cash distribution to them under *IRC Section 752* which, when considered along with their decrease in receivables, made the transaction subject to *IRC Section 751*. This provision may create some surprising results for cash basis partnerships.

[9] Transfer of Partnership Interest to Satisfy Partnership Debt

When a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally must recognize cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. Recognition is required without regard to whether the cancelled debt is recourse or nonrecourse indebtedness. Any cancellation of indebtedness income recognized is allocated solely among the partners who held interests in the partnership immediately prior to the satisfaction of the debt. n246.26

A partner who is allocated cancellation of indebtedness income is entitled to exclude it if the partner qualifies for one of the various exceptions to recognition of that income, including the exception for insolvent taxpayers or that for qualified real property indebtedness of taxpayers other than subchapter C corporations. n247 The availability of each of these exceptions is determined at the partner, rather than the partnership level.

FOOTNOTES:

(n1)Footnote 232. *IRC § 1001(a)*.

(n2)Footnote 232.1. *Treas Reg § 1.751-1(a)(1)*.

(n3)Footnote 232.2. See *Treas Reg § 1.704-3(d)*.

(n4)Footnote 232.3. *Treas Reg § 1.751-1(a)(2)*; see *IRC § 7701(g)*.

(n5)Footnote 232.4. *Treas Reg § 1.751-1(a)(2)*.

(n6)Footnote 233. *IRC § 751(b)*.

(n7)Footnote 234. *IRC § 6050K*.

(n8)Footnote 235. *Treas Reg § 1.737-2(a)*.

(n9)Footnote 236. *Treas Reg § 1.737-2(c)*.

(n10)Footnote 237. *Treas Reg § 1.737-1(a)(2)*.

(n11)Footnote 238. *Treas Reg § 1.737-2*.

(n12)Footnote 239. *Treas Reg § 1.737-1(b)*.

(n13)Footnote 240. *Treas Reg § 1.737-1(c)*.

(n14)Footnote 241. *Treas Reg § 1.737-1(d)*.

(n15)Footnote 242. *Treas Reg § 1.737-3*.

(n16)Footnote 243. *IRC § 751(c)*.

(n17)Footnote 244. *IRC § 751(d)*.

(n18)Footnote 245. *IRC § 751(d)*.

(n19)Footnote 246. *IRC § 751(d)(3)*.

(n20)Footnote 246.1. Pub Law No 108-27, §§ 301(a), (d), 303.

(n21)Footnote 246.2. *IRC § 1(h)(1)(B), (C)*.

(n22)Footnote 246.3. *IRC § 1(h)(1)(C)*. In the case of gain and loss taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule. See Pub Law No 108-27, § 301(c).

(n23)Footnote 246.4. *IRC § 1(h)(1)(C)*., before amendment by Pub Law No 108-27; see Pub Law No 108-27, § 303 (sunset provision).

(n24)Footnote 246.5. *IRC § 1(h)(1)(D), (6)*.

(n25)Footnote 246.6. *IRC § 1(h)(1)(E), (4)*.

(n26)Footnote 246.7. *Treas Reg § 1.1(h)-1(b)(1), (3)(ii)*.

(n27)Footnote 246.8. *IRC § 1(h)(6); Treas Reg § 1.1(h)-1(b)(3)(i).*

(n28)Footnote 246.9. *Treas Reg § 1.1(h)-1(d).*

(n29)Footnote 246.10. *See IRC § 1(h)(6)(A)(i).*

(n30)Footnote 246.11. *See Treas Reg § 1.704-3(d).*

(n31)Footnote 246.12. *Treas Reg § 1.1(h)-1(b)(3)(ii).*

(n32)Footnote 246.13. *See IRC § 1231(c)(3).*

(n33)Footnote 246.13.1. *See IRC § 1231(c)(3).*

(n34)Footnote 246.13.2. *Treas Reg § 1.1(h)-1(b)(3)(iii).*

(n35)Footnote 246.14. *Treas Reg § 1.1(h)-1(c).*

(n36)Footnote 246.15. *Treas Reg § 1.1223-3(c)(1);* see [7], below, for a discussion of partnership interest holding periods.

(n37)Footnote 246.16. *Treas Reg § 1.1223-3(c)(2).*

(n38)Footnote 246.17. *See IRC § 7704(b).*

(n39)Footnote 246.18. *Treas Reg § 1.1223-3(c)(2)(ii).*

(n40)Footnote 246.19. *See IRC §§ 1222(1),(2),(3),(4), 1223.*

(n41)Footnote 246.20. *Gray v Commr, 11 TCM 17 (1952) ; see Lehman v Commr, 7 TC 1088 , aff'd 165 F2d 383 (2nd Cir 1948) .*

(n42)Footnote 246.21. *IRC § 1366(a)(1).*

(n43)Footnote 246.22. (c).

(n44)Footnote 246.23. *Treas Reg § 1.1223-3(b)(2),(3),(5).*

(n45)Footnote 246.24. *Treas Reg § 1.1223-3(b)(4).*

(n46)Footnote 246.25. *1984-2 CB 119 .*

(n47)Footnote 246.26. *IRC § 108(e)(8),* effective for cancellations of indebtedness occurring on or after Oct 22, 2004.

(n48)Footnote 247. *IRC § 108(a).*

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.13A

§ 14.13A Partnership Terminations

[1] In General

A partnership is treated as continuing for tax purposes if it is not terminated. n247.1 A partnership is treated as terminated only if one of the following takes place: n247.2

- (1) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership; or
- (2) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. n247.3

It should be noted that sales to other members of the partnership as well as sales to third persons may trigger a termination, but gifts, bequests, or liquidations do not. A sale of both 50 percent of capital and 50 percent of profits must occur. Thus, a sale of 30 percent of capital and 60 percent of profits does not trigger termination. n247.4 Different sales over a given twelve-month period are aggregated, but repeated sales of the same interests are ignored. For example, if within 12 months A sells a 30 percent interest to D and B sells a 30 percent interest to E, a termination has occurred. If the second sale had been from D to E, there would be no termination. n247.5

If a partnership is terminated, its taxable year closes with respect to all of its partners on the termination date. This is either the date of final winding up of business, or the date on which the critical sale or exchange occurs. n247.6 A partnership that terminates under *IRC Section 708(b)(1)(B)* must file a short-year final return for the taxable year ending with the date of its termination. The new partnership is required to file a return for its taxable year beginning after the date of termination of the terminated partnership. n247.7

No special problems exist in terminating a partnership that has actually quit doing business, but a constructive termination requires a complementary constructive formation. If a partnership is constructively liquidated because of the sale or exchange of interests, the following is deemed to occur: (1) the partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and (2) immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated

partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. n247.8

The exact consequences of a constructive termination will differ in nearly every case. A constructive termination should be avoided if at all possible, for the accounting expense alone. Sometimes it will be possible to defer sales of partnership interests to avoid the triggering number of sales within a 12-month period. n247.9

[2] Mergers and Divisions

When two or more partnerships merge or consolidate into one partnership, either (1) one of the partnerships is deemed continued and the others terminated, or (2) all are deemed terminated and a new partnership is created. Whether any of the merging partnerships are treated as continuing depends on whether the members of that partnership hold more than a 50 percent interest in profits and capital of the resulting partnership. If more than one merging partnership so qualifies, the partnership that is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership is the sole continuing one. Any other merging or consolidating partnerships are considered terminated. n247.10

If there is a merger or consolidation of partnerships, increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under *IRC Section 752*. n247.11 If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results. n247.12

In the case of the division of a partnership into separate partnerships, each resulting partnership is treated as a continuation of the prior partnership if the members of the resulting partnership had more than a 50 percent interest in profits and capital of the prior partnership. Resulting partnerships that do not pass this test are treated as new partnerships. If none of the resulting partnerships pass the test, the prior partnership is deemed terminated. n247.13 Where partners in a partnership that has been divided into two or more partnerships do not become members of a partnership that is a continuation of the prior partnership, their interests are considered liquidated as of the date of the division. n247.14

Regulations also address continuity of partnership issues with respect to upper-tier/lower-tier partnerships. If the sale or exchange of an interest in an upper-tier partnership that holds an interest in a lower-tier partnership results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership. n247.15

FOOTNOTES:

(n1)Footnote 247.1. *IRC § 708(a)*.

(n2)Footnote 247.2. *IRC § 708(b)(1)*.

(n3)Footnote 247.3. See § 14.13 for a discussion of sales and exchanges of partnership interests.

(n4)Footnote 247.4. See *IRC § 708(b)(1)(B)*.

(n5)Footnote 247.5. *Treas Reg § 1.708-1(b)(2)*.

(n6)Footnote 247.6. *Treas Reg § 1.708-1(b)(3)*.

(n7)Footnote 247.7. *Notice 2001-5, 2001-3 IRB 327* ; see *IRC §§ 443(a)(2), 6031(a)*.

(n8)Footnote 247.8. *Treas Reg § 1.708-1(b)(4)*.

(n9)Footnote 247.9. *IRC § 708(b)(1)(B)*.

(n10)Footnote 247.10. *IRC § 708(b)(2); Treas Reg § 1.708-1(c)(1)*.

(n11)Footnote 247.11. *Treas Reg § 1.752-1(f)*.

(n12)Footnote 247.12. *Treas Reg § 1.708-1(c)(1)*.

(n13)Footnote 247.13. *IRC § 708(b)(2)(B); Treas Reg § 1.708-1(d)(1)*.

(n14)Footnote 247.14. *Treas Reg § 1.708-1(d)(1)*.

(n15)Footnote 247.15. *Treas Reg § 1.708-1(b)(2)*.

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CHAPTER 14 Partnerships and Limited Liability Companies *

*1-14 Federal Taxes Affecting Real Estate § 14.14***§ 14.14 Optional Basis Adjustments**

When a person purchases an interest in a partnership from a partner, the purchaser typically pays fair market value for the interest. Often, however, the assets in the partnership have a tax basis that differs from their fair market value. If the partnership sells some assets shortly after a new partner's purchase of an interest, the new partner would have to recognize a proportionate share of the gain or loss even though the new partner has paid fair market value for the assets and has, therefore, not realized any such gain or loss. n247.16

Example:

Assume that A purchases X's interest in the XY partnership for \$10,000 on January 1.

XY Balance

Sheet_____	Tax Basis_____	Fair Market Value_____
Noninventory assets	\$10,000_____	\$20,000_
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
Partners, Capital		
Partner X	\$5,000	\$10,000
Partner Y	\$5,000_____	\$10,000_
	_____	_____
	_____	_____
	\$10,000_____	\$20,000_

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A has paid fair market value for a one-half interest in this partnership. However, if, on January 2, the partnership sells its assets for \$20,000, both A and Y would realize a \$5,000 gain (when, in fact, A is selling his one-half interest in the assets for exactly what he paid for them (\$10,000)). n247.17

A similar situation exists when the partnership makes distributions to a partner that do not constitute simply the partner's pro rata share of all the assets of the partnership. In effect, the remaining partners are buying the distributee partner's interest in some of the partnership's assets (i.e., the non-distributed assets) and although they are paying fair market value, the basis of the partnership assets does not reflect their "purchase price."

To overcome these inequities, the partnership may elect to make an optional adjustment to the basis of partnership property following certain distributions or the sale or exchange of a partnership interest. n248 The elections cover two distinct situations: (1) when the partnership distributes property to a partner in exchange for its partnership interest; n249 and (2) when a partner sells or exchanges its partnership interest in a transaction with another person. n250 In the case of a transfer of a partnership interest by sale or exchange, regulations implementing the optional basis adjustment rules detail the manner of determining the transferee's basis in the transferred partnership interest n250.1 as well as the transferee's share of the adjusted basis to the partnership of the partnership's property. n250.2

The adjustments following a sale or exchange (or transfer of an interest at death) attempt to adjust the basis of a portion of the partnership property to the amount of the purchase price (or fair market value) of the interest. This adjustment is effective only for the partner who purchased the interest. n251 Adjustments made following certain property distributions are effective for all the partners remaining in the partnership. n252

This election must be made by the partnership as an entity. Also, if the partnership initially elects to make an adjustment following either a sale or an exchange of interest or a distribution because the adjustment is favorable, it must continue to make both favorable and unfavorable adjustments on all similar future transactions. This means that, although in the year of the election, the partnership or individual partner may benefit by having a basis increase; in succeeding years, similar transactions may require adjustments that decrease the basis of the assets. n252.1

Any increase or decrease in the adjusted basis of partnership property under *IRC Section 734(b)* or *IRC Section 743(b)* must be allocated in a manner that has the effect of reducing the difference between the fair market value and the adjusted basis of the partnership properties, or in any other manner permitted by regulations. n252.2 These increases or decreases arising from a distribution of, or transfer of an interest attributable to, capital assets, Section 1231 property, or any other partnership property must be allocated to partnership property of a like character. The basis of any property, however, cannot be reduced below zero. In the case of distributions of property, if a basis adjustment is prevented by the absence of property or by insufficient basis for that property, then the adjustment must be applied to later-acquired property of a like character, in accordance with regulations. n252.3 Regulations contain special basis allocation rules where one or more assets represent income in respect of a decedent n252.4 and for transferred basis exchanges. n252.5

In applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. n252.6 Any decrease in basis that, absent this provision, would have been allocated to the stock is allocated to other partnership assets. n252.7 If the decrease in

basis exceeds the basis of the other partnership assets, then gain must be recognized by the partnership in the amount of the excess. n252.8

FOOTNOTES:

(n1)Footnote 247.16. See *IRC* § 702(a).

(n2)Footnote 247.17. See *IRC* § 702(a).

(n3)Footnote 248. *IRC* § 754.

(n4)Footnote 249. *IRC* § 734.

(n5)Footnote 250. *IRC* § 743.

(n6)Footnote 250.1. *Treas Reg* § 1.743-1(c).

(n7)Footnote 250.2. *Treas Reg* § 1.743-1(d).

(n8)Footnote 251. *Id.*

(n9)Footnote 252. *IRC* § 734.

(n10)Footnote 252.1. *IRC* § 754.

(n11)Footnote 252.2. *IRC* § 755(a); see *Treas Reg* § 1.743-1(e).

(n12)Footnote 252.3. *IRC* § 755(b); *Treas Reg* § 1.755-1(a), (b)(1), (2), (3).

(n13)Footnote 252.4. *Treas Reg* § 1.755-1(b)(4).

(n14)Footnote 252.5. *Treas Reg* § 1.755-1(b)(5).

(n15)Footnote 252.6. *IRC* § 755(c)(1), effective for distributions after Oct 22, 2004.

(n16)Footnote 252.7. *IRC* § 755(c)(2).

(n17)Footnote 252.8. *IRC* § 755(c).

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.14A

§ 14.14A Required Basis Adjustments When There Is a Substantial Built-In Loss

[1] Distributions of Partnership Property

A basis adjustment must be made to undistributed partnership property under *IRC Section 734(b)* in the case of a distribution with respect to which there is a substantial basis reduction. n252.9 A substantial basis reduction means a downward adjustment of more than \$250,000 that would be made to the basis of partnership assets if an *IRC Section 754* election were in effect. n252.10

Example:

Assume that A and B each contributed \$2.5 million to a newly formed partnership and C contributed \$5 million, and that the partnership purchased LMN stock for \$3 million and XYZ stock for \$7 million. Assume that the value of each stock declined to \$1 million. Assume LMN stock is distributed to C in liquidation of its partnership interest. There is a substantial basis adjustment because the \$2 million increase in the adjusted basis of LMN stock (described in *IRC Section 734(b)(2)(B)*) is greater than \$250,000. Thus, the partnership is required to decrease the basis of XYZ stock (under *IRC Section 734(b)(2)*) by \$2 million (the amount by which the basis of LMN stock was increased), leaving a basis of \$5 million. If the XYZ stock were then sold by the partnership for \$1 million, A and B would each recognize a loss of \$2 million. n252.11

[2] Transfers of Partnership Interests

[a] In General

A basis adjustment must be made to partnership property whenever there is a transfer of a partnership interest with respect to which there is a substantial built-in loss. The basis adjustment is mandatory, and not elective. n252.12 For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than \$250,000 the fair market value of the partnership property. n252.13

[b] Special Rule for Electing Investment Partnerships

An electing investment partnership is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property, in the case of a transfer of a partnership interest. n252.14 In lieu of the

partnership basis adjustments, a partner-level loss limitation rule applies. Under this rule, the transferee partner's distributive share of losses (determined without regard to gains) from the sale or exchange of partnership property is not allowed, except to the extent it is established that the partner's share of those losses exceeds the loss recognized by the transferor partner. n252.15 An electing investment partnership must furnish to any transferee partner the information necessary to enable the partner to compute the amount of losses disallowed under this rule. n252.16

In the event of successive transfers, the transferee partner's distributive share of those losses is not allowed, except to the extent that it is established that they exceed the loss recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance under this rule). Losses disallowed under this rule do not decrease the transferee partner's basis in its partnership interest. n252.17 Thus, on subsequent disposition of its partnership interest, the partner's gain is reduced (or loss increased) because the basis of the partnership interest has not been reduced by those losses. This provision is applied without regard to any termination of a partnership. n252.18 In the case of a basis reduction to property distributed to the transferee partner in a nonliquidating distribution, the amount of the transferor's loss taken into account under this rule is reduced by the amount of the basis reduction. n252.19

An electing investment partnership is a partnership that satisfies the following requirements: n252.20

- it makes an election under the provision that is irrevocable except with the consent of the Secretary;
- it would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for certain exemptions under that Act;
- it has never been engaged in a trade or business;
- substantially all of its assets are held for investment;
- at least 95 percent of the assets contributed to it consist of money;
- no assets contributed to it had an adjusted basis in excess of fair market value at the time of contribution;
- all partnership interests are issued by the partnership pursuant to a private offering prior to the date that is 24 months after the date of the first capital contribution to the partnership;
- the partnership agreement has substantive restrictions on each partner's ability to cause a redemption of the partner's interest, and
- the partnership agreement provides for a term that is not in excess of 15 years.

[3] Exception for Securitization Partnerships

An exception to the rules requiring partnership basis adjustments in the case of transfers of partnership interests and distributions of property to a partner applies for securitization partnerships. n252.21 The exception provides that a securitization partnership is not treated as having a substantial built-in loss in the case of a transfer of a partnership interest, n252.22 or as having a substantial basis reduction in the case of a partnership distribution. n252.23 It is therefore not required to make basis adjustments to partnership property. Partnership basis adjustments remain elective for securitization partnerships. n252.24 Unlike in the case of an electing investment partnership, n252.25 the partner-level loss limitation rule does not apply in the case of a securitization partnership. n252.26

For this purpose, a securitization partnership is any partnership the sole business activity of which is to issue securities

that provide for a fixed principal (or similar) amount and that are primarily serviced by the cash flows of a discrete pool (either fixed or revolving) of receivables or other financial assets that by their terms convert into cash in a finite period, but only if the sponsor of the pool reasonably believes that the receivables and other financial assets comprising the pool are not acquired so as to be disposed of. n252.27

The Conference Report to the legislation n252.28 states that the rules requiring partnership basis adjustments on transfers or distributions are not to be avoided through dispositions of pool assets. It is intended that an electing investment partnership or securitization partnership that subsequently fails to meet the definition will be subject to the partnership basis adjustment rules of the provision with respect to the first transfer of a partnership interest (and, in the case of a securitization partnership, the first distribution) that occurs after the partnership ceases to meet the applicable definition and to each subsequent transfer (and distribution, in the case of a securitization partnership). The Conference Report also states that none of the new partnership loss transfer provisions can be avoided through the use of tiered partnerships.

FOOTNOTES:

(n1)Footnote 252.9. *IRC § 734(a), (b)*, effective generally for distributions made after Oct 22, 2004.

(n2)Footnote 252.10. *IRC § 734(d)(1)*.

(n3)Footnote 252.11. *IRC § 734*.

(n4)Footnote 252.12. *IRC § 743(a), (b)*, effective generally for transfers occurring after Oct 22, 2004.

(n5)Footnote 252.13. *IRC § 743(d)*.

(n6)Footnote 252.14. *IRC § 743(e)(1)*.

(n7)Footnote 252.15. *IRC § 743(e)(2)*.

(n8)Footnote 252.16. *IRC § 6031(f)*; the Conference Report to the legislation enacting *IRC § 6031(f)*, however, indicates an intent that this requirement be administered leniently and in a manner that minimizes the need for the partnership to furnish information to the transferee partner that the transferee partner has obtained from the transferor.

(n9)Footnote 252.17. *IRC § 743(e)(3)*.

(n10)Footnote 252.18. *IRC § 743(e)(4)*; see *IRC § 708(b)(1)(B)* (partnership termination).

(n11)Footnote 252.19. *IRC § 743(e)(5)*.

(n12)Footnote 252.20. *IRC § 743(e)(6)*.

(n13)Footnote 252.21. *IRC §§ 734(e), 743(f)*.

(n14)Footnote 252.22. *IRC § 743(f)(1)*.

(n15)Footnote 252.23. *IRC § 734(e)*.

(n16)Footnote 252.24. See *IRC §§ 734, 743, 754*.

(n17)Footnote 252.25. See § 14.14A[1][b], above.

(n18)Footnote 252.26. *IRC § 743(f)(1)*.

(n19)Footnote 252.27. *IRC* § 743(f)(2).

(n20)Footnote 252.28. See Pub L No 108-357, § 833.

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.15

§ 14.15 Tiered Partnerships

Tiered partnerships occur when a partnership is a partner in another partnership. This arrangement is used for a variety of business, legal and tax reasons. Tiered partnerships may be used to provide anonymity for investors, ease of investment decisions, or as a tool to raise capital without changing the record ownership of the property.

Tiered partnerships were not dealt with by the drafters of the Internal Revenue Code of 1986; therefore, many questions concerning their tax treatment remain unanswered. However, the Service rulings in this area have generally been in accord with accepted tax theory. For example, the Service has ruled that the liabilities of the lower-tier partnership will be allocated to the partners of the upper-tier partnership for purposes of determining a partner's basis. n253

The Service has also ruled that the basis of the lower-tier partnership's property can be adjusted when an upper-tier partner sells or exchanges his interest, assuming both partnerships make the optional election. n254 Regulations have been issued which address continuity of partnership issues with respect to upper-tier/lower-tier partnerships. These are discussed in § 14.13A, above. n254.1

FOOTNOTES:

(n1)Footnote 253. *Rev Rul 77-309, 1977-2 CB 216* .

(n2)Footnote 254. *Rev Rul 78-2, 1978-1 CB 202 , clarified and amplified by Rev Rul 87-115, 1987-2 CB 163* .

(n3)Footnote 254.1. *See Treas Reg § 1.708-1(b)(2)*.

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CHAPTER 14 Partnerships and Limited Liability Companies *

1-14 Federal Taxes Affecting Real Estate § 14.16

§ 14.16 Publicly-Traded Partnerships

A publicly-traded partnership (PTP) is simply a limited partnership whose interests are traded on securities exchanges, a secondary market, or the substantial equivalent thereof. Generally, PTPs are characterized by large numbers of limited partners and very large trading volumes. As with other partnerships, a PTP is not a tax-paying entity. The limited partners report their share of the PTP's income or loss directly on their individual tax returns. The Tax Reform Act of 1986 generally prevented the formation of new publicly-traded partnerships to engage in active trades or businesses by providing that they would be taxed as corporations, and by allowing a ten-year transition period for such existing entities. The Taxpayer Relief Act of 1997 provides the transitioned entities with an election to continue their publicly-traded partnership status after the end of 1997 by electing to remain as partnerships, but subjecting themselves to a 3.5 percent tax on their gross income. n255

There are several benefits to the formation of a PTP. In some circumstances, assets will have a higher value when held in partnership form than when held through a taxable corporation, because profits can be realized by the owners of those assets with only a single layer of taxation when they are held in partnership form, in contrast to the double layer of taxation that is imposed when the assets are held through a taxable corporation. Therefore, the value of individual partnership interests is enhanced.

In other circumstances, however, assets can be more valuable when held through other vehicles, such as REITs, because the owner does not have to deal with the tax return complexities of receiving a form K-1 with respect to the investment. However, for those investments that are suitable for PTP status, the benefits of consolidation of ownership and operation of properties and entities can also be substantial. The PTP provides a source of equity-type financing without a dilution of the sponsoring corporation's equity or control. Another benefit of the PTP is the availability of funds for acquisitions. The PTP may issue units in exchange for assets on a tax-free basis or acquire assets for cash and fund the acquisition cost through the sale of new PTP units. The PTP also provides several attractive features to investors. The most important feature appears to be cash yield. Other significant benefits are market liquidity, flow-through of tax benefits, risk diversification, and the ability to participate as an investor in a business or a fund without any minimum investment size requirements. Despite the apparent attractiveness of PTPs, in the current economic environment, the real estate public entity sector is dominated by REITs, which can provide flow-through tax benefits for entities that are managed and viewed by Wall Street as financial corporations, and which can make acquisitions either by using traditional partnership techniques and operating partnerships or by using traditional corporate finance techniques.

Although there are exceptions for entities eligible for the transition provisions of the 1986 legislation, as a general rule *IRC Section 7704* taxes publicly-traded partnerships (PTPs) as corporations. If an existing partnership becomes publicly traded, as of the first day that a partnership is treated as a corporation, the partnership is deemed to transfer all of its assets to a newly-formed corporation and to distribute stock in the corporation to its partners in acquisition of their interests in the partnership. n256

PTPs that meet certain qualified gross income requirements (e.g., relating to home building income and most real estate rental income) are not taxed as corporations. n257 However, this exception is not available to partnerships which come within the Code definition of "regulated investment company," even if they do not qualify for the special tax treatment available to those entities. n258

FOOTNOTES:

(n1)Footnote 255. *IRC § 7704(g)*.

(n2)Footnote 256. *IRC § 7704(f)*.

(n3)Footnote 257. *IRC § 7704(c)*.

(n4)Footnote 258. *IRC § 7704(c)(3)*.

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CHAPTER 14 Partnerships and Limited Liability Companies *

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§ 14.17 Withholding with Respect to Foreign Partners

Under prior law, U.S. partnerships engaged in a U.S. trade or business had to withhold tax with respect to foreign partners only when the partnership sold a U.S. real property interest or when passive U.S. noneffectively connected income was earned. n259 Since the U.S. trade or business income of U.S. or foreign partnerships was imputed to foreign partners, the foreign partners were required to file U.S. tax returns and pay U.S. tax on their share of the partnership's other income. n260

To improve compliance with respect to the "effectively connected" income of foreign partners, withholding is now required on "effectively connected taxable income" allocated to foreign partners, whether or not any amounts are actually distributed to the foreign partners. The withholding rate is the highest rate of tax applicable to corporations and individuals, currently 35 percent for corporations and 39.6 percent for individuals. n261 When the foreign partner files its U.S. federal income tax return, the amount withheld is credited against the U.S. income tax liability of the foreign partner or refunded as an overpayment. For widely-held partnerships held through one or more nominees, the last U.S. person in the chain of ownership is required to withhold. n262 Exceptions to the withholding requirements may be provided by regulations. This change creates additional burdens for U.S. partnerships with foreign partners as well as for foreign partnerships engaged in a U.S. trade or business. It also results in reduced cash flow to foreign partners caused by delays in receiving a refund from the Service, and in effect causes partnerships with foreign partners to make distributions to foreign partners, through the withholding payment to the federal government, whether or not the partnership's business plan would otherwise have required a distribution at that time. Publicly-traded partnerships are given some relief from this provision, and are required only to withhold from distributions, subject to an election to withhold from effectively connected income. n263

FOOTNOTES:

(n1)Footnote 259. *IRC §§ 1445* (U.S. Real Property Interest), 1441 & 1442 (Passive U.S. Non Effectively-connected Income].

(n2)Footnote 260. *IRC §§ 871(b); 882; 6012(a)(1), (2).*

(n3)Footnote 261. *IRC § 1446(b)(2).*

(n4)Footnote 262. *Rev Proc 89-31, 1989-1 CB 895 .*

(n5)Footnote 263. *Id.*

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§ 14.18 Tax-Exempt Organization Partners

Before 1987, if certain requirements were met, certain tax-exempt entities could become a partner in a partnership owning debt-financed rental real property without the income from that partnership being treated as unrelated business taxable income. This rule applied even if the partnership agreement contained special allocation provisions that allocated deductions to taxable partners and income to tax-exempt partners.

In response to the abuses in this area, therefore, Congress imposed new limitations on the ability of tax-exempt partners to realize tax-exempt income from debt-financed real property. These restrictions provide that income from debt-financed real property will be treated as unrelated business taxable income to tax-exempt partners unless all partnership allocations are "qualified allocations." n264

Qualified organizations that invest in debt-financed real property through a partnership in which one or more (but not all) of the partners are qualified organizations, however, are eligible for the *IRC Section 514(c)(9)* exception only if the partnership satisfies an additional requirement. Either each allocation to a partner that is a qualified organization must be a "qualified allocation" n265 or the partnership must satisfy the requirements of *IRC Section 514(c)(9)(E)*.

To satisfy the first prong, the partner must first be a qualified organization. Qualified organizations include the following:

- Qualified pension and retirement plans qualified under *IRC Section 401*;
- Certain educational organizations; n266
- Certain title-holding corporations and trusts organized for the exclusive purpose of acquiring, holding title to, and collecting income from real property, and turning over the entire amount less expenses to certain exempt member organizations; n267 and
- Retirement income accounts of a churches (or certain other organizations). n267.1

To satisfy the "qualified allocation" test of the first prong, (1) the allocation must be consistent with that entity's being allocated the same distributive share of each item of income, gain, loss, deduction, credit and basis, and that share must

be the same during the entire period the entity is a partner in the partnership; and (2) the allocation must have substantial economic effect. Distributions made to a partner with respect to property contributed by that partner to the partnership are not taken into account for this purpose. n267.2

As for the second prong, two requirements must be met to comply with *IRC Section 514(c)(9)(E)*. First, the "fractions" rule must be met. Under this rule, the allocation of items to a partner that is a qualified organization cannot result in that partner having a percentage share of overall partnership income for any partnership taxable year greater than that partner's fractions rule percentage, as described in *Regulations Section 1.514(c)-2(c)(2)*. Second, each partnership allocation must have substantial economic effect.

FOOTNOTES:

(n1)Footnote 264. *Treas Reg § 1.514(c)-2* sets forth the requirements that a qualified organization must meet in order to qualify for the exception, under *IRC § 514(c)(9)(E)*, allowing a qualified organization to exclude income from debt-financed real property from unrelated business taxable income (UBTI).

(n2)Footnote 265. *IRC § 168(h)(6)*.

(n3)Footnote 266. See *IRC §§ 170(b)(1)(A)(ii), 509(a)(3)*.

(n4)Footnote 267. See *IRC § 501(c)(25)*.

(n5)Footnote 267.1. *IRC § 403(b)(9)*; this exception is effective for tax years beginning on or after 8/17/06.

(n6)Footnote 267.2. *IRC § 168(h)(6)(B)*; see *IRC § 704(c)*.

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CHAPTER 14 Partnerships and Limited Liability Companies *

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§ 14.19 Limited Liability Companies

[1] Introduction

All 50 states and the District of Columbia have adopted limited liability company statutes. Therefore, it is becoming increasingly common for an entity owning, developing or managing real estate to be in the limited liability company form. Because the limited liability company is still a relatively new form of ownership, this area of the law has seen many new developments in recent years.

[2] Tax Status of Limited Liability Companies

Beginning in 1997, an LLC may elect its tax status for federal purposes under the federal entity classification rules. n268 Under those rules, an LLC with at least two members may choose to be classified for federal tax purposes as either a partnership or an association (taxable as a corporation) n269 and an LLC with a single member may choose to be classified as an association (taxable as a corporation) or may choose to be disregarded as an entity separate from its owner. Many states, including Delaware, California and New York, allow LLCs to be organized with only a single member.

A single-member LLC may not elect partnership classification for federal tax purposes. n269.1 The IRS has issued two revenue rulings that explain the tax consequences of the following:

- converting from a partnership to a single-member LLC that is disregarded for tax purposes; n269.2 and
- converting from a single-member LLC that is disregarded for tax purposes to a partnership. n269.3

The conversion of a partnership into a single-member LLC terminates the partnership under *IRC Section 708(b)(1)(A)*, whether one partner sells a partnership interest to the other partner or whether multiple partners sell out to a single third party. When one partner (SP) sells a partnership interest to the other, the partnership is deemed to make a liquidating distribution of all of its assets to the two partners; following that distribution, the buying partner (BP) is treated as acquiring the assets that are deemed to have been distributed to the other partner in liquidation of his or her partnership interest. BP's basis in the assets attributable to SP's one-half interest in the partnership is the amount paid, and BP's holding period for those assets begins on the day following the day of sale. Upon termination of the partnership, BP is

considered to receive a distribution of those assets attributable to his former interest in the partnership. BP must recognize gain or loss on the deemed distribution of assets to the extent required by *IRC Section 731(a)*. BP's basis in the assets received is determined under *IRC Section 732(b)*, and BP's holding period generally includes the partnership's holding period for those assets under *IRC Section 735(b)*. n269.4

In a sale of a partnership interests by both partners to a single third party, the partnership is deemed to make a liquidating distribution of its assets to the two partners. Immediately thereafter, the purchaser is deemed to acquire, by purchase, all the former partnership's assets. The purchaser's basis in the assets is the amount paid for the partnership interests, allocated among the assets. n269.5 The purchaser's holding period in the assets begins on the day following the date of sale. n269.6

Converting to a partnership from a single-member LLC that is disregarded as a separate entity from its owner for federal tax purposes has different tax consequences, depending on whether the purchaser (P) merely purchases a 50-percent ownership interest in the LLC from the sole member (S), with S not contributing any part of the money to the LLC, or whether P contributes cash to the LLC in exchange for a 50-percent interest in the LLC. In the direct purchase from S, S must recognize gain or loss from the deemed sale to P of a 50-percent interest in each asset of the LLC. S and P are then treated as contributing their respective interests in those assets to a partnership in exchange for partnership interests. This is a tax-free event under *IRC Section 721(a)*, and the partnership's basis in the property is S's and P's adjusted bases immediately before the contribution. S's holding period for the partnership interest will include the holding period in the capital assets and Section 1231 property held by the LLC when it was converted into a partnership. P's holding period in the partnership interest will begin the day after the date of P's purchase of the LLC interest from S. n269.7

If P contributes money to the LLC in exchange for a 50-percent interest, P is treated as making a tax-free contribution to a partnership in exchange for a partnership interest under *IRC Section 721(a)*. Similarly, S is treated as contributing all the assets of the LLC to the partnership in exchange for a partnership interest. This, too, will not result in a taxable event under *IRC Section 721(a)*. P's basis in the partnership interest is the amount of money contributed, and S's basis is equal to his or her basis in the assets of the LLC which S is treated as contributing to the partnership. The partnership also takes S's adjusted basis as its own basis in the property. S's holding period for the partnership interest includes the holding period in the capital and Section 1231 assets deemed contributed to the partnership, and the partnership's holding period in the assets includes S's holding period. P's holding period for the partnership interest begins on the day following the date of P's contribution of money to the LLC. n269.8

[3] State Tax Considerations

Although the rules relating to the classification of the limited liability company as a partnership for federal income tax purposes are now greatly simplified, the rules relating to state taxation of limited liability companies, and limited partnerships that do not meet the traditional federal income tax tests for partnership status, are not as clear, and several states do not simply follow the federal lead and treat the limited liability company as a partnership. For example, in Texas, the limited liability company is subject to corporate taxes on its capital and income. n270 Likewise, Florida also does not respect the limited liability company as a partnership and subjects it to corporate tax. n271 Pennsylvania also taxes LLCs as corporations in certain circumstances. California initially announced that it would continue to apply the historic federal "four factors" test in determining whether an entity would be taxed as a partnership for California tax purposes. Tax practitioners must always check the appropriate state law to determine the state tax treatment of LLCs as well as partnerships that rely on the federal entity classification rules. When organizing an entity that may be doing business in several different states, such as a large real estate partnership that intends to acquire a geographically diversified portfolio of properties, the conservative drafting approach is to organize a limited partnership, and insure that the entity will have at least two of the traditional partnership characteristics, to avoid unnecessary state entity level taxes.

FOOTNOTES:

(n1)Footnote 268. See *Treas Reg* § 301.7701-3; see § 14.02 for a detailed discussion of the entity classification rules.

(n2)Footnote 269. *Treas Reg* § 301.7701-3(a).

(n3)Footnote 269.1. *Treas Reg* § 301.7701-3(a).

(n4)Footnote 269.2. *Rev Rul* 99-6, 1999-6 *IRB* 6 .

(n5)Footnote 269.3. *Rev Rul* 99-5, 1999-6 *IRB* 8 .

(n6)Footnote 269.4. *Rev Rul* 99-6, 1999-6 *IRB* 6 .

(n7)Footnote 269.5. See *IRC* § 732(c).

(n8)Footnote 269.6. *Rev Rul* 99-6, 1999-6 *IRB* 6 .

(n9)Footnote 269.7. *Rev Rul* 99-5, 1999-6 *IRB* 8 .

(n10)Footnote 269.8. *Rev Rul* 99-5, 1999-6 *IRB* 8 .

(n11)Footnote 270. *Tex Code Ann* § 1.171.00.

(n12)Footnote 271. *Fla Stat* §§ 608.471 and 220.03(e).

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§ 14.20 Electing Large Partnerships

Large partnerships and their partners may elect to be excluded from certain provisions of Subchapter K and instead be subject to the "simplified" rules of *IRC Sections 771 through 777*. n271.1 The simplified flow-through rules allow large partnerships to make at the partnership level a substantial number of the computations that would otherwise be required to be made at the partner level. n271.2 A "large partnership" is a partnership with 100 or more partners. n271.3 An electing large partnership will also not be subject to the TEFRA audit procedures. The usefulness of these new procedures will be determined over time.

FOOTNOTES:

(n1)Footnote 271.1. *IRC § 775(a)(1)*, eff for tax years beginning after 12/31/97.

(n2)Footnote 271.2. *IRC §§ 773, 774*.

(n3)Footnote 271.3. *IRC § 775(a)(1)(A)*.

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§ 14.21 Self-Employment Taxes of Limited Partners and LLC Members

On January 13, 1997, the Service issued proposed regulations regarding the self-employment tax treatment of limited partners, including members of LLCs that are treated as partnerships. n272 The proposed regulations replace earlier proposed regulations dealing specifically with the self-employment tax treatment of members of LLCs. The earlier proposed regulations have been withdrawn. n273

The new proposed regulations would establish rules for determining which partners of an entity treated as a partnership for federal income tax purposes are considered limited partners for purposes of *IRC Section 1402(a)(13)*. Under that statutory provision, a limited partner's distributive share of income (other than guaranteed payments for services actually rendered to or on behalf of the partnership) is excluded from "net earnings from self-employment". The proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of state law characterization of the entity. Thus, the same standards apply when determining the status of an individual owning an interest in a state law limited partnership or the status of an individual owning an interest in an LLC. Generally, an individual is treated as a limited partner under the proposed regulations unless the individual:

- (1) has personal liability for the debts of or claims against the partnership by reason of being a partner;
 - (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or
 - (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.
- n274

If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, architecture, accounting, actuarial science or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner. n275

Under *IRC Section 1402(a)(13)*, an individual's net earnings from self-employment do not include that individual's distributive share of income or loss as a limited partner. Guaranteed payments made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business, however, are included in the individual's net earnings from self-employment. n276

The proposed regulations allow an individual who is not a limited partner to exclude from net earnings from self-employment a portion of that individual's distributive share if that individual holds more than one class of interest in the partnership. Similarly, an individual who participates in the trade or business of the partnership may bifurcate his or her distributive share by disregarding guaranteed payments for services. n277

In each case, however, the bifurcation of interests is permitted only to the extent the individual's distributive share is identical to the distributive share of partners who qualify as limited partners (without regard to the bifurcation rule) and who own a substantial interest in the partnership. The effect of these rules is to exclude from an individual's net earnings from self-employment amounts that are demonstrably returns on capital invested in the partnership. n278

FOOTNOTES:

(n1)Footnote 272. *Prop Treas Reg §§ 1.1402(a)-2(g), (h), (i), (j).*

(n2)Footnote 273. *See 62 Fed Reg 1701 (1/13/97) .*

(n3)Footnote 274. *Prop Treas Reg § 1.1402(a)-2(h)(2).*

(n4)Footnote 275. *Prop Treas Reg § 1.1402(a)-2(h)(5), (6)(iii).*

(n5)Footnote 276. *Prop Treas Reg § 1.1402(a)-2(g); see IRC § 707(c).*

(n6)Footnote 277. *Prop Treas Reg § 1.1402(a)-2(h)(3).*

(n7)Footnote 278. *Prop Treas Reg § 1.1402(a)-2(h)(3)(ii).*

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§ 14.22 Avoidance of Partnership Tax Provisions By Family Joint Ventures

Spouses engaged in a qualifying family joint venture may elect to have their business not be treated as a partnership for tax purposes, and instead treat their interests in the venture as if they were sole proprietors. n279

Comment:

Small family businesses not infrequently are categorized as partnerships by default. n280 As such, they are subject to the complex partnership income tax provisions discussed in this chapter dealing with determination of tax liability, n281 contributions, n282 distributions, n283 transfers of partnership interests and basis computations. n284 Informational partnership returns are also required. This elective provision excludes a "qualified joint venture" from the partnership provisions, and specifies how income, gain, loss, deductions and credits are to be allocated reported. n285 It is intended to free husband-wife business operations from the complexity of the Internal Revenue Code partnership provisions.

The provision is available only to qualified joint ventures conducted by a husband and wife who file a joint return for the taxable year. If those conditions are satisfied, the following tax treatments apply: n286

- The joint venture will not be treated as a partnership;
- All items of income, gain, loss, deduction, and credit must be divided between the spouses in accordance with their respective interests in the venture; and
- Each spouse must take into account his or her respective share of those items as if they were attributable to a trade or business conducted by that spouse as a sole proprietor.

To be a "qualified joint venture," an undertaking must meet the following requirements: n287

- It must be a joint venture involving the conduct of a trade or business;
- The only members of the joint venture are a husband and wife;

- Both spouses materially participate in the trade or business; and
- Both spouses must elect to have the joint venture not be treated as a partnership under *IRC Section 761(f)*.

Whether the spouses "materially participate" is generally determined under the passive activity loss material participation standard, n288 except that in determining whether one spouse materially participates, the participation of the other spouse cannot be taken into account. n289

Each spouse's share of income or loss from a qualified joint venture must also be taken into account as provided in *IRC Section 761(f)* in determining the net earnings from self-employment of that spouse. n290

FOOTNOTES:

(n1)Footnote 279. *IRC § 761(f)*, effective for taxable years beginning after Dec 31, 2006 [Pub Law 110-28, § 8215(c)].

(n2)Footnote 280. See *IRC §§ 761(a), 7701(a)(2)*.

(n3)Footnote 281. See *IRC §§ 701-709*.

(n4)Footnote 282. See *IRC §§ 721-724*.

(n5)Footnote 283. See *IRC §§ 731-737*.

(n6)Footnote 284. See *IRC §§ 741-755*.

(n7)Footnote 285. *IRC § 761(f)(1)*.

(n8)Footnote 286. *IRC § 761(f)(1)*.

(n9)Footnote 287. *IRC § 761(f)(2)*.

(n10)Footnote 288. See *IRC § 469(h)*.

(n11)Footnote 289. *IRC § 761(f)(2)(B)*; see *IRC § 469(h)(5)*.

(n12)Footnote 290. *IRC § 1402(a)(17)*; also see *42 USC § 411(a)* (same rule applies under the Social Security Act).

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CHAPTER 15 Corporate Ownership of Real Estate

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CHAPTER 15 Corporate Ownership of Real Estate

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§ 15.01 Introduction

The choice of the form used to accomplish the business and investment goals of entrepreneurs and investors is vitally important when bringing a business idea to profitable reality. In the previous chapter, partnerships and certain other unincorporated associations were discussed. This chapter concentrates on corporations.

Since each form of organization has its own relative advantages and disadvantages, the objectives of the individual investor must be evaluated and adapted to the appropriate business form. Both non-tax and tax considerations must be taken into account in deciding whether to use a corporation as a real estate holding entity. See *Section 15.01A* for a discussion of non-tax considerations and *Section 15.02* for a discussion of tax considerations. Also, if corporate form is desired, either a C corporation or S corporationⁿ¹ may be used, each with dramatically different tax consequences. Details of the S corporation election and the advantages and disadvantages of using an S corporation to hold property are discussed in *Section 15.04*.

The corporation is an organization separate and apart from its owners. It is a legal entity created under authority of the state and is limited in the scope of its activity by an approved charter. It pays an income tax on its earnings (at least in the case of C corporations); may be solely responsible for its debts; operates under authority of a board of directors elected by the shareholders; and continues in existence, unaffected by any transfer of ownership or by the death, retirement, or bankruptcy of its shareholders.

Rights of ownership are evidenced by shares of stock issued by the corporation in accordance with its charter. Most corporations have only one class of stock outstanding (common stock) so that each share has the same voting rights, claims to dividends, and status upon liquidation. The rights of ownership can, however, be varied by the issuance of separate classes of stock having different voting power, preferred dividend treatment, or preferred status upon liquidation. Thus, the degree of risk desired by each investor may be accommodated.

The nature of the stock certificate (i.e., its claim to potential dividends and net assets upon liquidation) gives it intrinsic value which may be used by the corporation and shareholder alike. A corporation may issue its stock to acquire the stock or assets of another business, to compensate its officers, to provide additional incentives to key employees, or to raise additional funds for expansion. Corporation stock may be used by shareholders to secure loans, to establish trusts for their children, to effect charitable contributions, to exchange for other property, or merely to serve as a convenient form of investment.

FOOTNOTES:

(n1)Footnote 1. See *IRC §§ 1361 through 1379*.



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CHAPTER 15 Corporate Ownership of Real Estate

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§ 15.01A Nontax Advantages and Disadvantages to C Corporations

[1] In General

Although the choice of entity for holding real estate may be primarily dependent on tax considerations, nontax considerations must also be weighed. The weight to be given to any factor will vary in each case, based on the facts and circumstances of the venture, as well as the objectives and concerns of the parties.

Nontax considerations include the following:

- ease of raising capital; n2
- limitation of liability; n3
- continuity of existence; n4
- transferability of interest and equity; n5
- management and control; n6 and
- compliance with statutory and regulatory requirements. n7

[2] Ease of Raising Capital

The corporate form of ownership can provide a versatile vehicle for attracting equity capital. Investors can limit their liability to the amount of capital contributed. In addition, the C corporation can issue different classes of stock to provide flexibility among different investors with respect to voting power, preferred dividend treatment, or preferred status upon liquidation.

Rights of corporate ownership are evidenced by shares of stock issued by the corporation in accordance with its charter and state law. The nature of a stock certificate (i.e., its claim to potential dividends and net assets upon liquidation) gives it intrinsic value that can be used by the corporation and by the shareholders. A corporation may issue its stock to acquire the stock or assets of another business, to compensate its officers, to provide additional incentives to key

employees, or to raise additional funds. Shareholders may use corporate stock to secure loans, establish trusts, make charitable contributions, or pay for other property.

A practitioner must review any issuance of shares with a view to requirements of securities laws. If an issuance of stock is not exempt, all applicable federal registration requirements must be complied with. If an issue is exempt, the practitioner must assure that all necessary state and federal disclosure statements and reports are filed, and that any necessary legends are placed on share certificates.

[3] Limitation of Liability

The use of a C corporation can shield shareholders from liabilities of the business, if the corporation is validly formed, complies with necessary formalities, and is adequately capitalized. This advantage is especially important for principals with substantial income or assets outside of the corporation.

Planning Note:

The limited liability afforded by incorporation is of less practical value than might be expected, especially for closely-held corporations. Limited liability is available with other entities as well, such as a limited partnership, LLC, or trust. In addition, insurance is often available to cover many anticipated liabilities, regardless of the entity used. Moreover, shareholders of closely-held corporations are often required by lenders and creditors to personally guarantee loans made to the corporation. State law may prevent an individual from avoiding liability for his or her own tortious conduct by transacting business through a corporation. Finally, personal liability may also be imposed under the *alter ego* doctrine if the corporate entity is disregarded.

[4] Continuity of Existence

A corporation may have unlimited duration. The death of a shareholder does not terminate the existence of the corporation. Unless specific actions are taken to dissolve the corporation in accordance with state law, either voluntarily or involuntarily, the corporation will continue to exist. Use of the C corporation entity can, therefore, avoid inadvertent entity termination problems faced by LLCs, S corporations, and partnerships when members, shareholders, or partners die or dispose of their interests to third parties.

The advantage of perpetual existence, however, is likely to be of little importance if a key individual shareholder responsible for the success of the corporation dies. This attribute may be of more importance in a larger C corporation with a degree of economic strength, as lending institutions may then take into consideration favorably the corporate feature of perpetual existence.

[5] Transferability of Interest and Equity

A sale of an interest in real estate held by a corporation may take place through a sale of either the real estate itself by the corporation or by a sale of shares of the corporation's stock by the shareholders. Transfers of ownership in the form of shares is relatively uncomplicated, both for the corporation and for the shareholders. In addition, unlike S corporations, which are limited to 100 shareholders, n8 C corporations are not restricted in the number or type of shareholders they may have. This allows C corporations to issue multiple classes of stock with different rights that can approximate a partnership's ability to make special allocations.

This relative ease of transferability is probably illusory for most closely-held corporations, however. Although publicly-traded stock is readily transferable, shares of stock in a closely-held corporation are usually no more readily transferable than interests in other closely-held business entities. This is primarily due to the restricted market for shares of stock in closely-held corporations and because of the significant restrictions that may have been (and often should be)

placed on the ability to dispose of those shares in buy-sell agreements.

Although perhaps less so for real estate holding entities than for closely-held corporations conducting other businesses, valuation of the shares itself may also be problematic and thus restrict marketability, especially if fractional or minority interest discounts are involved.

[6] Management and Control

An advantage of using a corporation to hold real estate is the centralized management that a corporation can provide. The management and control of a corporation is delegated by shareholder election to a board of directors. The board of directors, in turn, appoints officers, who are responsible for implementing the policies of the board of directors. Therefore, unless special voting or other rights are given to minority shareholders by the corporate articles of incorporation or bylaws, majority shareholders may control the management of a corporation even if there is dissent from minority shareholders.

[7] Compliance With Statutory and Regulatory Requirements

Compliance with state and federal laws, including state corporate laws and federal and state securities laws, is likely to be more complex and costly for corporations than for other entities. Statutory procedures for incorporating and maintaining corporate status must be followed, and all significant corporate actions undertaken by the board of directors must be documented. Shareholder meetings must also be properly noticed and regularly held, in compliance with state law. This may require more detailed recordkeeping than for other entities.

FOOTNOTES:

(n1)Footnote 2. See [2], below, for a discussion.

(n2)Footnote 3. See [3], below, for a discussion.

(n3)Footnote 4. See [4], below, for a discussion.

(n4)Footnote 5. See [5], below, for a discussion.

(n5)Footnote 6. See [6], below, for a discussion.

(n6)Footnote 7. See [7], below, for a discussion.

(n7)Footnote 8. See *IRC § 1361(b)(1)*, effective for taxable years beginning after Dec 31, 2004.



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CHAPTER 15 Corporate Ownership of Real Estate

1-15 Federal Taxes Affecting Real Estate § 15.02

§ 15.02 Tax Advantages and Disadvantages to C Corporations

[1] Tax Advantages

The use of a C corporation as a real estate holding entity can have several tax advantages:

- C corporations (other than closely-held C corporations and personal service corporations) are not subject to passive activity loss restrictions. Thus, C corporations may offset active income, portfolio income, and passive income with passive losses generated within the corporation. n9 For this purpose, a closely-held C corporation is one in which, at any time during the last half of the tax year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. n10 In contrast, partners and LLC members are subject to the passive activity losses for items passed through from partnerships and LLCs. n11
- A C corporation may be able to time the flow of income to shareholders more effectively than a partnership because the payment of corporate dividends is at the discretion of the officers or board of directors. This allows a corporation to give shareholders a more even flow of income over several years. In contrast, a partner's share of a partnership's income is taxable in the year it is earned, whether it is distributed or not. This can be a disadvantage, especially if income fluctuates widely from year to year. n12
- If the corporation can qualify as a small business corporation, an individual who incurs a loss on the sale of the stock may treat the loss as ordinary, rather than capital, in nature, up to \$50,000 per year (\$100,000 for spouses filing a joint return). n13

[2] Tax Disadvantages

The key tax disadvantage to the C corporation form is the double taxation caused by the corporate-level tax imposed on the C corporation. After-tax income of the C corporation is taxed again in the hands of the shareholders when dividends are paid to them, yet the corporation is not allowed a deduction for the dividends paid. n14 This can be a significant disadvantage with respect to income produced by real estate, and especially when gain is recognized upon the sale or liquidation of real property owned by the C corporation. n15 Double taxation of dividends is less of a concern during years in which dividends are taxable at lower capital gains rates (generally tax years beginning after December 31,

2002, and before January 1, 2009), but it is still a disadvantage to the C corporation form of business entity. n15.1

Planning Note:

For smaller, closely-held corporations with shareholders who actively participate in the business, double taxation may be less of a problem because the corporation can deduct reasonable compensation, and the compensation will thus be deducted by the corporation and taxed only once, as income received by the recipient. n16 What constitutes "reasonable" compensation in a given case, however, can be a hotly-contested issue, and the IRS frequently challenges salary deductions paid to corporate officers or shareholders as excessive. An error in what is considered to be "reasonable" in a given situation can result in increased tax, as well as significant penalties and interest. n17

Yet another disadvantage to C corporations is that property may be transferred tax-free to C corporations (and S corporations) in exchange for stock only if the transferors have "control" of the corporation immediately thereafter. n18 In contrast, transfers of property to partnerships, limited partnerships and LLCs are tax-free without regard to any control requirement. n19

A further disadvantage is that C corporations are not eligible for the low maximum capital gains rates that are available for individuals. Therefore, an individual or pass-through entity anticipating a sizable capital gain might wish to postpone any incorporation until the gain has been recognized. n20

An additional disadvantage is that losses and deductions sustained by a C corporation do not pass through directly to the shareholders, but can only be carried forward or back by the corporation, to be applied against corporate profits in those years. n21 Shareholders of a C corporation are thus unable to take advantage of the pass-through of losses and deductions that is available for partnerships, LLCs, and S corporations. This inability of a C corporation to pass through items directly to shareholders can be especially important with respect to passive income or losses. If a pass-through entity is used, the individual investors may be able to shelter passive items of the entity against other passive income and losses from other sources. n22 In contrast, C corporation capital and ordinary losses may only be carried back and forward to offset corporate profits in other years. n23 Furthermore, losses from sales or exchanges of capital assets by a corporation are allowed only to the extent of gains from those sales or exchanges. n24

Another key disadvantage to using a C corporation is that corporations, unlike LLCs, partnerships, or S corporations, are subject to both the accumulated earnings tax n25 and the tax on personal holding companies. n26 Noncorporate entities are not subject to these taxes. n27

A final tax disadvantage to C corporation status for years in which the collapsible corporation rules are in effect is that a C corporation may be characterized as a collapsible corporation under *IRC Section 341*. Collapsible status causes income from a sale or exchange of the corporation's stock, or a distribution, that would otherwise be capital gain to be converted into ordinary income. n28 The collapsible corporation rules, however, have been temporarily repealed and do not apply effective for tax years beginning after December 31, 2002, and before January 1, 2009. n28.1

FOOTNOTES:

(n1)Footnote 9. See *IRC § 469(a)(1), (2)(B), (C)*.

(n2)Footnote 10. *IRC §§ 465(a)(1)(B), 469(j)(1), 542(a)(2)*.

(n3)Footnote 11. *IRC § 469(a)(2)(A), (B)*.

(n4)Footnote 12. *IRC § 702(a), (c)*.

(n5)Footnote 13. *IRC § 1244(a), (b)*.

(n6)Footnote 14. *IRC* §§ 11, 61(a)(7).

(n7)Footnote 15. See *IRC* §§ 331, 336, 1201.

(n8)Footnote 15.1. See *IRC* §§ 1(h)(11), 61(a)(7), 301(c)(1), 316; see Pub Law No 108-27, §§ 302(f)(1), 303 (effective date and sunset provisions for dividend taxation at capital gains rates).

(n9)Footnote 16. *IRC* §§ 61, 162; see *Treas Reg* §§ 1.162-7, 1.162-9.

(n10)Footnote 17. *Elliot's, Inc v Commr*, 716 F.2d 1241 (9th Cir. 1983) ; *Rutter v Commr*, 853 F.2d 1267 (5th Cir 1988) ; *Kennedy v Commr*, 671 F.2d 167 (6th Cir 1982) ; *Rapco Inc v Commr*, TC Memo 1995-128 , aff'd 85 F.3d 950 (2nd Cir 1996) ; *Trucks, Inc v US*, 588 F. Supp 638 (D. Neb 1984) , aff'd 763 F.2d 339 (8th Cir 1985) ; *Labelgraphics, Inc v Commr*, TC Memo 1998-343 ; *The Escrow Connection, Inc v Commr*, TC Memo 1997-17 ; *PMT, Inc v Commr*, TC Memo 1996-303 .

(n11)Footnote 18. *IRC* §§ 351(a), 1371(a).

(n12)Footnote 19. *IRC* § 721(a).

(n13)Footnote 20. See *IRC* §§ 1(h), 11, 1201(a).

(n14)Footnote 21. *IRC* §§ 11, 165, 172.

(n15)Footnote 22. See *IRC* § 469.

(n16)Footnote 23. *IRC* §§ 172, 1212(a).

(n17)Footnote 24. *IRC* § 1211(a).

(n18)Footnote 25. See *IRC* § 531; see *IRC* § 1363(a); see § 15.05[2] for a discussion.

(n19)Footnote 26. See *IRC* § 541; see *IRC* § 1363(a); see § 15.05[3] for a discussion.

(n20)Footnote 27. See *IRC* §§ 531, 532, 541, 542.

(n21)Footnote 28. *IRC* § 341(a); see § 15.07 for a discussion of collapsible corporations.

(n22)Footnote 28.1. Pub Law No 108-27, § 302(e)(4)(A), *repealing IRC* § 341; see Pub Law No 108-27, §§ 302(f)(1), 303 (effective date and sunset provisions for repeal of collapsible corporation rules).



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CHAPTER 15 Corporate Ownership of Real Estate

1-15 Federal Taxes Affecting Real Estate § 15.03

§ 15.03 Use in Tax Planning

[1] Incorporation Issues

[a] In General

Incorporating a real estate operation sometimes expands the market for the real estate involved. Stock in a corporation owning real estate is more readily transferable than the real estate itself. A stockholder can transfer partial ownership to others and still retain control of the operation of the real estate as majority owner of a corporation's stock.

Owners of real estate usually can incorporate tax free by transferring properties and related mortgages to a corporation solely in exchange for the corporation's stock, provided that the transferors, as a group, are in control of the corporation immediately after the transfer. n29 Control, for this purpose, means ownership of at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent of the total number of shares of all other classes of stock. n30 The basis of property to the corporation is generally the same as the tax basis to the transferors. n31

Real estate entrepreneurs, however, sometimes face special problems on incorporation. Because of high leverage and accelerated deductions which are characteristic of real estate projects, the adjusted basis of the transferred property may be less than the amount of the mortgage note on the property. This situation frequently arises in the case of real estate rental projects for which depreciation charges exceed mortgage principal amortization. n32 In that case, if incorporation is contemplated, it would be more advisable to have the corporation purchase the property to avoid this problem: When there is an excess of liabilities over the tax basis of the property transferred, that excess results in taxable gain to the transferor at the date of transfer to the corporation. n33 Gain must be recognized even if a transferor remains personally liable for, or guarantees, the liabilities transferred to the corporation. n33.1

One way around this, however, may be by having the corporation record a loan receivable for the excess, as was done in the *Lessinger* case. n34 The Court held there that gain was not recognized because the taxpayer's note had value to the corporation, and it incurred a cost to acquire that note. The corporation had basis in the note equal to the face amount, and, therefore, liabilities did not exceed the tax basis of assets. Similarly, the taxpayer might simultaneously transfer a promissory note to the corporation with a basis that exceeds the amount of gain that would otherwise have to be recognized. Provided the note represents genuine indebtedness, the aggregate basis of the transferred property would exceed the transferred liabilities, and therefore gain recognition under *IRC Section 357(c)* would not be triggered. n34.1

In unusual situations, a tax-free incorporation may be disadvantageous. For example, a step-up in basis may be desired. This may be accomplished by having the corporation transfer cash and/or short-term notes to the transferor, in addition to stocks and securities. This boot will cause gain to be recognized to the extent of the money and the fair market value of the other boot received, and the step-up in basis will be equal to the gain recognized. To avoid a tax-free incorporation, the transfer must evidence all the elements of a bona fide sale or else the notes run the risk of being reclassified as equity. n35

Another way to have a taxable incorporation is simply to ensure that the transferors to the corporation own less than 80 percent of the stock of the corporation immediately after the transfer, thereby violating the control requirement of *IRC Section 351(a)*.

The IRS has issued a ruling explaining that *IRC Section 357(c)* (regarding the assumption of liabilities) does not apply to transactions that qualify as acquisitive D reorganizations, i.e. those that meet the acquisition and distribution requirements of *IRC Section 354(b)*. These transfers may also be transfers to which *IRC Section 351* applies. The ruling extends to other acquisitive reorganizations--to A, C, and G reorganizations that meet the acquisition and distribution requirements of *IRC Section 354(b)*. The rationale of the ruling is that the transferor ceases to exist in the reorganization, and therefore cannot be enriched by the assumption of liabilities. n35.1

Example 1:

A, an individual, owned all of the stock of corporation X and corporation Y. Y acquired all of the assets of X in exchange for an amount of Y stock constituting control n35.2 and the assumption by Y of X's liabilities. Pursuant to the plan, X liquidated and distributed the Y stock to A. At the time of the acquisition, the sum of the X liabilities assumed by Y exceeded X's total adjusted basis in the property transferred to Y. Further, the value of X's assets transferred to Y exceeded the amount of X's liabilities assumed by Y, and, immediately after the exchange, the value of Y's assets exceeded the amount of Y's liabilities. The transaction qualified as a D reorganization n35.3 and also as an exchange to which *IRC Section 351* applied. In the transaction, X ceases to exist and, therefore, cannot be enriched as a result of the assumption of its liabilities. Therefore, *IRC Section 357(c)(1)* does not apply to X's transfer of assets to Y in exchange for Y stock and assumption of X's liabilities notwithstanding the fact that the transfers were also exchanges to which *IRC Section 351* applied. n35.4

Example 2:

A, an individual, owned all of the stock of corporation X. B, an individual unrelated to A, owned all of the stock of corporation Y. Y acquired all of the assets of X in exchange for Y voting stock and the assumption by Y of X's liabilities. Pursuant to the plan, X liquidated and distributed the Y voting stock to A. At the time of the acquisition, the sum of the X liabilities assumed by Y exceeded X's total adjusted basis in the property transferred to Y. Further, the value of X's assets transferred to Y exceeded the amount of X's liabilities assumed by Y, and, immediately after the exchange, the value of Y's assets exceeded the amount of Y's liabilities. Simultaneously, and as part of the overall plan, B contributed property to Y in exchange for additional Y stock so that immediately after the transaction, B held more than 50 percent of the vote and of the value of all the stock of Y. The Y stock issued to X along with the Y stock issued to and held by B immediately after the transaction constituted control of Y. n35.5 The transfer by X of all of its assets to Y in exchange for Y voting stock and assumption of liabilities, followed by the liquidation of X, qualified as a C reorganization n35.6 Further, X's transfer of assets to Y in exchange for Y voting stock along with B's transfer of property to Y in exchange for additional Y stock was an exchange to which *IRC Section 351* applied. As a result of the transaction, X ceases to exist and, therefore, cannot be enriched as a result of the assumption of its liabilities. Therefore, *IRC Section*

357(c)(1) does not apply to X's transfer of assets to Y in exchange for Y stock and assumption of X's liabilities notwithstanding the fact that the transfers were also exchanges to which *IRC Section 351* applied. n35.7

[b] Assumptions of Liability

A transfer of property to a corporation in which the corporation assumes liabilities of the transferring taxpayer in a tax-free incorporation transaction generally is not subject to tax, unless the amount of liabilities assumed exceeds the basis in the property (as mentioned in [a], above). n36 However, an exception to this general rule arises when the principal purpose in the assumption of liabilities by the corporation is to avoid federal income taxes or when the business purpose is not bona fide. If the court determines that there is a tax avoidance purpose or a lack of a bona fide business purpose for the assumption of the liabilities by the corporation, the shareholder is treated as having received cash in the transaction equal to the amount of liabilities assumed, and this will most likely result in the recognition of gain on the transaction. This provision might be invoked, for example, when a taxpayer borrows against property, retains the borrowed cash for personal purposes, and then contributes the property to the corporation. n37

Except as may be provided in regulations, a recourse liability is treated as having been assumed if, based on all facts and circumstances, the transferee has agreed and is expected to satisfy the liability, whether or not the transferor has been relieved of the liability. n38 A nonrecourse liability is generally treated as having been assumed by the transferee of any asset subject to that liability, except as may be provided by regulations. n39 The amount of the nonrecourse liability so treated, however, is reduced by the lesser of the following: n40

- (1) the amount of such liability which an owner of other assets not transferred to the transferee and also subject to that liability has agreed with the transferee to, and is expected to, satisfy; or
- (2) the fair market value of those other nontransferred assets, determined without regard to *IRC Section 7701(g)* (which treats the fair market value as being not less than the amount of any nonrecourse indebtedness to which the property is subject).

Planning Note:

For transfers occurring before October 19, 1998, both the assumption of a liability and the acquisition from the taxpayer of property subject to a liability were not treated as boot under *IRC Section 357(a)*. n41 For transfers after October 18, 1998, the *IRC Section 357(d)* boot rules, at first glance, apply only to assumptions of a taxpayer's liabilities, and not to acquisitions of property that are subject to a liability. n42 The statutory clarification of when liability is assumed, however, as discussed above, has the effect of including under *IRC Section 357(d)* specified recourse and nonrecourse liabilities when property subject to those liabilities is transferred as part of the transaction. n43

[2] "Straw" Corporations

The use of the corporate form to avoid usury laws has developed as a result of occasional periods of high interest rates. In many states, usury laws are not applicable to corporations. Therefore, it has become necessary, in some cases, to arrange financing through a "straw" corporation, even though the real estate transaction, for all other purposes, is carried out in some other organizational form, such as a limited partnership. The tax problem involved is having the corporation recognized as the legal borrower and mortgagor, but in such a way that the tax law "ignores" the corporation for purposes of income, deductions, gain and loss. A misstep in this situation will likely have the Service asserting that the corporation is a viable taxable entity fully subject to taxation.

The Supreme Court provided guidance on this subject in *Bollinger v. Commissioner*. n44 The issue in that case was

what standard should be used in determining whether a corporation is the mere agent of its owners and, therefore, not taxable on the income it receives as a separate tax-paying entity.

The Court held that if the corporation conducts itself in essentially the same manner as an independent agent would, a principal-agent relationship is established. If, therefore, a corporation receives income which really belongs to its owners, it should not be taxed on it, regardless of whether the corporation is compensated for its services in the same manner as an independent agent.

FOOTNOTES:

(n1)Footnote 29. *IRC § 351.*

(n2)Footnote 30. *IRC § 368(c).*

(n3)Footnote 31. *IRC § 362(a).*

(n4)Footnote 32. At the time of purchase of real estate, the basis in the real estate is rarely less than the amount of any indebtedness it secures. In some instances, however, a purchaser of real estate may actually be able to borrow an amount in excess of the purchase price of the real estate.

(n5)Footnote 33. *IRC § 357(c).*

(n6)Footnote 33.1. *Owen v Commr, TC Memo 1987-375, affd 881 F2d 832 (9th Cir 1989); Rosen v Commr, 62 TC 11 (1974), affd without published opinion 515 F2d 507 (3rd Cir 1975); Seggerman Farms, Inc, et al v Commr, TC Memo 2001-99, affd 2002-2 USTC P 50,728 (7th Cir 2002); Tester v Commr, 327 F2d 788 (7th Cir 1964).*

(n7)Footnote 34. *Lessinger v Commr, 872 F2d 519, 89-1 USTC P 9254 (2d Cir 1989).*

(n8)Footnote 34.1. *See Peracchi v Commr, 143 F3d 487 (9th Cir 1998).*

(n9)Footnote 35. *Curry v US, 396 F2d 630, 68-2 USTC P 9439 (5th Cir 1968).*

(n10)Footnote 35.1. *Rev Rul 2007-8, 2007-7 IRB 469.*

(n11)Footnote 35.2. *See IRC § 368(c).*

(n12)Footnote 35.3. *See IRC § 368(a)(1)(D).*

(n13)Footnote 35.4. *Rev Rul 2007-8, 2007-7 IRB 469.*

(n14)Footnote 35.5. *See IRC § 368(c).*

(n15)Footnote 35.6. *See IRC § 368(a)(1)(C).*

(n16)Footnote 35.7. *Rev Rul 2007-8, 2007-7 IRB 469.*

(n17)Footnote 36. *IRC § 357(a), (c).*

(n18)Footnote 37. *IRC § 357(b).*

(n19)Footnote 38. *IRC § 357(d)(1)(A).*

(n20)Footnote 39. *IRC § 357(d)(1)(B).*

(n21)Footnote 40. *IRC § 357(d)(2).*

(n22)Footnote 41. *IRC § 357(a)*, before amendment by Pub Law No 106-36.

(n23)Footnote 42. *IRC § 357(a)*.

(n24)Footnote 43. See *IRC § 357(d)*.

(n25)Footnote 44. *Bollinger v Commr*, 485 US 340 (1988) . See also *Lukins v Commr*, *TC Memo* 1992-569 ; *Fredericks v Commr*, *TC Memo* 1994-27 . *Bollinger* is discussed in many articles, including Liebmann, "Disregarding the Corporate Nominee: *Commissioner v. Bollinger*," 42 *Tax Lwyr* 371 (1989); Meyer, "Use of Related Corporations as Agents After *Bollinger*," 6 *J Tax'n Investments* 91 (1989).



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CHAPTER 15 Corporate Ownership of Real Estate

1-15 Federal Taxes Affecting Real Estate § 15.04

§ 15.04 Election to be Treated as an S Corporation

If statutory requirements are met, n45 an entity may elect to be taxed as an S corporation. Use of an S corporation may avoid the double taxation problems of the C corporation but still retain advantages of the corporate form. n45.1

For federal tax purposes, an S corporation is generally not subject to taxes at the entity level. Instead, income and losses from the S corporation flow directly through to the shareholders, rather than being taxed at the corporate level. n45.2

[1] Advantages and Disadvantages to S Corporations

[a] Advantages

The S corporation, as a choice of entity for owning real estate, has several advantages. Tax advantages include the following:

- No corporate-level federal taxation of income, n45.3 other than taxation of certain built-in gains, n45.4 and a special tax imposed when passive investment income of the corporation exceeds 25 percent of gross receipts and the corporation has accumulated earnings and profits. n45.5 The ability to avoid this second level of taxation is usually enough of a benefit to warrant an S election, even though there is a relative parity between the highest individual tax rate, 35 percent, n45.6 and the 34 percent rate that applies to most corporate income between \$75,000 and \$10 million. n45.7 Note that an additional 5 percent tax is imposed on corporate taxable income exceeding \$100,000, with a cap of \$11,750 on this additional tax liability. The result is an effective tax rate of 39 percent on corporate taxable income between \$100,000 and \$335,000. A 35 percent tax rate applies on corporate taxable income in excess of \$10 million. An additional 3 percent tax is imposed on corporate taxable income exceeding \$15 million, with a cap of \$100,000 on this additional tax liability. The result is an effective tax rate of 38 percent on corporate taxable income between \$15 million and \$18,333,333. n45.8 Any advantage that may exist from a rate spread differential will usually be offset by the avoidance of a second level of tax, which usually will favor an S corporation election. Future tax rate changes may always occur of course, and corporate and individual state tax rates must also be considered in weighing the tax advantage or disadvantage from an S corporation election.
- Pass-through of corporate income, deductions and losses to the shareholders. n45.9 Subject to

passive loss limitations, n45.10 shareholders may use these pass-through losses to offset other taxable income, to the extent of their basis in the stock and debt of the corporation. n45.11 S corporation losses and deductions that exceed basis may be carried over indefinitely and may be deducted in future years to the extent that the shareholders' basis in the stock and debt of the corporation increases. n45.12 Furthermore, if a shareholder's stock in an S corporation is transferred to a spouse, or to a former spouse incident to a divorce, any suspended loss or deduction with respect to that stock is treated as incurred by the corporation with respect to the transferee in the subsequent taxable year. n45.13 It should be noted, however, that an individual S corporation shareholder's filing for bankruptcy will prevent any allocation of S corporation items to that shareholder. All of an S corporation's items for the year are allocated to the bankruptcy estate if the shareholder's bankruptcy filing occurs before the corporation's year end. The reason is that the income or loss of the S corporation is determined as of the last day of the corporation's taxable year, and, therefore, an individual shareholder does not receive or accrue any items from the S corporation before filing for bankruptcy. n45.14

- S corporation shareholders are not subject to the self-employment tax on pass-through items from the S corporation. n45.15

- Stock in an S corporation may qualify as Section 1244 stock. If so, a loss on the disposition of the stock of up to \$50,000 (\$100,000 for spouses filing a joint return) may be treated as an ordinary loss, rather than a capital loss. n45.16

- S corporations are not subject to the corporate alternative minimum tax, n45.17 the corporate-level environmental tax, n45.18 the personal holding company penalty tax, n45.19 or the tax on accumulated earnings. n45.20

- S corporations are not subject to the mandatory rules that apply to partnerships regarding allocations of pre-contribution gain or loss to the contributor of the property. In some cases, this can be an advantage because it allows an allocation of deductions and of gain to other shareholders if the property is distributed to a shareholder based on stock ownership. n45.21

- The statutory tax framework that applies to S corporations, although restrictive, is relatively simple and straightforward, especially when compared to the complex partnership tax provisions. n45.22

Several non-tax advantages to using an S corporation to hold real estate should also be noted:

- S corporations insulate their shareholders from liability. As with C corporations, this advantage may be somewhat illusory due to the availability of insurance for all entities and the likelihood that principal shareholders will be required to personally guarantee corporate obligations. n45.23

- S corporations have perpetual existence, although, as with C corporations, this advantage is likely to be of little importance if a key individual shareholder who is responsible for the success of the corporation dies. This attribute may be of more importance in a larger S corporation with a degree of economic strength, as lending institutions may then take into consideration favorably the corporate feature of perpetual existence.

- Unlike limited partners in a limited partnership, S corporation shareholders have rights to full participation in the management of the S corporation's business.

- The availability of qualified subchapter S subsidiaries (QSSSs) allows an S corporation to insulate different projects from the liabilities of other projects. The availability of QSSSs also enhances

segregation of businesses in a manner that can facilitate an ultimate split-off of a business. The availability of QSSSs may also permit a single group of investors to create multiple QSSSs to satisfy lenders that require bankruptcy-remote entities of ownership of separate properties. n45.24

- If an eventual public offering of stock (and C corporation status) is anticipated, the S corporation can be a good initial choice because initial losses may be passed through to shareholders, n45.25 and yet the conversion to C status will not require a liquidation of the entity or re-filing of corporation status documents with the state. This is not true if the initial entity converting to a C corporation is a partnership or LLC.

[b] Disadvantages

Several disadvantages to using an S corporation to hold real estate should be noted:

- Pass-through losses from an S corporation may be deducted only to the extent of a shareholder's adjusted basis in the S corporation stock and the adjusted basis of any loans the shareholder has made directly to the S corporation. n45.26 A shareholder's basis in S corporation stock and debt does not include any corporate-level debt owed to third parties, even if the shareholder guarantees the debt. n45.27 This, in turn, can limit the shareholder's ability to take advantage of the S corporation's deductions and losses that are passed through. n45.28 In contrast, the basis of a partner's investment in a partnership can include partnership debts, such as mortgage obligations, for which the partnership (but not the individual partner) is liable. The same is true of LLCs that are treated as partnerships. n45.29 Thus, an S corporation shareholder may be less able to deduct entity-level losses than a similarly situated partner in a partnership or a member in an LLC. n45.30

Planning Note:

Because of the above limitation, if real estate owned by an entity is subject to a large outside mortgage, the S corporation may be an unwise choice of entity. If the investment in real estate is made in cash or with a small mortgage, the S corporation choice may be more appropriate.

- S corporations cannot provide for special allocations of income, deductions, and loss inconsistent with a shareholder's *pro rata* ownership of stock. n45.31 This limitation is a significant contrast to partnerships, which may provide special allocations of partnership items, as long as they have substantial economic effect. n45.32

- S corporations are restricted in the number and types of eligible shareholders, as noted in [2], below; this disadvantage may be fatal with a large real estate development, since developers and other participants (often partnerships or other entities) are frequently compensated with an ownership interest in the project. n45.33

- S corporations may have only one class of stock; this prevents S corporations from issuing a mere profits interest in the entity that differs from the rights of other shareholders. n45.34

- The optional basis adjustment election that is available for assets owned by a partnership or LLC when a partnership interest or interest in the LLC is sold is not available for an S corporation. n45.35

- Inadvertent termination of S corporation status for failing to comply with S corporation requirements. Although some inadvertent S corporation and qualified subchapter S subsidiary

terminations may be cured and S corporation status (or qualified subchapter S subsidiary status) retroactively reinstated, n45.36 termination of S corporation status will cause the entity to be treated as a C corporation, resulting in undesired tax consequences. Inadvertent termination can occur if the corporation ceases to be a small business corporation, n45.37 as where ineligible persons become shareholders, or where there are more than 100 shareholders, n45.38 or the one-class-of-stock requirement is violated. n45.39 It can also occur if the "passive investment income" of the corporation exceeds 25 percent of gross receipts for three consecutive taxable years and the corporation has accumulated earnings and profits at the close of each of those years. n45.40 Although passive investment income includes rents, n45.41 other than those derived in an active trade or business of renting property, n45.42 this potential termination should not be worrisome to a real estate holding entity because of the ease of eliminating accumulated earnings and profits during any year.

- Like C corporations, S corporations may be costlier to implement than partnerships or LLCs because of the necessity of observing all of the corporate formalities, such as preparing and filing various documents, adopting bylaws, and holding regular meetings.

- Converting a C corporation to an S corporation may result in the imposition of an entity-level tax on unrealized built-in gains that exist at the time of conversion. The tax is imposed if the S corporation disposes of the property within ten years of the date on which the S corporation begins. n45.43 The recognition period is temporarily reduced from 10 years to 7 years, effective for any taxable year beginning in 2009 and 2010. Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax will be imposed under *IRC Section 1374* after the seventh taxable year the S corporation election is in effect. n45.43.1

- Conversion from an S corporation into an LLC or partnership can entail great expense if the S corporation holds appreciated property because the corporation must first be liquidated, with resulting gain. n45.44

- Similarly, if appreciated property is to be distributed by an S corporation to a shareholder, the corporation may recognize gain, n45.45 which, in turn, must be passed through to, and recognized by, the shareholders. n45.46 In this situation, a partnership or LLC can be a preferable entity choice, because there will be no entity-level gain recognized on the distribution. n45.47 Rather, the partner will generally take the partnership's adjusted basis in the property distributed, and recognize gain or loss accordingly when the property is later sold or disposed of. n45.48 A partner who contributes property with a built-in gain to a partnership may, however, recognize gain if that property is distributed to another partner within seven years of the contribution, n45.49 or if the partnership distributes other property to the contributing partner within seven years of the contribution. n45.50

[2] Requirements for S Corporation Status

In order to qualify as an S corporation, the following requirements must be met:

- The corporation must have 100 or fewer shareholders. n45.51 For this purpose, a husband and wife (and their estates) are treated as one shareholder. n45.52 In addition, all members of a family (and their estates) are treated as one shareholder. n45.53 Detailed regulations set forth rules regarding ownership of stock by family members. n45.53.1

- Each shareholder must be an individual, an estate, a qualifying trust, or a specified exempt organization. n45.54 If an electing small business trust is a shareholder, n45.55 the total number of current beneficiaries (that is, the number of beneficiaries to whom the trustee may "spray" trust property)

is generally included in determining whether the corporation has 100 or fewer shareholders. n45.56 An ESBT, however, is treated as the shareholder during any period in which there is no potential current beneficiary of the trust. n45.56.1 An IRA or Roth IRA may be a shareholder of a bank or a depository institution holding company that is an S corporation, but only to the extent of bank or holding company stock held by the IRA on October 22, 2004; n45.57 the individual for whose benefit the trust was created is treated as the shareholder. n45.58 IRAs and Roth IRAs are not otherwise eligible S corporation shareholders. n45.58.1

- No nonresident aliens may be shareholders. n45.59
- The corporation may have only one class of stock (but qualified "straight debt" obligations, discussed below, will not be treated as a second class of stock). n45.60

For this purpose, however, differences in common stock voting rights are disregarded. Therefore, an S corporation can have voting and nonvoting stock, as long as all other stock rights are equal. n45.61 In general, the regulations treat an S corporation as having only one class of stock if all outstanding shares of the corporation have identical rights as to distributions and liquidation proceeds. n45.62

The two-classes-of-stock prohibition can create problems when an S corporation issues debt. If the debt is not carefully structured, the Service may recharacterize it as equity. n45.63 The likely result is that the S corporation will be considered as having two classes of stock.

Most S corporations are able to avoid this problem by making sure that their debt qualifies for the "straight debt safe harbor." n45.64 The Code provides that straight debt cannot be treated as a second class of stock. To be straight debt, the debt must be a written unconditional promise to pay a fixed sum of money on demand or on a specified date. The interest rate and payment dates cannot depend on the corporation's profits, the corporation's discretion, or similar factors. The debt cannot be convertible into stock and the creditor must be an individual (other than a nonresident alien), an estate, a trust which could be an S corporation shareholder, or "a person which is actively and regularly engaged in the business of lending money."

[3] Making the Election

To qualify as an S corporation, the corporation must file a completed Form 2553 with the IRS. n45.65

Taxpayers may request relief from a variety of late S corporation elections, under either of two revenue procedures. The first is *Revenue Procedure 2007-62*. n45.65.1 Under this procedure, an entity may request relief if the following requirements are met: n45.65.2

- the entity fails to qualify for its intended status as an S corporation on the first day that status was desired solely because of the failure to file a timely Form 2553 with the applicable campus;
- the entity has reasonable cause for its failure to file a timely Form 2553;
- the entity seeking to make the S corporation election has not filed a tax return for the first taxable year in which the election was intended;
- the application for relief is filed under this *Revenue Procedure 2007-66* no later than six months after the due date of the tax return (excluding extensions) of the entity seeking to make the election for the first taxable year in which the election was intended; and

- no taxpayer whose tax liability or tax return would be affected by the S corporation election (including all shareholders of the S corporation) has reported inconsistently with the S corporation election, on any affected return for the year the S corporation election was intended.

To request relief for a late S corporation election under *Revenue Procedure 2007-62*, the entity must file a properly completed Form 2553 with a Form 1120S for the first taxable year the entity intended to be an S corporation. A properly completed Form 2553 includes a statement establishing reasonable cause for the failure to file the S corporation election timely. The forms must be filed together no later than six months after the due date of the tax return (excluding extensions) of the entity for the first taxable year in which the S corporation election was intended. These items constitute the application requesting relief. n45.65.3 If the requirements are satisfied and the forms properly filed, the IRS will determine whether the requirements for granting relief for the late S corporation election have been satisfied. n45.65.4 An entity that does not meet the requirements for relief under *Revenue Procedure 2007-62* may request relief for a late S corporation election following *Revenue Procedure 2003-43*. n45.65.5 Relief under *Revenue Procedure 2003-43* is available only if the request for relief is filed within 24 months of the due date of the election. n45.65.6

An entity that makes a timely election to be classified as an S corporation is deemed to have elected to be classified as an association taxable as a corporation for federal entity classification purposes. n45.66 A separate election to be classified as an association by filing a Form 8832 n45.67 is not necessary. If both the entity's S corporation election (Form 2553) and its entity classification election (Form 8832) are filed late, the above deemed election rule does not apply. In that case, a taxpayer must generally apply for relief through a letter ruling. However, there are two revenue procedures-- *Revenue Procedure 2007-62* n45.68 and *Revenue Procedure 2004-48*, n45.68.1 that provide a simplified method for taxpayers to request relief for a late S corporation election and a late corporate classification election intended to be effective on the same date that the S corporation election was intended to be effective. Either procedure is in lieu of the letter ruling process ordinarily used, and avoids the user fees that ordinarily apply for letter rulings. Both revenue procedures as they relate to late S corporation elections and late corporate classification elections are discussed in Chapter 14.

A partnership that has converted to corporation tax status either under entity selection regulations n45.68.2 or under a state law formless conversion statute is allowed to make an S election effective for the corporation's first taxable year. If it does so, the corporation will not be deemed to have an intervening short taxable year in which it was a C corporation. n45.68.3

Example:

On January 1 of Year 1, X, a calendar year taxpayer, is organized in State as an unincorporated entity that is classified as a partnership for federal tax purposes. X elects under regulations n45.68.4 to be treated as an association (corporation) for federal tax purposes, effective January 1 of Year 2. On February 1 of Year 2, X files an S corporation election effective January 1 of Year 2. There is no person who held stock in X on January 1 of Year 2 who does not hold stock at the time the election is made.

Upon making the election to be treated as an association for federal tax purposes, X is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association. Immediately thereafter X is deemed to liquidate by distributing the stock of the association to its partners. These deemed steps are treated as occurring immediately before the close of the day before the election is effective. n45.68.5 Thus, the partnership's taxable year ends on December 31 of Year 1, and the association's first taxable year begins on January 1 of Year 2. Therefore, the partnership will not be deemed to own the stock of the association during any portion of the association's first taxable year beginning January 1 of Year 2. Thus, X is eligible to elect to be an S corporation effective January 1 of Year 2. Because the partnership's taxable year ends immediately before the close of the day on December 31 of Year 1, and the association's first taxable year begins at the start of the day on January 1 Year 2, the

deemed steps will not cause X to have an intervening short taxable year in which it was a C corporation. n45.68.6

All shareholders must consent to the S corporation election. n45.69 The IRS allows automatic relief from the late filing of shareholder consents for spouses of S corporation shareholders in community property states if certain conditions are met. n45.70

As a general rule, a corporation needs special IRS consent to make an S election if its S election was terminated within the prior five years. n45.71

The IRS may grant relief in certain situations where a small business corporation inadvertently fails to make the S corporation or qualified subchapter S subsidiary election or inadvertently makes an invalid election. n45.72 The IRS may also consider a late or non-existent election to be timely in certain circumstances. n45.73

[4] Termination or Revocation of S Corporation Status

[a] In General

Voluntary revocation of the S election requires the consent of persons owning more than one-half of the issued and outstanding stock (including nonvoting stock) of the corporation. Violation of the principles of a small business corporation will also terminate the election. n45.74

The Service is allowed to undo an inadvertent termination, provided that the termination was, in fact, inadvertent, and the taxpayers take steps to rectify the problem. n45.75 The Service may also waive inadvertent qualified subchapter S subsidiary terminations. n45.76 For example, the fact that the "terminating event" was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent. n45.77 The corporation and each shareholder must agree to make such adjustments as the Commissioner may require. n45.78 In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation (or QSub) during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination, the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien). n45.79

As noted above, once an S corporation election is terminated, a new election may not be made for five years without the consent of the Secretary of the Treasury. n45.80 Therefore, any decision to terminate existing S corporation status should consider not only the current tax and non-tax ramifications of that revocation, but also an expectation of the situation several years into the future.

[b] Termination Based on Excessive Passive Investment Income

An S corporation that has no accumulated C corporation earnings has no limitation on the amount of passive income that it may earn. However, if an S corporation was previously a C corporation and has earnings and profits from the period it was a C corporation, its S election will be automatically terminated if its "passive investment income" exceeds 25 percent of its gross receipts for three consecutive tax years. n45.81 For this purpose, "passive investment income" does not mean passive income under the passive activity rules. There is a special definition. "Passive investment income," for the above purposes, includes rents, subject to an important exception, set out in the regulations as follows:

Rents does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on

all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. n45.82

Factors to consider under this test include the number of employees and other parties who provide services, the extent and significance of those services, and the type and amount of expenditures, excluding depreciation. The IRS has made extensive rulings in this area, almost always in response to taxpayers who have made, or anticipate making, an S corporation election, and who wish to assure that income they receive will not be passive investment income. The rulings detail at length various the managerial, maintenance, leasing, and administrative duties performed, and the expenses incurred in connection with rental properties. The rulings almost always conclude that the services and expenses are sufficient to prevent the rental income from being passive investment income. n45.83

An extremely rare exception involved a taxpayer who owned a parcel of commercial real property consisting of land and a single-tenant industrial warehouse. The taxpayer participated in negotiating the tenant's lease terms, lease extensions, and did limited repair and maintenance of the building exterior and interior. It received income for and incurred various expenses in performing these activities. The IRS ruled that the rental income the taxpayer received was passive investment income, and determined that the taxpayer's S corporation election terminated on the date that the taxpayer first failed the passive income/accumulated earnings and profits test. n45.84 The ruling does not state exactly how much time the taxpayer spent on services, or the dollar amounts it spent or received in performing those services, so as to cause the IRS to rule as it did. The ruling gives two clues, however. First, the taxpayer held only a single property, with only a single tenant. Most of the rulings involve one or more large commercial, or residential buildings, with many tenants. Second, the tenant operated only a warehouse, which required relatively simple maintenance oversight by the taxpayer, and the lease negotiations the taxpayer was involved with were only those involving the tenant. Other rulings often involve a taxpayer's negotiations between tenants or between tenants and third parties. Even though the ruling was unfavorable, the IRS found that the termination of the taxpayer's S corporation election was inadvertent and ruled that the taxpayer's S corporation election could continue in effect if the taxpayer made a distribution of its retained subchapter C earnings and profits no later than 30 days from the date of the ruling, and the taxpayer sent a payment to the IRS in a stated amount as an adjustment under *IRC Section 1362(f)(4)*. n45.85

The IRS has privately ruled that certain coal royalties are not passive investment income for purposes of determining whether S corporation status has terminated. n45.86

In determining the S corporation's gross receipts, an S corporation that is a partner in a partnership cannot merely look at its share of the net partnership income or loss. n45.87 The S corporation's distributive share of each item of partnership gross receipts must be taken into account, n45.88 even though the partnership experienced a net loss for the year.

[c] S Corporation Post-Termination Transition Period

Shareholders of an S corporation whose status as an S corporation terminates are allowed a period of time after the termination (the post-termination transition period ("PTTP")) to use certain of the benefits of S corporation status. The shareholders may claim losses and deductions previously suspended due to lack of stock or debt basis up to the amount of the stock basis as of the last day of the PTTP. n45.89 Also, shareholders may receive cash distributions from the corporation during the PTTP that are treated as returns of capital to the extent of any balance in the S corporation's accumulated adjustments account ("AAA"). n45.90 The PTTP generally begins on the day after the last day of the corporation's last tax year as an S corporation and ends on the later of the day which is one year after that last day or the due date for filing the return for that last year as an S corporation (including extensions). n45.91 There is also a 120-day PTTP following an audit of the corporation that adjusts an S corporation item of income, loss, or deduction arising during the most recent period while the corporation was an S corporation. This provision allows the tax-free distribution of any additional income determined in the audit. n45.92 The 120-day PTTP does not apply for purposes of allowing

suspended losses to be deducted (since the increased income determined in the audit can be offset with the losses).
 n45.93 Tax-free distributions of money by the corporation are allowed during the 120-day period only to the extent of any increase in the AAA n45.94 by reason of adjustments from the audit. n45.95

[5] Other Operative Rules

[a] Loss Limitations

A very important consideration in the use of an S corporation is the limitation on the amount of the corporation's losses which a particular shareholder may offset against other income. In addition to the effect of the passive activity loss limitation on the shareholder's ability to deduct losses from an S corporation (see Chapter 13), the shareholder's current deduction is also limited to his tax basis in his stock plus any amounts owed to him by the corporation. n45.96 Unlike the situation with partnerships, an S corporation shareholder is not permitted to include the entity's debt in his basis. n45.97 This is often enough to make a partnership or LLC a better choice of entity.

The basis limitation for deductions and losses does not apply to a charitable contribution of appreciated property to the extent the shareholder's pro rata share of the contribution exceeds the shareholder's pro rata share of the adjusted basis of the property. Thus, the basis limitation does not apply to the amount of deductible appreciation in the contributed property. n45.97.1 This exception, however, applies only for charitable contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008. n45.98

Losses limited by the passive activity rules and losses in excess of the shareholder's basis can be carried forward indefinitely and used if passive income is subsequently generated or if basis is restored by future profits or additional investment. n45.99 Moreover, such losses may even be carried to a period after termination of S corporation status. n45.100

[b] Tax Year

The taxable year of an S corporation must be a "permitted year." n45.101 A permitted year is a taxable year ending December 31, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary. (Not surprisingly, deferral of income to shareholders is not considered a business purpose.) n45.102 An S corporation may, however, elect a fiscal year under *IRC Section 444*, even without an acceptable business purpose, if the corporation makes the payments required by *IRC Section 7519*. The effect of these payments is to offset any deferral benefits. n46

[c] Application of C Corporation Rules

Except for the provisions of Subchapter S, an electing corporation is treated as a normal corporation under other sections of the Code, such as those relating to organization, reorganization, and liquidation. An S corporation is not a partnership, and potential investors should not rely on partnership taxation principles in evaluating an S corporation election.

Further, it should be noted that many states consider S corporations to be regular corporations and tax them accordingly.

[6] Taxation of S Corporations That Once Were C Corporations

[a] Tax on Passive Investment Income

As noted in § 15.04[4][b], above, an S corporation's election can be terminated if an S corporation was previously a C corporation and has earnings and profits from the period it was a C corporation: Its S election will be automatically terminated if its "passive investment income" exceeds 25 percent of its gross receipts for three consecutive tax years.

Even if a corporation is able to avoid termination (for example, because its passive investment income is excessive in two, but not three, consecutive years), it will be subject to a tax under *IRC Section 1375*. The tax, at the maximum corporate rate, is imposed on "excess net passive income" in taxable years when an S corporation has both passive income in excess of 25 percent of gross receipts and accumulated earnings and profits. n47

[b] Taxation of Distributions

If an S corporation has accumulated earnings and profits from the period it was a C corporation, distributions may result in dividend income if they exceed the "accumulated adjustments account." n48 The purpose of this rule is to prevent C corporations with accumulated earnings and profits from electing S corporation status and distributing the earnings and profits as either capital gains or tax-free returns of capital. n49

[c] Capital Gains

Capital gains realized by an S corporation, like other income, generally are not taxable to the corporation but are passed through to the shareholders. Like all other items of income and expense, capital gains retain their character in the shareholder's hands. Each shareholder is taxed at capital gains rates on his share of the corporation's income which constitutes capital gains.

The rules can be somewhat different when an S corporation was previously a C corporation. Special rules apply in this situation to reflect the theory and intent underlying the repeal of the *General Utilities* doctrine and to prevent the avoidance of those provisions through the conversion of a C corporation to an S corporation. The tax is imposed on the resulting S corporation when it has "net recognized built-in gains" during the ten-year period beginning with the first day of the first taxable year for which the corporation was an S corporation. n50 The recognition period is temporarily reduced from 10 years to 7 years, effective for any taxable year beginning in 2009 and 2010. Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax will be imposed under *IRC Section 1374* after the seventh taxable year the S corporation election is in effect. n50.1

"Net unrealized built-in gain" is defined as the excess of the fair market value of the S corporation's assets when the S election became effective over the aggregate adjusted basis of these assets at that time. "Net recognized built-in gain" is the lesser of: (1) the sum of recognized built-in gains less recognized built-in losses; or (2) the taxable income of the corporation for the taxable year. n51

"Recognized built-in gain" generally means any gain recognized on the disposition of any asset during the ten-year (or temporary 7-year) period noted above. n51.1 However, it does not include gain from the disposition of an asset if it is established that: (1) the asset was not held by the S corporation when its S election became effective; or (2) the gain is attributable to appreciation that occurred after the S election became effective. n52 Taxpayers may request private letter rulings as to whether particular items will be subject to the built-in gains tax. n52.1

"Recognized built-in losses" include losses recognized during the recognition period on the disposition of assets for which the fair market value is less than the tax basis on the first day the S corporation election is effective. Additionally, the term encompasses amounts that are allowed as deductions during an S year, but that are attributable to periods before the first S year. n53

The tax imposed is the tax computed by applying the highest rate of tax specified in *IRC Section 11(b)* (currently 35 percent) to the net recognized built-in gain of the S corporation for the taxable year. n54 In computing its *IRC Section 1374* tax, however, the corporation may use the net operating loss carryovers and capital loss carryovers that were available to it as a C corporation. n55

IRC Section 1374(d)(2)(B) provides for a carryover of net recognized built-in gains when the amount taxed is limited to

the S corporation's taxable income.

Example:

Assume an electing S corporation had a total built-in gain on its first S day of \$1,000. During its first S year, it recognizes the net built-in gain of \$1,000 but also realizes and recognizes other operating losses of \$1,000, netting to zero taxable income. The \$1,000 net recognized built-in gain carries over and is treated as recognized in the next S year when it is again subject to the previously described taxable income limit.

Recognized built-in gains and losses of an S Corporation are not included in the computation of passive investment income for purposes of applying the tax on excess net passive income. n56

FOOTNOTES:

(n1)Footnote 45. See [2], below, for a discussion.

(n2)Footnote 45.1. See *IRC § 1363(a)*.

(n3)Footnote 45.2. *IRC §§ 1363(a), 1366*.

(n4)Footnote 45.3. *IRC §§ 1363(a), 1366*.

(n5)Footnote 45.4. See *IRC § 1374*.

(n6)Footnote 45.5. See *IRC § 1375*.

(n7)Footnote 45.6. *IRC § 1(i)(2)*.

(n8)Footnote 45.7. See *IRC § 11(b)(1)*.

(n9)Footnote 45.8. *IRC § 11(b)(1)*.

(n10)Footnote 45.9. *IRC §§ 1363(a), 1366*; see *Treas Reg §§ 1.1366-1* (shareholder's share of S corporation items), 1.1366-2 (limitations on deduction of pass-through items of S corporation to its shareholders).

(n11)Footnote 45.10. See *IRC § 469*.

(n12)Footnote 45.11. *IRC § 1366(d)(1)*.

(n13)Footnote 45.12. *IRC § 1366(d)(2)(A)*.

(n14)Footnote 45.13. *IRC § 1366(d)(2)(B)*, effective for transfers after Dec 31, 2004.

(n15)Footnote 45.14. *Williams v Commr, 123 TC 144 (2004)* ; see *IRC § 1398(e)(1)*.

(n16)Footnote 45.15. *Ding v Commr, TC Memo 1997-435* ; *Rev Rul 59-221, 1959-1 CB 225* ; *TAM 9530005* .

(n17)Footnote 45.16. See *IRC § 1244*.

(n18)Footnote 45.17. See *IRC §§ 55 through 59*.

(n19)Footnote 45.18. *Rev Rul 89-92, 1989-1 CB 23* ; see *IRC § 59A*.

(n20)Footnote 45.19. *IRC* § 541.

(n21)Footnote 45.20. *IRC* § 1363(a); see *IRC* § 531.

(n22)Footnote 45.21. *IRC* § 1366(a); see *IRC* §§ 704(c), 737(a).

(n23)Footnote 45.22. Compare *IRC* §§ 1361-1379 with *IRC* §§ 701-777.

(n24)Footnote 45.23. See § 15.01A for a discussion.

(n25)Footnote 45.24. See *IRC* § 1361(b)(3)(B); *Treas Reg* §§ 1.1361-2 through 1.1361-5. QSSSs may be required to file separate information returns (*IRC* § 1361(b)(3)(A)).

(n26)Footnote 45.25. *IRC* § 1366.

(n27)Footnote 45.26. *IRC* § 1366(d)(1).

(n28)Footnote 45.27. *IRC* §§ 1366, 1367; *Hafiz v Commr*, *TC Memo* 1998-104, *Sleiman, Jr et al v Commr*, *TC Memo* 1997-530.

(n29)Footnote 45.28. *IRC* § 1366(d)(1).

(n30)Footnote 45.29. *IRC* §§ 722, 752.

(n31)Footnote 45.30. See *IRC* §§ 704, 705, 722, 1366(d)(1). This subject is discussed in greater detail in Ch 14.

(n32)Footnote 45.31. *IRC* §§ 1366(a), 1377(a)(1).

(n33)Footnote 45.32. See *IRC* § 704(b)(1).

(n34)Footnote 45.33. See *IRC* § 1361(b)(1).

(n35)Footnote 45.34. *IRC* § 1361(b)(1)(D).

(n36)Footnote 45.35. See *IRC* §§ 743(b), 754.

(n37)Footnote 45.36. See *IRC* § 1362(f); *Treas Reg* § 1.1362-4.

(n38)Footnote 45.37. *IRC* § 1362(d)(2).

(n39)Footnote 45.38. See *IRC* § 1361(b)(1)(A).

(n40)Footnote 45.39. See *IRC* § 1361(b)(1)(D).

(n41)Footnote 45.40. *IRC* § 1362(d)(3).

(n42)Footnote 45.41. *IRC* § 1362(d)(3)(C)(i).

(n43)Footnote 45.42. *Treas Reg* § 1.1362-2(c)(5)(ii)(B)(2).

(n44)Footnote 45.43. *IRC* § 1374(a), (d)(7)(A), (8); see *Rev Rul* 2001-50, 2001-2 CB 343; *Rev Proc* 2001-51, 2001-2 CB 369 (built-in gains tax under *IRC* § 1374 does not apply to certain timber, coal, and domestic iron ore transactions).

(n45)Footnote 45.43.1. *IRC* § 1374(d)(7)(B).

(n46)Footnote 45.44. *IRC* § 336

(n47)Footnote 45.45. *IRC* §§ 311(b)(1), 336.

(n48)Footnote 45.46. *IRC* § 1366(a)(1), (c).

(n49)Footnote 45.47. *IRC* § 731(b).

(n50)Footnote 45.48. *IRC* § 732(a); see *IRC* § 1001.

(n51)Footnote 45.49. *IRC* § 704(c)(1)(B).

(n52)Footnote 45.50. *IRC* § 737(a), (b)(1).

(n53)Footnote 45.51. *IRC* § 1361(b)(1)(A), effective for taxable years beginning after Dec 31, 2004. The prior limit was 75 shareholders (*IRC* § 1361(b)(1)(A), before amendment by Pub L No 108-357); see *Rev Rul 94-43, 1994-2 CB 198* (shareholder limit avoided by the formation of three separate corporations, each with allowable number of shareholders, which then organized a partnership for the joint operation of single business). See *Treas Reg* § 1.1361-1(b)(1)(i); see *Treas Reg* § 1.1361-1(e) (rules regarding number of shareholders).

(n54)Footnote 45.52. *IRC* § 1361(c)(1)(A)(i).

(n55)Footnote 45.53. *IRC* § 1361(c)(1)(A)(ii); see *IRC* § 1361(c)(1)(B),(C) (members of family defined, and effect of adoption).

(n56)Footnote 45.53.1. *Treas Reg* § 1.1361-1(e)(3).

(n57)Footnote 45.54. *IRC* § 1361(b)(1)(B), (c)(2), (c)(6).

(n58)Footnote 45.55. See *IRC* § 1361(e).

(n59)Footnote 45.56. *IRC* § 1361(c)(2)(B)(v).

(n60)Footnote 45.56.1. *Treas Reg* § 1.1361-1(e)(1).

(n61)Footnote 45.57. *IRC* § 1361(c)(2)(A)(vi).

(n62)Footnote 45.58. *IRC* § 1361(c)(2)(B)(vi).

(n63)Footnote 45.58.1. *Treas Reg* § 1.1361-1(h)(1)(vii); *Taproot Administrative Services, Inc v Commr, 133 TC No 9 (2009)* (holding that Roth IRAs cannot be S corporation shareholders).

(n64)Footnote 45.59. *IRC* § 1361(b)(1)(C).

(n65)Footnote 45.60. *IRC* § 1361(b)(1)(D), (c)(5).

(n66)Footnote 45.61. *IRC* § 1361(c)(4).

(n67)Footnote 45.62. *Treas Reg* § 1.1361-1(l)(1).

(n68)Footnote 45.63. This subject is discussed in § 15.05[1], below.

(n69)Footnote 45.64. See *IRC* § 1361(c)(5) for requirements.

(n70)Footnote 45.65. *Treas Reg* § 1.1362-6(a)(2).

- (n71)Footnote 45.65.1. *Rev Proc* 2007-62, 2007-41 IRB 786 .
- (n72)Footnote 45.65.2. *Rev Proc* 2007-62 , § 4.01, 2007-41 IRB 786 .
- (n73)Footnote 45.65.3. *Rev Proc* 2007-62 , § 4.02, 2007-41 IRB 786 .
- (n74)Footnote 45.65.4. *Rev Proc* 2007-62 , § 4.01, 2007-41 IRB 786 .
- (n75)Footnote 45.65.5. *Rev Proc* 2003-43, 2003-1 CB 998 .
- (n76)Footnote 45.65.6. *Rev Proc* 2003-43 , § 1, 2003-1 CB 998 .
- (n77)Footnote 45.66. *Treas Reg* § 301.7701-3(c)(1)(v)(C).
- (n78)Footnote 45.67. See *Treas Reg* § 301.7701-3(c)(1)(i).
- (n79)Footnote 45.68. *Rev Proc* 2007-62, 2007-41 IRB 786 .
- (n80)Footnote 45.68.1. *Rev Proc* 2004-48, 2004-2 CB 172 .
- (n81)Footnote 45.68.2. See *Treas Reg* § 301.7701-3(c)(1)(i).
- (n82)Footnote 45.68.3. *Rev Rul* 2009-15, 2009-21 IRB 1035 .
- (n83)Footnote 45.68.4. See *Treas Reg* § 301.7701-3(c)(1)(i).
- (n84)Footnote 45.68.5. *Treas Reg* § 301.7701-3(g)(3)(i),
- (n85)Footnote 45.68.6. *Rev Rul* 2009-15, 2009-21 IRB 1035 .
- (n86)Footnote 45.69. *IRC* § 1362(a)(2); see *Treas Reg* § 1.1362-6(b)(2)(i) regarding shareholder consents.
- (n87)Footnote 45.70. *Rev Proc* 2004-35 , § 4.01, 2004-1 CB 1029 .
- (n88)Footnote 45.71. *IRC* § 1362(g).
- (n89)Footnote 45.72. *IRC* § 1362(f); *Treas Reg* § 1.1362-4.
- (n90)Footnote 45.73. *IRC* § 1362(b)(5).
- (n91)Footnote 45.74. *IRC* § 1362(d).
- (n92)Footnote 45.75. *IRC* § 1362(f); *Treas Reg* § 1.1362-4
- (n93)Footnote 45.76. *IRC* § 1362(f)(1); *Treas Reg* § 1.1362-4
- (n94)Footnote 45.77. *Treas Reg* § 1.1362-4(b).
- (n95)Footnote 45.78. *IRC* § 1362(f)(4).
- (n96)Footnote 45.79. *Treas Reg* § 1.1362-4(d).
- (n97)Footnote 45.80. *IRC* § 1362(g).
- (n98)Footnote 45.81. *IRC* § 1362(d); *Treas Reg* § 1.1362-2(c)(1).

(n99)Footnote 45.82. *Treas Reg § 1.1362-2(c)(5)(ii)(B)(2)*; For examples of precedents predating these 1992 regulations, see Ltr Ruls 8921039, 9131053, and 9250011 (the lessor provided the tenants with managerial evaluations, sales performance reports, demographic profiles, tenant placement services, and various other services including common area maintenance; the IRS concluded that these services were "significant"); cf *McIlhinny v Commr, TC Memo 1979-473 (1979)* (the services the lessor provided included operating and maintaining the common areas of the property, maintenance and repair of the building exterior, and maintenance and repair of the plumbing and electrical wiring of the building; tenants were responsible for their own utility bills and for nonstructural parts of their leased premises; the court found that the services provided were usual and customary in the rental of the space and were not a significant part of the lessor's operations; therefore, the rents collected from the property were considered to be passive investment income).

(n100)Footnote 45.83. Ltr Ruls 200628005, 200414038, 200413009, 200409011, 200408017, 200404019, 200403083, 200403078, 200351015, 200350008, 200348007, 200343012, 200343011, 200339040 through 200339045, 200338025, 200338008, 200335018, 200334023, 200332016, 200332010, 200329022, 200327029, 200326018, 200326014, 200324030, 200324028, 200324027, 200317004, 200317002, 200316016, 200310022, 200252037, 200252036, 200247026, 200245007, 200229003, 200229027, 200229036, 200237005, 200237014, 200239008, 200240003, 200240005, 200240017, 200240026, 200240032, 200240033, 200240034, 200240039, 200241002, 200241006, 200241007, 200226025, 200226024, 200224021, 200221027, 200220024, 200218033, 200217045, 200217034, 200217023, 200217012, 200217008, 200215045, 200210042, 200210041, 200208007, 200206032, 200206031, 200206030, 200206023, 200205019, 200203017, 200147040, 200147050, 200148021, 200148032, 200144021, 200141027, 200143012, 200125089, 200128025, 200133019, 200137020, 200123036, 200114030, 200114024, 200112035, 200112032, 200111019, 200106034, 200106030, 200104010, 200052032, 200051012, 200050035, 200050020, 200049014, 200047036, 200034017, 200033035, 200033018, 200032025, 200027037, 200025042, 200024044, 200007022, 200014011, 200014031, 200016011, 200002033, 200002031, 9952077, 9952070, 9948010, 9944029, 9943031, 9943017, 9943010, 9938012, 9924008, 9924011, 9935040, 9935018, 9935015, 9935014, 9935013, 9933016, 9921014, 9921017, 9921018, 9921021, 9844007, 9825014, 9823019, 9824018.

(n101)Footnote 45.84. *Ltr Rul 200227004* ; see *IRC § 1362(d)(3)(A)*.

(n102)Footnote 45.85. *Ltr Rul 200227004* .

(n103)Footnote 45.86. *Ltr Rul 9825008* .

(n104)Footnote 45.87. *Rev Rul 71-455, 1971-2 CB 318* .

(n105)Footnote 45.88. *Id.*

(n106)Footnote 45.89. *IRC §§ 1366(d)(3), 1377(b)*.

(n107)Footnote 45.90. *IRC § 1371(e)*.

(n108)Footnote 45.91. *IRC § 1377(b)(1)(A)*.

(n109)Footnote 45.92. *IRC § 1377(b)(1)(B)*.

(n110)Footnote 45.93. *IRC § 1377(b)(3)(A)*.

(n111)Footnote 45.94. See *IRC § 1368(e)*.

(n112)Footnote 45.95. *IRC § 1377(b)(3)(B)*.

(n113)Footnote 45.96. *IRC § 1366(d)(1), (3)(B), (D)*.

(n114)Footnote 45.97. *IRC §§ 704, 705, 722, 1367; Hafiz v Commr, TC Memo 1998-104, Sleiman, Jr et al v Commr, TC Memo 1997-530.*

(n115)Footnote 45.97.1. *IRC § 1366(d)(4).*

(n116)Footnote 45.98. *Pub Law No 110-172, § 3(j).*

(n117)Footnote 45.99. *See, eg, Ltr Rul 9406010.*

(n118)Footnote 45.100. *IRC § 1366(d)(3).*

(n119)Footnote 45.101. *IRC § 1378(a).*

(n120)Footnote 45.102. *IRC § 1378(b).*

(n121)Footnote 46. *See Godshalk, "A Section 444 Election: Who, What, When, and Why," Tax Notes, Mar 28, 1988, at 1537.*

(n122)Footnote 47. *IRC § 1375(a).* *See Lux, "Realty Rental S Corporations: Those With Excess Passive Investment Income and C Earnings and Profits Face a Tax Dilemma," 23 Tax Adv 391 (1992).*

(n123)Footnote 48. *IRC § 1368(c).*

(n124)Footnote 49. *For additional coverage of this subject, see Siddle, "Impact of the AAA Rules on Distributions and Other Transactions," 3 J S Corporation Tax'n 57 (1991).*

(n125)Footnote 50. *IRC § 1374(a), (d)(2), (d)(7)(A).* *This tax does not apply to a corporation that has been an S corporation for all of its taxable years. See IRC § 1374(c).*

(n126)Footnote 50.1. *IRC § 1374(d)(7)(B).*

(n127)Footnote 51. *IRC § 1374(d)(2)(A).*

(n128)Footnote 51.1. *See IRC § 1374(d)(7)(A), (B).*

(n129)Footnote 52. *IRC § 1374(d)(3).* *See also Treas Reg §§ 1.1374-0 through 1.1374-10.*

(n130)Footnote 52.1. *See Ltr Rul 9825008 (certain coal royalties not subject to tax); Ltr Rul 9825018 (certain income from disposition of timber and logs not subject to tax).*

(n131)Footnote 53. *IRC §§ 1374(d)(4)(A), 1374(d)(5)(B).*

(n132)Footnote 54. *IRC § 1374(b).*

(n133)Footnote 55. *Treas Reg § 1.1374-5(a).* *For articles discussing the IRC § 1374 regulations, issued at the end of 1994, see Lux, "Comprehensive Guidance of S Corporation Built-In Gains Limits Use of Losses," 82 J Tax'n 266 (1994); Thomas, "Built-In Gains Under the Final Regulations," Tax Notes, Nov 6, 1995, at 751.*

(n134)Footnote 56. *IRC § 1375(b)(4).*



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Federal Taxes Affecting Real Estate

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CHAPTER 15 Corporate Ownership of Real Estate

1-15 Federal Taxes Affecting Real Estate § 15.05

§ 15.05 Special Corporate Tax Problems

The corporate form of organization invites potential taxation through sections of the Internal Revenue Code not applicable to other types of business entities. A complete discussion of these principles is beyond the scope of this book. However, comments regarding "thin" capitalization, the accumulated earnings tax, the personal holding company tax, liquidations, and collapsible corporations are made in subsequent sections.

[1] "Thin" Capitalization

"Thin" capitalization refers to the situation in which the equity capital of a corporation is so small, relative to its debt, that the purported interest or principal payments on corporate indebtedness to shareholders may be considered to be distributions of corporate earnings. In other words, the purported debt of the corporation may be recast as equity for tax purposes. The Service may then also redesignate the distributions and tax them as dividends, rather than as deductible interest payments.

Because of uncertainty in this area, Congress enacted *IRC Section 385*, which gives the Service authority under several broad guidelines to determine whether a particular instrument is debt or equity. Although the Treasury issued final regulations pertaining to debt versus equity securities, the regulations were formally withdrawn and never became effective. n57

The factors used by the Service in making a distinction between debt and equity securities range from the instrument's characteristics to the financial position of the issuing corporation. Some of the more pertinent factors which the Service uses to classify securities as either debt or equity include: n57.1

- (1) Whether there is a written, unconditional promise to pay on demand or on a specified date a sum certain in return for adequate consideration, and to pay a fixed rate of interest, and the reasonableness of that interest rate.
- (2) Whether there is subordination to, or preference over, any other indebtedness of the corporation.
- (3) Whether the ratio of debt to equity is excessive.

- (4) Whether certain debt is convertible into stock.
- (5) Whether the stock and debt in question are held pro rata or "substantially" proportionate.
- (6) The ability of the issuing corporation to make principal and interest payments by the due date.

The U.S. Supreme court has noted that the distinction between debt and equity is basically factual, n57.2 but the judicial criteria used in distinguishing debt and equity securities vary somewhat from circuit to circuit. The Ninth Circuit considers the following factors: n57.3

- (1) The name of the instrument--whether it is referred to as a note or a debenture or as stock;
- (2) The maturity date--whether there is a fixed maturity date that is reasonable in length;
- (3) The source of the payments--whether the payment must be made from the general funds of the corporation or from its profits. If repayment is possible or expected to be made only out of corporate earnings, the instrument is likely to be treated as equity, but if repayment does not hinge on earnings, the instrument reflects a debt or loan;
- (4) The right to enforce payment--whether there is a definite right to enforce payment upon default or at maturity. If a fixed obligation to repay the advance exists, the instrument is indicative of debt or a loan;
- (5) Participation in management--whether the holders of the debt, in their capacity as holders of debt, have any right to participate in management of the corporation;
- (6) The relationship of the would-be creditors to general creditors--whether the rights of the debt holders are equal to those of the general creditors or are they in a subordinate position to general creditors. Subordination of a putative loan to that of other creditors indicates equity, or a contribution to capital;
- (7) The intention of the parties--whether the form of the instrument itself, as well as the corporate minutes authorizing it, clearly indicates that both the corporation and the lender intended to create an unconditional and legally enforceable obligation for the payment of money. This factor weighs heavily, but self-serving statements of intent to create debt are accorded little weight by the courts; circumstances surrounding the transaction are scrutinized to reveal the intent of the parties; if a corporation does not make required payments or a shareholder does not enforce a right to receive payments, an instrument is likely to be characterized as equity rather than debt;
- (8) The adequacy of capitalization--the ratio of the corporation's debt to its equity. An instrument is likely to be treated as equity if the corporation is thinly capitalized;
- (9) The relationship, if any, between the creditors and the shareholders--whether the creditors and the shareholders are one and the same and, if so, is the debt ownership proportionate or disproportionate to the equity ownership;
- (10) The source of the interest payments--whether the interest is payable out of general corporate funds or is it payable out of profits; and
- (11) The ability of the corporation to obtain loans elsewhere--whether the corporation is able to obtain the necessary loans from banks or third parties or are the shareholders the only source of the needed capital.

Note:

The number of factors varies from circuit to circuit. As noted from the above list, the Ninth Circuit analyzes 11 factors. n57.4 The Fifth and Eleventh Circuits have 13, n57.5 The Third Circuit uses 16. n57.6

[2] Accumulated Earnings Tax

When a C corporation accumulates its earnings beyond the reasonable needs of the business and it can be shown that the accumulation is used to avoid the tax on shareholders' dividend distributions, a special penalty tax applies. The tax is imposed on accumulated taxable income. The rate of tax imposed is a flat 15 percent. n58 Accumulated taxable income generally is computed as taxable income, reduced by federal income taxes, dividends paid, and various other items. n59

A corporation, other than a mere holding or investment company, may retain, after dividends, an amount equal to the reasonable needs of its business. A minimum accumulation, generally \$250,000 and referred to as the accumulated earnings credit, is not subject to the surcharge. n60

A corporation can establish reasonable need by showing that it is providing for the expansion of its business, the replacement of its assets, the acquisition of another business, the retirement of indebtedness, or necessary working capital. The ultimate question in every accumulated earnings tax case, however, is whether corporate earnings and profits have been accumulated for the purpose of avoiding income taxes with respect to the shareholders.

Example:

A corporation has accumulated earnings and profits of \$200,000 at December 31 of year 1. It has earnings and profits for the year ended December 31 of year 2, of \$175,000 and has a dividends-paid deduction of \$20,000, so that the earnings and profits retained for the taxable year are \$155,000. The reasonable needs of the business amount to \$30,000. Accumulated earnings subject to the tax on that accumulation are:

Accumulated earnings	\$ 355,000
Less: Greater of \$ 250,000 credit or reasonable needs of business	\$ 250,000
Accumulated earnings subject to surcharge	\$ 105,000
Accumulated earnings tax @ 15% n60.1	\$ 15,750

Indications of accumulation beyond reasonable needs include loans to shareholders or payments for their benefit, loans to others having no reasonable relation to the conduct of the corporate business, investments in properties or securities unrelated to the business of the corporation, loans to another corporation owned by the corporation's stockholders, and retention of earnings to provide against unrealistic hazards.

A well-managed real estate company should not have unreasonable accumulation problems. Should the problem of excess funds arise, other real estate may be acquired or the funds may be used to reduce existing mortgage debt. Note that the accumulated earnings tax cannot apply in any year in which the corporation is a personal holding company. n61

[3] Personal Holding Company Tax

Apart from the accumulated earnings tax, a penalty tax is imposed on the undistributed personal holding company

income of a personal holding company (PHC). The tax is imposed only on personal holding companies. n62 The rate of the tax is a flat 15 percent. n62.1 A personal holding company is any C corporation that for the tax year meets both a stock ownership test and an income test. n63 The stock ownership test is met if at any time during the last half of the taxable year more than 50 percent in value of the corporation's outstanding stock is owned by or for not more than five individuals. n64 For this purpose, certain employee pension trusts, trusts paying unemployment compensation benefits, private foundations, and a portion of a trust set aside for charitable purposes are treated as an individual. n65

The income test is met if at least 60 percent of the corporation's adjusted ordinary gross income for the tax year is "personal holding company income". n66 Subject to several exceptions and limitations, personal holding company income includes that portion of adjusted ordinary gross income that consists of income from a variety of passive investments, including dividends, interest, and royalties. n67 Personal holding company income can also include amounts received for the use of corporate property by a 25-percent shareholder, n68 and certain amounts received under a contract under which the corporation must furnish personal services, if the person performing those services is a 25-percent shareholder at some time during the tax year. n68.1

Major exceptions important to real estate investment and operation concern capital gains and rental income. Capital gains are not included in personal holding company income. n68.2 Nor is gain from the sale or disposition of property used in the taxpayer's trade or business. n68.2.1 Further, adjusted rental income (i.e., gross rents less depreciation, amortization, property taxes, interest, and rent allocable thereto) n68.3 is not personal holding company income if: (1) the adjusted rental income is at least 50 percent of the adjusted ordinary gross income, and (2) the corporation distributes a specified portion of its non-rent PHC income. This portion must equal or exceed the amount (if any) by which the corporation's non-rent PHC income exceeds 10 percent of its ordinary gross income. n68.4 The rationale for this rule is that corporations actively engaged in a real estate business should not be subject to the PHC penalty tax on their rental income.

The term "rents" includes any compensation, however designated, for the use of real property. It also includes interest on debts owed to the corporation, to the extent they represent the price for which real property held primarily for sale to customers in the ordinary course of its business was sold or exchanged. n68.5

Although rental income is not included in the calculation of personal holding company income, a real estate corporation holding rental real estate must carefully monitor the amounts of other passive-type income received. Because gross rents are reduced by expenses before being compared with personal holding company income, the 50 percent test might be failed in a situation of falling rents or rising costs. Moreover, the corporation could easily fail the 10 percent test if either rental income or other personal holding company income change unexpectedly. n68.6 Even if a corporation is in fact engaged in an active real estate business, the mathematical rules are applied automatically, and can be a trap for the unwary with harsh and unfair results. n68.7 Concerns regarding the personal holding company tax can be avoided entirely if a business operates as an S corporation, limited liability company or other entity not subject to the personal holding company tax. n68.8

Example:

A domestic corporation receives \$95,000 in rents from real estate, incurs \$85,500 in depreciation, taxes, interest, and other related expenses, and receives \$5,000 in dividends and \$10,000 in long-term capital gains for its taxable year. The corporation pays out \$5,000 in dividends during the year. The shareholders are four unrelated individuals, and no dividends are distributed during the year. The stock ownership test is met since all the stock is owned by fewer than five individuals.

The income test is not met, however, so the corporation is not a personal holding company and is not subject to a personal holding company tax for the year. Because capital gains are excluded, the corporation's "ordinary gross income" is \$100,000 (\$95,000 rents + \$5,000 dividends). n68.9 "Adjusted ordinary gross income" is \$14,500 (\$100,000 less \$85,500 expenses). n68.10 Personal holding company

income is \$5,000, the amount of dividends. Capital gains are excluded. The "adjusted income from rents" (\$14,500) is also excluded because: (1) it is at least 50 percent of the adjusted ordinary gross income, and (2) the dividends paid during the year (\$5,000) are at least equal to the amount by which the non-rent personal holding company income for the year (\$5,000) exceeds 10 percent of the ordinary gross income for the year (\$10,000 [10% x \$100,000]). The personal holding company income (\$5,000) does not exceed \$8,700 (60 percent of \$14,500), so the income test is not met. The corporation is therefore not a personal holding company. n68.11

Additionally, the passive activity rules of *IRC Section 469* may make a corporation more susceptible to being cast as a personal holding company, since passive activity losses can only offset active income, and not portfolio income (i.e., dividends, interest and royalties). Although not always the same, portfolio income may also constitute personal holding company income. This could result in a corporation with undistributed personal holding company income and nondeductible passive activity losses. Net-operating-loss carryovers may be of little help, since only a net operating loss from the immediately preceding year may be taken into account in computing undistributed personal holding company income, and net operating carrybacks are not allowable at all. n68.12

FOOTNOTES:

(n1)Footnote 57. *TD 7920, 1983-2 CB 69* .

(n2)Footnote 57.1. See *IRC § 385*.

(n3)Footnote 57.2. *John Kelley Co v Commr 326 US 521 (1946)* .

(n4)Footnote 57.3. *Bauer v Commr, 748 F2d 1365 (9th Cir 1984)* ; *Hardman v US, 827 F2d 1409 (9th Cir 1987)* .

(n5)Footnote 57.4. *Bauer v Commr, 748 F2d 1365 (9th Cir 1984)* ; *Hardman v US, 827 F2d 1409 (9th Cir 1987)* .

(n6)Footnote 57.5. *Stinnett's Pontiac Serv, Inc v Commr, 730 F2d 634 (11th Cir 1984)* ; *Selfe v US, 778 F2d 769 (11th Cir 1985)* (adds the following to the Ninth Circuit list: (1) the extent to which the advance is used to purchase capital assets, and (2) the failure of debtor to repay obligation on due date or to seek extension); see also *Texas Farm Bureau v US, 725 F2d 307 (5th Cir 1984)* , cert denied 469 US 1106 ; *Estate of Mixon v US, 464 F2d 407 (5th Cir 1972)* ; *American Offshore, Inc v Commr, 97 TC 579 (1991)* ; *Nachman v Commr, TC Memo 1996-288* .

(n7)Footnote 57.6. *Fin Hay Realty Co v US, 398 F2d 694 (3d Cir 1968)* .

(n8)Footnote 58. *IRC § 531*, effective for tax years beginning after Dec 31, 2002 and before Jan 1, 2009. (See Pub L No 108-27, §§ 302(f)(1), 303). For other tax years, the tax rate is the highest rate of tax imposed under *IRC § 1(c)*. (See *IRC § 531*, before amendment by Pub L No 108-27).

(n9)Footnote 59. *IRC § 535*.

(n10)Footnote 60. *IRC § 535(c)*.

(n11)Footnote 60.1. *IRC § 531*.

(n12)Footnote 61. *IRC § 532(b)(1)*.

(n13)Footnote 62. *IRC § 541*.

(n14)Footnote 62.1. *IRC § 541*, effective for tax years beginning after Dec 31, 2002 and before Jan 1, 2009. (See Pub L No 108-27, §§ 302(f)(1), 303). For other tax years, the tax rate is the highest rate of tax imposed under *IRC § 1(c)*. (See *IRC § 541*, before amendment by Pub L No 108-27).

(n15)Footnote 63. *IRC § 542(a)*.

(n16)Footnote 64. *IRC § 542(a)(2); Treas Reg § 1.542-3(a)*.

(n17)Footnote 65. *IRC § 542(a)(2); see IRC §§ 501(a), Treas Reg § 1.337-6(e), Treas Reg § 1.337-6(a)(1), (b)(1)*.

(n18)Footnote 66. *Treas Reg § 1.337-6(b)(2)*.

(n19)Footnote 67. *Treas Reg § 1.337-6(b)(1)*.

(n20)Footnote 68. See *IRC § 543(a)(6)*.

(n21)Footnote 68.1. *IRC § 543(a)(7)*.

(n22)Footnote 68.2. *IRC § 543(a), (b)(1)(A), (2)*.

(n23)Footnote 68.2.1. *IRC § 543(b)(1)(B); see IRC § 1231(b)*.

(n24)Footnote 68.3. See *IRC § 543(b)(2)(A)*.

(n25)Footnote 68.4. *IRC § 543(a)(2)*. Rents received when "significant services" are rendered, however, have been held to be personal holding company income. *Eller v Commr, 77 TC 934 (1981)* .

(n26)Footnote 68.5. *IRC § 543(b)(3); Treas Reg § 1.543-1(b)(10); see Char-Lil Corp v Commr, TC Memo 1998-457 , affd 2000-2 USTC P 50,827 (10th Cir 2000)* (interest received on purchase money notes was not "rents" because property sold was not held for sale in the ordinary course of business).

(n27)Footnote 68.6. See *IRC § 543(a)(2)*.

(n28)Footnote 68.7. See *Char-Lil Corp v Commr, TC Memo 1998-457 , affd 2000-2 USTC P 50,827 (10th Cir 2000)*.

(n29)Footnote 68.8. See *IRC § 542*.

(n30)Footnote 68.9. See *IRC § 543(b)(1)*.

(n31)Footnote 68.10. *IRC § 543(b)(2)*.

(n32)Footnote 68.11. *IRC § 542(a)*.

(n33)Footnote 68.12. *IRC § 545(b)(4)*.



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CHAPTER 15 Corporate Ownership of Real Estate

1-15 Federal Taxes Affecting Real Estate § 15.06

§ 15.06 Liquidations and Other Property Distributions

Often, the sale of the assets of a corporation will be accomplished in a manner other than the outright sale of capital stock. There are various reasons for selecting an alternate method, important among which are the fear of undisclosed liabilities or a lack of interest in some of the assets.

[1] Liquidations

Normally, the complete liquidation of a corporation generates capital gains or losses to be reported by the individual shareholders. n68.13 Gain or loss is measured by the difference between the basis of the stock transferred and the amount of cash and fair market value of the property received. n68.13.1 The basis to the transferee shareholder is the fair market value of the property received. n68.14

As a general rule, the liquidating corporation also recognizes gain or loss on distribution of its assets in complete liquidation. The corporation's gain or loss is computed by treating the distribution as if it were a sale of the property to the shareholder at its fair market value. n68.15

An exception applies to liquidations of 80 percent-or-more domestically owned corporate subsidiaries. In these situations, the subsidiary does not recognize gain or loss on distributions to the "80-percent distributee" (i.e. the parent corporation). n68.15.1 Gain or loss must be recognized on certain distributions if the parent corporation is an exempt organization. n68.15.2 In addition, a liquidating subsidiary recognizes gain, but not loss, on any property distributed to minority shareholders. n68.16

A special rule also applies to an S corporation's distribution of an installment obligation as part of a complete liquidation under *IRC Section 331*. n69 If the corporation distributes an installment obligation it acquired from a sale or exchange during a 12-month period beginning on the date a plan of complete liquidation is adopted, and the liquidation is completed during that 12-month period, the shareholder's receipt of that installment obligation is not treated as payment received in exchange for his stock, except to the extent that the corporation has built-in gains subject to *IRC Section 1374*. Instead, the payments that the shareholder receives under the installment obligation are treated as the liquidating payment. This effectively allows him to recognize this part of the gain on his stock over the installment period.

[2] Other Property Distributions

Corporations frequently distribute property to their shareholders other than in a complete liquidation. For example, a corporation may wish to distribute some of its assets in a "partial liquidation" n69.1 or in a "redemption" n69.2 of the stock of one or more of its shareholders. Although an in-depth discussion of the relevant rules governing the effects of a partial liquidation or a redemption is beyond the scope of this section, the basic rules can be summarized as follows:

1. *Effects on shareholders.* Generally, if the redemption or partial liquidation meets certain special criteria, the effect on the shareholder is the same as if the corporation had fully liquidated; that is, the shareholder recognizes capital gain or loss equal to the difference between the fair market value of the property received and his tax basis in the stock transferred. n70 If, on the other hand, the special criteria are not met, the property received in the transaction is treated as a dividend distribution to the shareholder, and is, therefore, governed by the rules on the treatment of dividends. n71
2. *Effect on the distributing corporation.* A corporation generally recognizes no gain or loss on a distribution in redemption or in partial liquidation. n72 The corporation must recognize gain, however, if the distribution is of appreciated property. n72.1

In determining whether a distribution by a corporation is taxable to the shareholders as a dividend, the corporation's current and accumulated earnings and profits (E&P) must be determined. The shareholder's distribution is a dividend to the extent the corporation has current or accumulated E[P] the balance of the distribution is capital gain (or is considered a nontaxable return of basis). n73 Traditionally, avoiding dividend treatment has been important because dividends have been taxed as ordinary income. n73.1 This is no longer a concern, at least for years in which qualifying dividends are taxable at lower capital gains rates (generally tax years beginning after December 31, 2002, and before January 1, 2009). n73.2 Any "capital gain" from dividend income, however, cannot be used to offset capital losses. n73.3

Many real estate corporations have sales that are reported on the installment sales method for federal income tax purposes. Therefore, it is important to note that in computing a corporation's earnings and profits, the installment sale treatment is not taken into account: that is, for earnings and profits purposes, the full amount of the gain is recognized in the year of the sale and is not deferred. n74 Additionally, the use of longer depreciable lives and the straight-line method of accounting is often required in computing depreciation for earnings and profits purposes. n75 The general effect of these rules is to increase the amount of a property distribution.that is treated as a dividend. n75.1

FOOTNOTES:

(n1)Footnote 68.13. *IRC § 331.*

(n2)Footnote 68.13.1. *IRC § 331(a).*

(n3)Footnote 68.14. *IRC § 334(a).*

(n4)Footnote 68.15. *IRC § 336.* *IRC § 336(d)* includes rules which prevent a corporation from recognizing certain losses. These rules are generally designed to prevent abusive tax planning.

(n5)Footnote 68.15.1. *IRC § 337(a).*

(n6)Footnote 68.15.2. *IRC § 337(b).*

(n7)Footnote 68.16. *IRC §§ 336(d)(3), 337(a).*

(n8)Footnote 69. *IRC §§ 453B(h) and 453(h).* Installment sale rules are discussed in Chapter 7.

(n9)Footnote 69.1. See *IRC* § 302(b)(4), (e).

(n10)Footnote 69.2. See *IRC* §§ 302(a), 317(b).

(n11)Footnote 70. *IRC* § 302(a).

(n12)Footnote 71. See *IRC* § 301(a), (c)(1), 316..

(n13)Footnote 72. *IRC* § 311(a).

(n14)Footnote 72.1. *IRC* § 311(b).

(n15)Footnote 73. *IRC* §§ 301(c), 316(a).

(n16)Footnote 73.1. *IRC* §§ 61(a)(7), 301(a), (c), 316(a).

(n17)Footnote 73.2. See *IRC* § 1(h)(11); see Pub Law No 108-27 §§ 302(f)(1), 303 (effective date and sunset provisions for dividend taxation at capital gains rates).

(n18)Footnote 73.3. *IRC* § 1(h)(3).

(n19)Footnote 74. *IRC* § 312(n)(5).

(n20)Footnote 75. *IRC* § 312(k).

(n21)Footnote 75.1. See *IRC* § 316(a).



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Federal Taxes Affecting Real Estate

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CHAPTER 15 Corporate Ownership of Real Estate

1-15 Federal Taxes Affecting Real Estate § 15.07

§ 15.07 Collapsible Corporations

NOTE:

The collapsible corporation rules are repealed and do not apply effective for tax years beginning after December 31, 2002, and before January 1, 2009. n75.2 The following discussion applies only for tax years in which the collapsible corporation rules are in effect.

The collapsible corporation provisions of the tax law were specifically designed to deter a prevalent practice of real estate developers as well as several other types of business. Typically, a corporation was formed to construct a building or subdivide a tract of land under circumstances in which the income produced would have been ordinary income if received by the individuals themselves. The stock of the corporation was, however, a capital asset and could produce a substantial capital gain when sold before the realization of the ordinary income by the corporation.

To dissuade individual taxpayers from using corporations to alter the character of the taxpayers' gain, Congress enacted *IRC Section 341*. n76 Essentially, the "collapsible" corporation provisions under this section require that the gain from the sale, exchange, or redemption of stock of a "collapsible" corporation be considered gain from the sale or exchange of property which is not a capital asset. Therefore, the gain is taxable at ordinary income tax rates. n77

Even before their repeal, n78 statutory changes that repealed the *General Utilities* doctrine rendered the collapsible corporation provisions somewhat obsolete. Under current law, a corporation must recognize gain on liquidating distributions of appreciated property to shareholders, and this gain is taxable at ordinary income rates. n79 Thus, the collapsible corporation rules applicable to corporate liquidating distributions to shareholders are now unnecessary. However, collapsible corporation rules could have some effect in situations that did not involve corporate liquidations, such as when the shareholder sold his or her stock before the corporation recognized gain on its appreciated assets. Then, the collapsible corporation recharacterization rules could affect shareholders who had capital losses that they wanted to offset against capital gains. n79.1

[1] Definition of a Collapsible Corporation

A collapsible corporation is one formed or used principally for the manufacture, construction, or production of property or for the purchase of "Section 341" assets. In addition, the corporation's shareholders must have, as an objective, "the sale or exchange of stock by its shareholders (whether in liquidation or otherwise)," or a distribution of corporate

property before the corporation has realized two-thirds of the taxable income to be derived from such property. n80 The reason for this is that shareholders, rather than the corporation, wish to realize the gain attributable to the property.

Several of the forbidden objectives that trigger application of the collapsible corporation rules can never in fact occur because statutory recognition provisions outside the collapsible corporation statute require a the corporation to recognize all, and not just two-thirds, of gain attributable to the property. n80.1 For example, although the Code includes liquidation as one of the forbidden objectives, n80.2 the triggering intent to liquidate before the corporation realizes the two-thirds of its taxable income from property n80.3 can never occur because a corporation must fully recognize all gain when it distributes property in a complete liquidation. n80.4 The same is true with respect to the triggering intent regarding distributions to shareholders before the corporation realizes the two-thirds of its taxable income from property n81 because corporations must fully recognize gains on distributions of appreciated property to shareholders. n82

Thus, Section 341's provisions are most likely to come into play when a shareholder sells stock in a corporation before the corporation has realized the required amount of income from the property described in Section 341(b)(1).

Example:

A taxpayer forms a corporation, the only activity of which is the construction of a building. More than one year later, when construction is nearly completed, he sells or exchanges his capital stock at a gain. If it were not for *IRC Section 341*, the taxpayer would realize long-term capital gain. Instead, he realizes ordinary income.

Section 341 assets are generally assets held for less than three years which, if sold by the corporation, would produce ordinary income. n83

It should be noted that *IRC Section 341* has no effect until the shareholder has realized a gain through the sale or exchange of collapsible corporation stock or a corporate distribution. Only when one of these events takes place do the collapsible corporation rules come into play. n83.1

As indicated by the collapsible corporation definition, a corporation is collapsible if it is formed or used for the prohibited purposes. n84 Thus, it makes no difference whether the shareholders form the corporation or acquire the stock of one already in existence.

[2] Relief Provisions

[a] Section 341(d) Relief

Although a corporation may fit the collapsible definition, there are relief provisions which may, nevertheless, allow a stockholder to realize capital gain on the disposition of his stock. n85 Ordinary income treatment will not apply:

- (1) To any stockholder who owns 5 percent, or less, in value of the corporation's outstanding stock at all times after construction of the property has commenced or, in the case of purchased Section 341 assets, at all times on or after such purchase. For purposes of determining ownership, the shareholder is considered to own stock actually owned by certain members of his family and by certain organizations in which he has an interest.
- (2) To transactions when more than 30 percent of the gain on the transaction is attributable to nontainted assets.
- (3) To gain realized after the expiration of three years following the completion of any construction,

purchase, etc., of the property.

The second of these three "escape hatches" (sometimes referred to as the "70/30" rule) warrants further discussion. Under this rule, none of a shareholder's recognized gain is treated as ordinary income if 30 percent or more of his gain is attributable to noncollapsible assets held by the corporation; if more than 70 percent of his gain is attributable to collapsible assets, all of his gain is ordinary income.

If the taxpayer can show that the collapsible corporation has more than one property, this may increase his chances of using the 70/30 rule. This will be the case if 30 percent or more of the taxpayer's gain results from property where the corporation has realized at least two-thirds of the taxable income to be derived from the property. This is so, even though the larger part of the taxpayer's gain is due to collapsible assets. n86

Example (1):

A taxpayer owns all the stock of a collapsible corporation and sells his stock at a gain. Forty percent of the taxpayer's gain is attributable to appreciated securities held by the corporation since its formation, and the remaining 60 percent is attributable to property the corporation constructed (including any land on which the property is constructed). The taxpayer realizes capital gain because not more than 70 percent of his gain is attributable to the constructed property.

Example (2):

A corporation's assets consist of two buildings which it constructed on separate tracts of land. Building A was completed in 1994 and Building B was completed in 1997. In 1999, the taxpayer sells his stock at a gain, 40 percent of which is attributable to Building A and the remaining 60 percent of which is attributable to Building B. The taxpayer does not qualify under exception (2) above because more than 70 percent of his gain is attributable to property which the corporation constructed (actually, 100 percent of the gain is attributable to such property). However, the taxpayer may treat 40 percent of the gain as capital gain under exception (3) above since Building A has been completed for more than three years. The remaining 60 percent of the gain is ordinary income.

For purposes of applying the three-year exception, the determination of when construction, etc., is completed is crucial. An apartment house was held not to be completed until all construction, including landscaping, had been completed and final inspection had been made by the FHA. n87 Another case held that construction was complete when the property was ready to begin earning a substantial part of its net income. n88 In this case, the construction of the property was considered complete when the building was fully occupied, despite the fact that landscaping and certain corrections were due under the contract.

A question also arises when improvements are made to the property after its original completion. If these improvements change the character of the construction or appreciably increase either the value of the property or the amount of income to be realized from it, the improvement may constitute new construction, starting a new three-year waiting period. n89

[b] The Section 341(f) Election

An election under Section 341(f) allows shareholders to recognize capital gain on the sale of their stock in a collapsible corporation if the corporation consents to recognize income on the following types of transactions which normally permit recognition to be deferred: *IRC Section 721* transfers to partnerships, Section 1031 exchanges, abandonment, retirement and gifts. n90 The election is not available to a shareholder, however, if the shareholder (or certain persons related to the shareholder) sold stock of another consenting corporation within the preceding five years. n91

[c] Corporations Not Considered as Collapsible

As originally enacted, *IRC Section 341* did more than was intended. It not only prevented taxpayers from converting ordinary income into capital gain, but it sometimes served to convert what would have been a capital gain into ordinary income. For example, suppose that an investor's corporation purchases rental property. Two years later, the investor sells his stock at a gain. Absent a special exception, the taxpayer gain would be considered ordinary, even though a capital gain would have resulted if he had owned and disposed of the property personally, or if the corporation had sold it directly. To avoid this, and similar unintended results, *IRC Section 341(e)* allows for relief in certain circumstances.

IRC Section 341(e) contains a corporate-level test and a shareholder-level test. Both tests must be met before a shareholder can obtain relief from the collapsible corporation provisions. The corporate-level test is applied to determine if the corporation's assets are primarily of a nature that would produce capital gains if sold by the corporation. If the corporation fails to meet this test, none of its shareholders may take advantage of *IRC Section 341(e)*. If the corporation passes this test, the shareholder-level test is applied on a shareholder-by-shareholder basis. Since this second test is applied to each shareholder individually, some of the corporation's shareholders may qualify for capital gains treatment while others do not.

In applying the test to the corporation, the shareholder must first determine the amount of the unrealized appreciation of the corporation's Section 341(e) assets. Essentially, Section 341(e) assets are those assets which would produce ordinary income if sold by a shareholder who owns more than 20 percent in value of the corporation's stock.

Example:

Corporation A is not a dealer in real estate but has certain real property which it uses in its business. The real estate would produce a capital gain to the corporation under *IRC Section 1231* if sold at a profit and, therefore, is not a Section 341(e) asset. However, if a shareholder owning more than 20 percent of the corporation's stock is a real estate dealer, the real property in the corporation would become a Section 341(e) asset of the corporation. Thus the business of one shareholder adversely affects all other shareholders for this purpose.

Once it is determined which of the corporation's assets are subsection (e) assets, it is necessary to determine the net unrealized appreciation in value of these assets. If the total of net unrealized appreciation is more than 15 percent of the corporation's net worth, the corporation fails the test and none of its shareholders is entitled to capital gains treatment under *IRC Section 341(e)*. For this purpose, net worth is defined as the excess of the total fair market value of the corporation's assets (plus the amount of any distribution the corporation has made in complete liquidation) over its total liabilities. n92

[3] Planning Considerations

If a shareholder cannot escape the collapsible provisions under any of the statutory exceptions discussed above, other avenues of escape may be explored. These are usually highly sophisticated, individualized plans which are beyond the scope of this discussion. However, one approach is the use of a tax-free transaction. Stock in a collapsible corporation can be exchanged tax free in a corporate reorganization, such as a statutory merger, for stock in another corporation. If, in the merger, the stockholders who exchange their stock in the collapsible corporation receive stock in a corporation that is not collapsible, a sale of this stock in the future should result in capital gain. n93

FOOTNOTES:

(n1)Footnote 75.2. Pub Law No 108-27, § 302(e)(4)(A), *repealing IRC § 341*; see Pub Law No 108-27, §§ 302(f)(1), 303 (effective date and sunset provisions for repeal of collapsible corporation rules).

(n2)Footnote 76. This Code section is one of the most notoriously complex provisions in a tax code not generally known for its simplicity. One source describes these rules as "characterized by a pathological degree of complexity,

vagueness and uncertainty." American Law Institute, *Federal Income Tax Project: Subchapter C* 111 (1992). The subject of collapsible corporations is discussed in greater detail in Nicholson, "Collapsible Corporations--General Coverage," T.M. 29-4th (1989).

(n3)Footnote 77. *IRC* § 341(a), before repeal by Pub Law No 108-27.

(n4)Footnote 78. *IRC* § 341, before repeal by Pub Law No 108-27.

(n5)Footnote 79. *IRC* § 336(a).

(n6)Footnote 79.1. See *IRC* § 341, before repeal by Pub Law No 108-27.

(n7)Footnote 80. *IRC* § 341(b).

(n8)Footnote 80.1. See *IRC* §§ 311(b) (gain on shareholder distributions), 336(a) (gain on distributions in liquidation).

(n9)Footnote 80.2. *IRC* § 341(a)(2) before repeal by Pub Law No 108-27.

(n10)Footnote 80.3. See *IRC* § 341(b)(1)(A).

(n11)Footnote 80.4. *IRC* § 336(a).

(n12)Footnote 81. See *IRC* § 341(b)(1)(A).

(n13)Footnote 82. *IRC* § 311(b)(1).

(n14)Footnote 83. *IRC* § 341(b)(1), (2).

(n15)Footnote 83.1. *IRC* § 341(a).

(n16)Footnote 84. *Treas Reg* § 1.341-2(a)(3).

(n17)Footnote 85. These relief provisions help the shareholders, but have no effect on the corporation. See *Leisure Time Enterprises, Inc v Commr*, 56 TC 1180 (1971) .

(n18)Footnote 86. See *Treas Reg* § 1.341-4.

(n19)Footnote 87. *Glickman v Commr*, 256 F2d 108 , 58-2 USTC P 9598, 1 AFTR2d 1883 (1958) .

(n20)Footnote 88. *Weil v Commr*, 252 F2d 805 , 58-1 USTC P 9357, 1 AFTR2d 1096 (2d Cir 1958) .

(n21)Footnote 89. *Thomas v Commr*, TC Memo 1981-387, 42 TCM 496 (1981) ; *Rev Rul* 72-422, 1972-2 CB 211 ; *Rev Rul* 64-125, 1964-1 CB 131 .

(n22)Footnote 90. *Treas Reg* § 1.341-7(e)(1).

(n23)Footnote 91. *IRC* § 341(f)(5).

(n24)Footnote 92. *IRC* § 341(e)(7).

(n25)Footnote 93. *Rev Rul* 73-378, 1973-2 CB 113 .



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CHAPTER 16 Special Forms of Holding Real Estate *

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CHAPTER 16 Special Forms of Holding Real Estate *

1-16 Federal Taxes Affecting Real Estate § 16.01

§ 16.01 Introduction

There are various forms of business entities that resemble corporations and partnerships, yet provide distinct tax and investment advantages for businesses that own real estate. This chapter addresses several of these special business entities, including real estate investment trusts, real estate mortgage investment conduits, condominiums, cooperatives, employee benefit trusts, and financial asset securitization investment trusts. Master limited partnerships are discussed in Chapter 14.

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CHAPTER 16 Special Forms of Holding Real Estate *

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§ 16.02 Real Estate Investment Trusts (REITs)

[1] Introduction

The REIT is a special form of business entity created for the specific purpose of encouraging widespread ownership of real estate by small investors. n1 REITs provide the average investor with an opportunity to pool capital with others for investment in managed real estate, to spread risks through diversified holdings and to acquire properties which might otherwise be beyond the means of the individual investor. Additionally, a REIT is an investment vehicle that affords its shareholders the ability to easily sell or transfer their ownership interests.

A REIT has certain federal income tax advantages over a conventional corporation. The principal advantage is that a REIT is allowed a tax deduction for dividends paid to its shareholders, thereby avoiding the tax normally assessed at the corporate level on distributions. n2 Additionally, unlike a corporation, a REIT may elect to pass through long-term capital gains to its shareholders. n3 To obtain these tax advantages, an entity must first elect to be taxed as a REIT, and further, the entity must satisfy certain technical requirements. n4 Failure to satisfy these requirements or failure to elect REIT status may result in the entity being treated as a corporation, or, in the case of a failure to ascertain ownership, result in a fine. n5

One disadvantage of a REIT is that tax losses are trapped inside the REIT, while other investment vehicles, such as limited partnerships, permit losses to be passed directly to the investors.

[2] Qualification as a REIT

The Internal Revenue Code (Code) imposes stringent qualifying requirements for an entity to receive favorable REIT tax status. The requirements, which must be satisfied throughout the life of the entity, relate to the organization of the REIT, the nature of its income and assets, its dividend distributions, its reporting and recordkeeping and the management of properties owned by the REIT. If all statutory requirements are met, the REIT is permitted a deduction for all earnings distributed to shareholders; thus, the earnings distributed to the shareholders are taxed only once, at the shareholder level. n6

[a] Organizational Requirements

An entity must satisfy certain organizational requirements to be eligible to elect REIT status. The organizational

requirements are summarized as follows:

- A REIT must be formed as a corporation, trust or association. n7 Two major considerations in deciding which type of entity is to be used are: (1) whether and to what degree the trustees or directors are liable for the REIT's contracts under state law; and (2) the effect of the type of entity on state income and franchise taxes. n8
- A REIT must be managed by one or more directors or trustees. The trustees must have continuing exclusive authority over the management of the trust, the conduct of its affairs and the management and disposition of its property. n9 Trustees must have such rights and powers as will satisfy the corporate characteristic of "centralization of management." n10
- A REIT must have beneficial ownership evidenced by transferable shares or by transferable certificates of beneficial interest. n11 The regulations provide that provisions in the trust instrument, corporate charter or bylaws which permit the trustees or directors to redeem shares or to refuse to transfer shares in any case where the trustees or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a REIT will not render the shares "nontransferable." n12
- A REIT (but for its election to be taxed as a REIT) must otherwise be taxable as a domestic corporation. n13 This determination is made in accordance with the normal entity classification rules found in Section 7701(a)(3) and (4) of the Code. n14
- A REIT must not be a financial institution or an insurance company. n15
- A REIT must have its beneficial ownership held by at least 100 or more persons during at least 335 days of a full taxable year or a proportionate part of a short taxable year. n16 There is no attribution of ownership in determining the 100 shareholders. n17 Because newly-formed REITs could have difficulties meeting the "100 shareholder rule," this requirement is waived during the first tax year for which a REIT election is made. n18
- During the last half of the taxable year, no more than 50 percent of the value of the outstanding shares can be owned by five or fewer individuals (*i.e.*, the REIT cannot be a "personal holding company"). n19 This test is referred to in this chapter as the "50 percent shareholder test". The personal holding company attribution rules apply to determine the number of individual shareholders for this purpose. n20 However, an individual is not deemed to own equity interests if such interests are actually owned by a person with whom the individual participates in a partnership. n21 Special rules apply to domestic pension or profit-sharing trusts. Generally, beneficiaries of a pension or profit-sharing trust will be treated as holding the stock of the REIT in proportion to their actuarial interests in the pension trust. n22 In order to avoid circumvention of the unrelated business taxable income rules, a pension or profit-sharing trust holding shares in a REIT will be subject to unrelated business income tax under some circumstances. n23 The requirement that a REIT cannot be closely held does not apply during the first tax year for which a REIT election is made. n24 It should also be noted that a REIT that complies with regulations for ascertaining its ownership, n25 and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, is treated as meeting the requirement that it not be a personal holding company. n26

These organizational criteria must be carefully observed, because the failure to comply with any requirement will result in the entity's failure to qualify as a REIT.

Additionally, newly-formed REITs must adopt a calendar year. n27 A newly-electing REIT is permitted to change its annual accounting period to a calendar year without approval from the Internal Revenue Service (Service) if the entity has not previously engaged in an active trade or business. n28 Further, an electing entity must either have been treated as a REIT for all taxable years beginning after February 28, 1986, or, by the end of its first year as a REIT, have distributed to its shareholders all earnings and profits attributable to any tax years during which the entity was not a REIT. n29 In effect, this rule requires existing C corporations that wish to elect REIT status to eliminate their accumulated earnings and profits accounts. The IRS has ruled that a taxpayer may offset its surplus in accumulated E & P by its REIT predecessor's cumulative deficit in E & P for purposes of satisfying the requirement that it have no E & P accumulated in any non-REIT year. n30

Two sets of regulations have been issued regarding the net built-in gain of assets of C corporations that are converted to REITs. n30.1 One set of regulations, *Regulation Section 1.337(d)-6* (the -6 regulations), applied to conversion transactions occurring on or after June 10, 1987 and before January 2, 2002. n30.2 Another set of regulations, *Regulation Section 1.337(d)-7* (the -7 regulations), applies to conversion transactions occurring on or after January 2, 2002. n30.3 Both the -6 and -7 regulations apply to certain transactions or events that result in a REIT or a regulated investment company (RIC) owning property that has a basis determined by reference to a C corporation's basis in the property.

Under the -7 regulations, if property owned by a C corporation becomes the property of a RIC or REIT (the converted property) in a conversion transaction, then *IRC Section 1374* becomes the default treatment unless the C corporation elects deemed sale treatment with respect to the conversion transaction. n30.4 Accordingly, the RIC or REIT will be subject to tax on the net built-in gain in the converted property under the rules of *IRC Section 1374* (as modified) as if the RIC or REIT were an S corporation. n30.5

If a RIC or REIT succeeds to property in a continuation transaction that was subject to *IRC Section 1374* in the hands of a predecessor RIC, REIT, or S corporation, the rules of *IRC Section 1374* apply to the successor to the same extent that the predecessor was subject to the rules of *IRC Section 1374* with respect to the property. In addition, the 10-year recognition period of the successor with respect to the property n30.6 is reduced by the portion of the 10-year recognition period of the predecessor that expired before the date of the continuation transaction. (Note that 10-year recognition period is temporarily reduced to 7 years, effective for any taxable year beginning in 2009 or 2010.) n30.7 For this purpose, a continuation transaction means the qualification of the predecessor as a RIC or REIT or the transfer of property from the predecessor to the successor in a transaction in which the successor's basis in the transferred property is determined, in whole or in part, by reference to the predecessor's basis in that property. n30.8

In determining the RIC's or REIT's net recognized built-in gain, several modifications to the *IRC Section 1374* rules are made. First, the pre-limitation amount n30.9 is reduced by the portion of that amount, if any, that is subject to tax under *IRC Section 857(b)(4), (5), (6), or (7)*. n30.10 Those provisions impose a tax on a REIT's capital gains, income from foreclosure property, the income of certain REITs that fail to meet the 75-percent or 95-percent gross income tests, n30.11 and a 100 percent penalty tax on income from prohibited transactions and income from redetermined rents, redetermined deductions, and excess interest. n30.12 Second, the taxable income limitation n30.13 is reduced by an amount equal to the tax imposed under *IRC Section 857(b)(5), (6), and (7)*. n30.14

The -7 regulations generally allow RICs and REITs to use loss carryforwards and credits and credit carryforwards arising in taxable years for which the corporation that generated the attribute was a C corporation (and not a RIC or REIT) to reduce net recognized built-in gain and the tax on it, subject to limits imposed by *IRC Section 1374(b)(2) and (b)(3)* (dealing with NOL and credit carryforwards from C years to S years). n30.15 In addition, the -7 regulations provide an ordering rule for applying loss carryforwards, credits, and credit carryforwards to reduce net recognized built-in gain (and the tax thereon) and RIC or REIT taxable income (and the tax thereon). The ordering rule requires that loss carryforwards of a RIC or REIT be used to reduce net recognized built-in gain for a taxable year to the greatest extent possible before those losses can be used to reduce investment company taxable income or REIT taxable income

under *IRC Section 857(b)* for that taxable year. Similarly, credits and credit carryforwards of a RIC or REIT must be used to reduce the tax on net recognized built-in gain imposed under the -7 regulations to the greatest extent possible before those credits and credit carryforwards can be used to reduce the tax, if any, on investment company taxable income or on REIT taxable income for purposes of *IRC Section 857(b)* for that taxable year. n30.16

Recognized built-in gains and losses of a RIC or REIT are taken into account for purposes of Subchapter M (*IRC Sections 851-860L*). Thus, they are included in computing investment company taxable income, n30.17 REIT taxable income n30.18 capital gains for purposes of *IRC Sections 852(b)(3)* and *857(b)(3)*, gross income derived from sources within any foreign country or possession of the United States for purposes of *IRC Section 853*, and the dividends paid deduction for various RIC and REIT purposes. n30.19 In computing those income and deduction items, capital loss carryforwards and net operating loss carryforwards that are used by the RIC or REIT to reduce recognized built-in gains are allowed as a deduction, but only to the extent that they are otherwise allowable as a deduction under the Internal Revenue Code (including *IRC Section 852(b)(2)(B)*). n30.20

The entity-level tax imposed on net recognized built-in gain is treated as a loss that reduces the RIC's or REIT's taxable income and earnings and profits. The character of the loss attributable to the tax on net recognized built-in gain is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. n30.21 An example in the -7 regulations clarifies that earnings and profits attributable to built-in gain recognized by a REIT or RIC are subchapter M (*IRC Sections 851-860L*) earnings and profits. n30.22

If the C corporation that qualifies as a RIC or REIT or transfers property to a RIC or REIT makes a deemed sale election, it will recognize gain and loss as if it had sold the converted property to an unrelated party at fair market value on the deemed sale date. The deemed sale treatment does not apply, however, if its application would result in the recognition of a net loss. For this purpose, "net loss" is the excess of aggregate losses over aggregate gains (including items of income), without regard to character. n30.23 If a corporation recognizes a net gain under the deemed sale, the converted property has a basis in the hands of the RIC or REIT equal to the fair market value of the property on the deemed sale date. n30.24

If the conversion transaction is a qualification of a C corporation as a RIC or REIT, then the deemed sale date is the end of the last day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC or REIT. If the conversion transaction is a transfer of property owned by a C corporation to a RIC or REIT, then the deemed sale date is the end of the day before the day of the transfer. n30.25

The -7 regulations also contain an anti-stuffing rule for taxpayers electing deemed sale treatment, which prevents those taxpayers from decreasing net gains on conversion transactions by stuffing loss property into a C corporation prior to a conversion transaction. n30.26 Under the -7 regulations, aggregate principles apply to partnership transactions. Accordingly, the -7 regulations apply to property transferred by a partnership to a RIC or REIT to the extent of any C corporation partner's proportionate share of the transferred property. n30.27

A C corporation (or a partnership to which the regulations apply) n30.28 makes the deemed sale election with the following statement: "[Insert name and employer identification number of electing corporation or partnership] elects deemed sale treatment under § 1.337(d)-7(c) with respect to its property that was converted to property of, or transferred to, a RIC or REIT, [insert name and employer identification number of the RIC or REIT, if different from the name and employer identification number of the C corporation or partnership]." The statement must be attached to the federal income tax return of the C corporation or partnership for the taxable year in which the deemed sale occurs. The election is irrevocable. n30.29

The default treatment provided by the -7 regulations n30.30 does not apply to any conversion transaction to the extent that gain or loss otherwise is recognized on such conversion transaction. n30.31 In addition, subject to exceptions

discussed below, the default treatment provided by the -7 regulations n30.32 does not apply to any corporation that: n30.33

- immediately prior to qualifying to be taxed as a RIC or REIT was subject to tax as a C corporation for a period not exceeding two taxable years; and
- immediately prior to being subject to tax as a C corporation was subject to tax as a RIC or REIT for a period of at least one taxable year.

The -7 regulations default treatment does apply, however, to property acquired by the corporation while it was subject to tax as a C corporation from any person in a transaction that results in the acquirer's basis in the property being determined by reference to a C corporation's basis in the property. n30.34 The -7 regulations default treatment also applies if the RIC or REIT was previously subject to *IRC Section 1374* before it became subject to tax as a C corporation. In this case, the default *IRC Section 1374* treatment applies to the RIC or REIT upon its requalification as a RIC or REIT, except that the 10-year recognition period with respect to the property is reduced by the portion of the 10-year recognition period that expired before the RIC or REIT became subject to tax as a C corporation and by the period of time that the corporation was subject to tax as a C corporation. n30.35

The -6 regulations, in effect for transaction before January 2, 2002, n30.36 impose a reverse default treatment from the -7 regulations, and provide that, if property of a C corporation that is not a RIC or REIT becomes the property of a RIC or REIT in a conversion transaction, then the C corporation is subject to deemed sale treatment, unless the RIC or REIT elects to be subject to *IRC Section 1374* [the tax on S corporation built-in gains]. Thus, the C corporation generally recognizes gain and loss as if it sold the property converted to RIC or REIT property or transferred to the RIC or REIT (the converted property) to an unrelated party at fair market value immediately before the conversion transaction. n30.37 If the C corporation recognizes net gain on the deemed sale, then the basis of the converted property in the hands of the RIC or REIT is adjusted to its fair market value immediately before the conversion transaction. n30.38 The -6 regulations do not permit a C corporation to recognize a net loss on the deemed sale. For this purpose, net loss is defined as the excess of aggregate losses over aggregate gains (including items of income), without regard to character. Where there is a net loss, the C corporation recognizes no gain or loss on the deemed sale, and the C corporation's basis in the converted property carries over to the RIC or REIT. n30.39

The -6 regulations in most other respects are the same as the -7 regulations, although there is no equivalent anti-stuffing rule. n39.40 In lieu of the -6 regulations, taxpayers may apply a modified version of rules that were included in prior temporary regulations to determine the tax consequences of conversion transactions occurring on or after June 10, 1987, and before January 2, 2002. n31

[b] Source of Income Requirements

Entities electing REIT status must also satisfy certain requirements as to the sources of annual income. These requirements are similar to those imposed on regulated investment companies (mutual funds), but with some modifications designed to ensure that a REIT's income is derived primarily from passive investment in real estate. n31.1

For purposes of the various REIT gross income tests, "gross income" generally has the same meaning under *IRC Section 61* and the regulations thereunder. n31.2 Any discharge of indebtedness income, however, is not taken into account in determining whether an entity meets the REIT gross income tests. n31.3 Private letter rulings are frequently requested as to whether particular items are included in a REIT's "gross income." For example, the IRS has ruled that an *IRC Section 481* adjustment resulting in gross income as a result of a mandatory statutory provision is not taken into account in applying REIT gross income tests and does not otherwise influence the taxpayer's REIT status. n31.4

Most ruling requests regarding a REIT's gross income involve reimbursements received by the REIT, a taxable REIT

subsidiary, or a pass-through entity owned by a REIT or a taxable REIT subsidiary. Whether a particular reimbursement is includable in gross income sometimes depends on whether the reimbursements are for services that are integrally related to the services being performed by the entity. If the entity is generally in the business of receiving compensation for services of the type that are being reimbursed, the reimbursements will ordinarily be included in the entity's gross income. n31.5 If this is not the case, however, and the reimbursements relate to services not typically performed by the REIT or the REIT subsidiary, then the reimbursements will not be included in gross income. n31.5.1

Thus, in one ruling, the taxpayer, an umbrella partnership REIT, conducted its operations through a subsidiary operating partnership (OP). OP engaged in property management and leasing activities for wholly-owned properties and for properties that are owned by third parties. The taxpayer planned to restructure its leasing and management activities, after which neither it nor OP would be in the business of providing leasing or property management services to third parties. OP would contribute all of its third party leasing and property management contracts (including those with its joint venture partners) to either Corporation A or a wholly-owned subsidiary of Corporation A (collectively, "TRS"). TRS would become a taxable REIT subsidiary of the taxpayer. The employees performing the leasing and property management services on behalf of TRS for joint venture property owners would remain employees of OP for administrative purposes. OP and TRS would enter into an employee sharing agreement under which those employees would be treated as loaned or advanced to TRS. Under the agreement, TRS would reimburse OP for TRS's allocable share of the employee costs including salaries, benefits, and other compensation, costs associated with payroll administration, and allocable overhead costs. The reimbursements would be solely for costs, both direct and indirect, and OP will not charge for profit. The IRS ruled that the amounts paid to OP by TRS as reimbursement for TRS's allocable share of employee costs and other shared expenses would not be treated as gross income received by either OP or the taxpayer, largely because neither OP nor the taxpayer would engage in the business of providing property management and leasing services. n31.5.2

In another ruling, with a different result, reimbursements received for employee expenses and other costs incurred by a taxpayer in providing residential property development and management services to lower-tiered entities were includable in the taxpayer's gross income because the taxpayer was generally in the business of receiving compensation for services of that type. In contrast, reimbursements the taxpayer for general liability and property and casualty insurance the taxpayer obtained for the lower-tiered entities were not includable in gross income because the taxpayer was not in the insurance business. n31.6 Funds collected by a REIT that must be used to pay expenses of the lower-tier entity and over which the REIT has no control also are not included in the REIT's gross income. n31.7 Similarly, reimbursements of REIT salaries and other costs of its employees by entities in which the REIT has an interest in order to compensate their time spent performing services for those entities are not treated as gross income in applying the REIT gross income requirements. n31.8

A guarantee substitution payment received in exchange for agreeing to relinquish rights to pursue legal remedies against guarantor in connection with various leases has also been held not to be gross income for purposes of the REIT gross income tests. n31.9 The IRS has also ruled that taxable income associated with the receipt of State tax credits can be ignored in determining whether a REIT satisfies the REIT gross income tests. The credits were intended to promote the remediation and development of contaminated real estate, and the furtherance of this public policy did not interfere with or impede the policy objectives behind the REIT gross income tests. n31.10 In contrast, the IRS has ruled that amounts received as abatements or refunds of real property taxes connected with a development in which a REIT had an interest through a partnership may be included for purposes of satisfying the REIT gross income test of *IRC Section 856(c)(2)*. n31.11

The IRS has also issued a notice providing guidance as to when foreign currency gain under *IRC Section 987* will be qualifying income under the REIT income tests. n31.12 The notice is directed to REITs that have invested in real estate assets outside the United States through entities or partnerships that qualify as qualified business units (QBUs). n31.13 The notice applies to foreign currency gains that result from investing in real property or other assets through a QBU with a functional currency other than the US dollar. Absent a ruling to the contrary, a REIT automatically has the US

dollar as its functional currency. A REIT may have a QBU, however, that is subject to *IRC Section 987* and that has a functional currency other than the US dollar. n31.14 In that case, the REIT may recognize currency gain under *IRC Section 987* when the QBU remits property to the REIT. n31.15 *Notice 2007-42* provides that, until further guidance, REITs should use rules set forth in proposed regulations under *IRC Section 987* to determine if that gain qualifies under the REIT income tests. n31.16 Under those proposed regulations, n31.17 the owner of a QBU must generally determine the character of a *IRC Section 987* gain or loss in the year of remittance using a modified asset method. n31.18 The modified gross income method n31.19 cannot be used. The IRS intends to amend the proposed regulations under *IRC Section 987* to include guidance concerning the proper characterization under the REIT income tests of the foreign currency gain recognized by a REIT on a remittance from a QBU of the REIT. n31.20

[i] 75 Percent Income Test

At least 75 percent of a REIT's gross income (excluding gross income from prohibited transactions, as described below) for the year must be derived from passive real estate or real estate mortgage investments. n32 Permissible sources of income for this 75 percent income test include:

- rents from real property;
- interest on obligations secured by mortgages on real property or on interests in real property n32.1 (as discussed in § 16.02[2][c][ii][E], below, the IRS has also provided a safe harbor under which interest on a loan from a REIT that is secured by an interest in a partnership or by the sole membership interest in a disregarded entity will be treated as interest on an obligation secured by a mortgage on real property or on an interest in real property for purposes of the 75-percent REIT gross income test); n32.2
- gains from the sale or other disposition of real property which is not inventory or property held primarily for sale to customers in the ordinary course of business (including interests in real property and interests in mortgages on real property); n33
- dividends and other distributions on, and gains from the sale of, shares of other qualified REITs;
- abatements and refunds of real property taxes;
- income and gains derived from foreclosure property;
- commitment fees; and
- qualified temporary investment income. n34

Interest on a second mortgage loan is treated as secured by real property, even if personal property also secures the loan, where the fair market value of the real property securing the loan is equal to or exceeds the loan amount. n35

The Treasury Department is authorized to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under the 75-percent test, or to be included as qualifying income for that test, in appropriate cases consistent with the purposes of the REIT provisions. Treasury regulatory authority applies solely for purposes of applying the percentage test for REIT qualification, and does not affect the substantive characterization of an item as income for purposes of computing the REIT's taxable income. n36

[ii] 95 Percent Income Test

In addition to the 75 percent income test, at least 95 percent of a REIT's gross income (excluding gross income from

prohibited transactions, as described below) for the year must be derived from the following items: n37

- dividends;
- interest;
- rents from real property;
- gain from the sale or other disposition of stock, securities, and real property that is not inventory;
- abatements and refunds of real property taxes;
- income and gain from foreclosure property; n38
- amounts for entering into agreements to: (1) make loans secured by mortgages on or interests in real property; or (2) purchase or lease real property (including interests in real property and interests in mortgages on real property);
- gain from the sale or disposition of a real estate asset that is not a prohibited transaction; and
- mineral royalty income earned in the first taxable year beginning after May 22, 2008 from real property owned by a timber REIT and held, or once held, in connection with the trade or business of producing timber by that REIT.

The Treasury Department is authorized to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under the 95-percent test, or to be included as qualifying income for that test, in appropriate cases consistent with the purposes of the REIT provisions. Treasury regulatory authority applies solely for purposes of applying the percentage test for REIT qualification, and does not affect the substantive characterization of an item as income for purposes of computing the REIT's taxable income. n39

[iii] 30 Percent Income Limitation

The 30-percent gross income requirement applicable to REITs is repealed, effective for tax years beginning after August 5, 1997. n40 For tax years beginning before August 6, 1997, less than 30 percent of a REIT's gross annual income must be derived from the sale or disposition of the following:

- stock or securities that have been held for less than 1 year;
- inventory-type property (prohibited transactions); and
- real property that has been held for less than four years. n41

Gains from real property which has been involuntarily converted--for example, by casualty or condemnation--and gains from the sale of foreclosure property are specifically excluded from this limitation. n42

[iv] Shared Appreciation Provisions

Income received from a shared appreciation provision in a debt instrument secured by real property is treated as gain recognized from the sale of the underlying secured property. n43 For purposes of the income test and the prohibited transaction provisions, the REIT is treated as having held the secured property for the period during which it held the

shared appreciation provision (or if shorter, for the period during which the borrower held the secured property).ⁿ⁴⁴ If the underlying secured property is an inventory-type asset held primarily for sale to customers in the ordinary course of business in the hands of the borrower, the shared appreciation provision will be treated as such property.ⁿ⁴⁵ Interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within four years of the REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor, unless the REIT acquiring the mortgage knew or had reason to know that the property subject to the mortgage would be sold in a bankruptcy proceeding.ⁿ⁴⁶ The purpose of the shared appreciation provisions is to clarify the treatment of shared appreciation provisions for income test purposes. As written, however, they are not particularly beneficial to REITs. First, the definition of a "shared appreciation provision" is so narrow as to preclude its applicability to many shared appreciation mortgages.ⁿ⁴⁷ Second, notwithstanding the bankruptcy safe harbor,ⁿ⁴⁸ the fact that a REIT could have a prohibited transaction or nonqualifying income based on the actions of a borrower is quite worrisome.

[v] Prohibited Transactions

A "prohibited transaction" is a sale or other disposition of property which is not "foreclosure property" (as described in Section 16.02 [c] [iii], below) and which is either inventory or property held primarily for sale to customers in the ordinary course of business.ⁿ⁴⁹ Examples of prohibited transactions include subdividing land and selling the resulting lots, and developing and selling condominiums. Any net income derived from prohibited transactions is taxed at a rate of 100 percent.ⁿ⁵⁰ Net income from prohibited transactions includes the excess of the gain from prohibited transactions over deductions that are directly connected with them. Foreign currency gains and losses^{n50.1} that are attributable to any prohibited transaction are taken into account in determining the amount of prohibited transaction net income subject to the 100-percent tax.^{n50.2} Losses from prohibited transactions cannot be used to offset gains from other prohibited transactions.ⁿ⁵¹

[vi] Rents from Real Property

The definition of "rents from real property" is critical to most REITs because it is typically the principal source of income qualifying for the 75 percent income test. Rents from real property include amounts denominated as "rents" and "charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated."ⁿ⁵² Services rendered to tenants of a particular building are considered customary if, in the geographic area in which the building is located, tenants in similar buildings are customarily provided with the service.^{n52.1}

When rent is received on property consisting of both real and personal property, such as a furnished apartment building, an apportionment of the rent may be required to determine the (nonqualifying) rent attributable to personalty. If 15 percent or less of the rent is attributable to the personal property, determined based on the ratio of the average fair market values of the personal property to the average fair market values of both the real property and personal property, all of the rent is includable as "rents from real property."ⁿ⁵³ If more than 15 percent of the rent is attributable to personal property, that portion will be nonqualifying income.ⁿ⁵⁴ Certain income from taxable REIT subsidiaries is also included in rents from real property.ⁿ⁵⁵

The definition of "rents from real property" excludes certain other types of rents. First, rent will be nonqualifying if the amount of rent depends on the profits or income of any person;ⁿ⁵⁶ however, rents based on a fixed percentage or percentages of gross receipts are allowable.^{n56.1} Amounts received under a naming agreement have been held not to constitute "rents from real property."^{n56.2}

Second, except for certain amounts received from taxable REIT subsidiaries,ⁿ⁵⁷ nonqualifying rental income includes amounts received from a tenant in which the REIT holds, directly or indirectly, a 10 percent or greater interest.ⁿ⁵⁸ Complex attribution rules apply in determining whether a REIT is deemed to own an interest in a tenant.ⁿ⁵⁹ The IRS

has ruled in several rulings that a REIT's momentary ownership of corporate stock of a tenant that exceeds the permissible percentage limit will not cause amounts to be excluded as "rents from real property." This situation usually arises with respect to temporary transfers of property as a component part of a larger transaction or corporate restructuring. n60

Third, effective for tax years beginning after August 5, 1997, the term "rents from real property" does not include any impermissible tenant service income. n61 "Impermissible tenant service income" means amounts received by a REIT for: (1) services furnished or rendered by the REIT to the tenants of rental property; or (2) managing or operating that property. n62 Certain amounts received for services rendered by independent contractors and incidental amounts received for the rental of personal property are not included in impermissible tenant service income. n63 Applying this provision, the IRS ruled that a REIT's supervision and coordination of construction build-outs performed by independent contractors for REIT tenants would not cause amounts received from tenants to be impermissible tenant service income. Its rationale was that under the various build-out arrangements, only independent contractors would perform the construction work, the taxpayer would not receive or derive income from the independent contractors, and the taxpayer would not bear any of the costs of the work. n63.1

Income from a taxable REIT subsidiary is also not treated as impermissible tenant service income. n64 Therefore, a taxable REIT subsidiary or a partnership in which it is a partner may provide non-customary services to tenants of a REIT without adverse tax consequences; the rents paid by those tenants to the REIT will not thereby fail to qualify as rents from real property under *IRC Section 856(d)*. n64.1

A REIT may render a *de minimis* amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rents from real property. The value of the impermissible services may not exceed 1 percent of the gross income from the property. For these purposes, the services may not be valued at less than 150 percent of the REIT's direct cost of the services. If a REIT provides more than the above *de minimis* amount of services, all amounts received for those services are treated as impermissible tenant service income and are not treated as rents from real property. n65 The IRS has clarified how a REIT's receipt of impermissible tenant service income will affect the qualification of other amounts as rents from real property. n66

Example 1:

Y, a REIT that files its returns on a calendar year basis, owns a high-rise apartment building, Building P. P has 100 apartments, of which 95 are standard unfurnished apartments rented on an annual basis. The remaining five apartments are furnished guest apartments available for short-term leases to guests of tenants. Employees of Y render maid service in connection with the lease of guest apartments. Y also provides heat and light to all tenants in P. Y does not render other services to tenants of P or engage in any other activity at P that could give rise to impermissible tenant service income.

Y derives a total of \$1,000x from all tenants of P for the year, including \$90x from visitors who rent guest apartments. Of the \$90x received from tenants of guest apartments, the amount received with respect to maid service is \$9x, which is greater than 150 percent of the direct costs of Y in rendering the service. Of the \$1,000x received from all the tenants, the amount paid to Y for heat and light is \$100x (\$1x for each unit, including the guest units), which is also greater than 150 percent of the direct costs of Y for providing heat and light. The amount of rent attributable to personal property leased in connection with the rental of each guest apartment in P does not exceed 15 percent of the total rent for the apartment attributable to both the real property and the personal property.

Only \$9x attributable to the impermissible tenant services rendered to tenants of the guest apartments fails to qualify as rents from real property. Because the provision of heat and light is a permissible tenant service, no amount attributable to that service (including amounts paid by tenants of the guest

apartments) is treated as impermissible tenant service income in applying the one percent *de minimis* rule. The \$9x of impermissible tenant service income does not exceed one percent of the \$1,000x received or accrued directly or indirectly by Y with respect to P. Therefore, the rendering of impermissible tenant services to tenants of the guest apartments does not prevent otherwise qualifying amounts received by Y from tenants of P (including tenants of the guest apartments) from qualifying as rents from real property. n67

Example 2:

Assume the same facts as in Example 1, except that Y derives \$110x from visitors who rent guest apartments. Of the \$110x received from those visitors, the amount received with respect to maid service is \$11x, which is greater than 150 percent of the direct costs of Y in rendering the service.

In this situation, the \$11x attributable to the impermissible tenant services rendered to tenants of the guest apartments is impermissible tenant service income. n68 The \$11x of impermissible tenant service income also exceeds one percent of the \$1,000x received or accrued directly or indirectly by Y with respect to Building P. Therefore, **all** of the \$1,000x derived by Y from P is impermissible tenant service income, and the entire \$1,000x fails to qualify as rents from real property. n69

For tax years beginning before August 6, 1997, the term "rents from real property" excludes amounts received when the REIT furnishes services to its tenants or manages or operates the property other than through an independent contractor from whom the REIT receives no income, unless the services are those that, if performed by a tax-exempt entity, would not produce "unrelated business income." n70

For a more detailed discussion of the issues related to the effect of self-management on qualifying income, see *Section 16.02[2][f]*, below. These exclusions are meant to ensure that the majority of the REIT's income is from passive income sources and not from the active conduct of a trade or business. n71

A REIT may participate in the net income of its tenants in certain limited situations. If a REIT receives amounts from a tenant that receives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and a portion of the amount the tenant receives would be qualified rental income if received by the REIT, then the amounts the REIT receives will constitute "rents from real property" to the extent such amounts are attributable to the qualified rents received by the tenant. n72 In other words, the REIT can receive contingent rent or interest based on net income as long as a tenant does not include such terms in its lease agreements.

Planning Tip:

Shifting of Nonqualified Income Between Years. Prohibitions on the shifting of nonqualified income between years are far-reaching, and careful planning of each transaction within the REIT framework is required. Because the income tests are performed on a taxable year basis, n72.1 the timing of income recognition is important. The shifting of nonqualified income between years could adversely or beneficially affect REIT status.

Example:

A REIT sells a large portion of its real estate portfolio on December 20 of Year 1 as part of a management decision to change the geographic distribution of its properties. The cash proceeds are invested in high-yield interest-bearing instruments that do not qualify for the 75 percent income test. Reinvestment of the proceeds in real estate takes longer than originally planned. The REIT's gross income for Year 2 is as follows

1-16 Federal Taxes Affecting Real Estate § 16.02

Rents	\$25,000
Interest on mortgage loans	5,000
Interest on non-mortgage loans	12,000
Total	\$42,000

The REIT fails the 75 percent income test because it only has 71 percent of its income from qualifying sources $((25,000 + 5,000) / 42,000)$. The REIT should have invested some of the cash proceeds from its real estate sales in a real estate asset. For example, the REIT could have invested in pass-through certificates issued by the Government National Mortgage Association. Such certificates produce qualifying income and are liquid investments.

Note:

Another aspect of rents from real property can come into play for REITS. Solely by virtue of its functions with respect to rental activity that produces income qualifying as rents from real property, a REIT can be engaged in the active conduct of a trade or business under *IRC Section 355*. This can allow *IRC Section 355* treatment for distributions of stock by a C corporation that converts to a REIT. n72.2

[vii] Certain Income From Taxable REIT Subsidiaries**[A] In General**

In general, rents paid to a REIT cannot qualify as "rents from real property" if the REIT owns more than 10 percent of the value and voting power of a corporation paying the rents. n73

Effective for tax years beginning after 2000, an exception to this general rule applies for income from certain business activities conducted by a taxable REIT subsidiary. The subsidiary can provide services to tenants of REIT property (even if those services are not considered services customarily furnished in connection with the rental of real property), and the subsidiary can manage or operate properties, generally for third parties, without causing amounts received or accrued directly or indirectly by the REIT for those activities to fail to be treated as rents from real property. n74 This exception can come into play if either of two requirements is met. The first requirement relates to a limited rental situation. It is met when at least 90 percent of the leased space of the property is rented to unrelated third persons at rents that are substantially comparable to those paid by other of the REIT's tenants for comparable space. n75

Specific safe-harbor timing rules apply for testing rent comparability for this purpose. The substantial comparability requirement is met with respect to a lease to a taxable REIT subsidiary of a REIT if the requirement is met under the terms of the lease at the following times: n75.1

- At the time the lease is entered into;
- At the time of each extension of the lease, including a failure to exercise a right to terminate; and
- At the time of any modification of the lease between the trust and the taxable REIT subsidiary if the rent under that lease is effectively increased pursuant to the modification. With respect to this item, if the REIT owns more than 50 percent of the taxable REIT subsidiary n75.2 rents from real property do not include rent under the lease to the extent of the increase in that rent on account of that modification.

If the rent comparability requirements are met during the safe harbor testing times, they will continue to be treated as

met so long as there is no increase in the space leased to any taxable REIT subsidiary of the REIT or to certain related parties in which the REIT holds a 10-percent or greater interest. n75.3 If there is an increase in the space leased during any calendar quarter with respect to any property, the substantial rent comparability requirements are treated as met during the quarter and the succeeding quarter if they are met at the close of such succeeding quarter. n75.4

The second requirement is for certain lodging facilities or qualified health care property. n75.5 It is met if the REIT's interest in real property is a qualified lodging facility or qualified health care property that is leased by the REIT to a taxable REIT subsidiary of the REIT, provided that the property is operated on behalf of that subsidiary by a person who is an eligible independent contractor. n76 A qualified lodging facility is any lodging facility provided that no wagering activities are conducted on the premises. n77 A "lodging facility" is a hotel or motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis. n77.1 Qualified health care property is any real property (including interests in it) and any personal property incident to it which is a health care facility or is necessary or incidental to the use of a health care facility. n77.2 Under the lodging facility or qualified health care property exception, the rents paid are treated as rents from real property, so long as the lodging facility or qualified health care property is operated by an independent contractor for a fee. The subsidiary can bear all expenses of operating the facility or qualified health care property and receive all the net revenues, minus the independent contractor's fee. n78 For purposes of the exception, a taxable REIT subsidiary is not considered to be operating or managing a qualified health care property or qualified lodging facility solely because it (1) directly or indirectly possesses a license, permit, or similar instrument enabling it to do so, or (2) employs individuals working at the facility or property located outside the United States; an eligible independent contractor, however, must be responsible for the daily supervision and direction of those individuals on behalf of the taxable REIT subsidiary pursuant to a management agreement or similar service contract. n78.1

For purposes of the rule that an independent contractor may operate a qualified lodging facility or qualified health care property, an independent contractor will qualify so long as, at the time it enters into the management agreement with the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities or qualified health care properties for any person who is not related to the REIT or the taxable REIT subsidiary. n79 The REIT may receive income from such an independent contractor with respect to certain pre-existing leases without jeopardizing the independent contractor's status under the lodging facilities and qualified health care property exception. n80

NOTE:

It should be noted that interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules of *IRC Section 163(j)*. This rule prevents a taxable REIT subsidiary from deducting interest in any year that would exceed 50 percent of the subsidiary's adjusted gross income. n81

Taxable REIT subsidiaries sometimes form a joint venture with one or more third parties to provide services to tenants of the parent REIT. To facilitate the services that are provided to tenants, the joint venture may lease space at the property where it is providing services to tenants. The IRS has issued a detailed revenue procedure that details the conditions that must be met for the joint venture's rental payments to the REIT to be treated as rents from real property for purposes of meeting the REIT gross income tests. n81.1 The revenue procedure applies to a REIT that leases space to a joint venture between its taxable REIT subsidiary and a third party that is unrelated to either the taxable REIT subsidiary or the REIT, and which is treated as a partnership for federal income tax purposes. The revenue procedure applies only if the REIT would be treated as having at least a 10 percent or more interest in the assets or net profits of the joint venture. n81.2

For a joint venture that qualifies, the IRS will treat rents paid by it to the REIT as rents from real property if the amounts paid are substantially comparable to rents paid by the other tenants of the REIT's property for comparable space, and at least 90 percent of the REIT's property is rented to persons other than (1) its taxable REIT subsidiaries and

(2) related parties, n81.3 including joint ventures that qualify under the revenue procedure. n81.4

[B] Taxable REIT Subsidiary Defined

In general, a taxable REIT subsidiary is a corporation in which a REIT directly or indirectly owns stock. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election to treat the corporation as a taxable REIT subsidiary. The election is irrevocable unless both the REIT and the corporation consent to a revocation. The consent of the Secretary is not required for either the election or the revocation. n82 The election is made on Form 8875, "Taxable REIT Subsidiary Election." The election may be filed at any time, but the effective date of the election cannot be more than 2 months and 15 days prior to the date of filing, or twelve months after the date of filing. n82.1 The IRS may, however, grant extensions of time for filing an election. n82.2 Extensions are also granted to retroactively correct defective elections. n82.3

In addition, a taxable REIT subsidiary generally includes, with respect to any REIT, any corporation (other than a REIT or a qualified REIT subsidiary under *IRC Section 856(i)*) that does not properly elect with the REIT to be a taxable REIT subsidiary) with respect to which a taxable REIT subsidiary of that REIT owns, directly or indirectly, outstanding securities totalling more than 35 percent of the vote or value of that corporation. n83 For purposes of applying the 35-percent ownership-by-value alternative, n83.1 straight debt securities n83.2 are not taken into account. n83.3

Several additional restrictions should be noted. A corporation that, directly or indirectly, operates or manages a lodging facility or health care facility cannot be a taxable REIT subsidiary, n84 nor can a corporation that provides to any person (under a franchise, license or otherwise) rights to any brand name under which hotels or healthcare facilities are operated. n85 An exception applies to rights provided to an independent contractor to operate or manage a lodging facility or health care facility if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility or health care facility is owned by the subsidiary or leased to it by the REIT. n86

[viii] Hedging Transactions

Except to the extent determined by the Secretary of the Treasury, certain income from hedging transactions, n86.1 including gain from the sale or disposition of a hedging transaction, is excluded from and is not treated as gross income under either the 75-percent or the 95-percent REIT income test. n86.2 The exclusion applies only to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets. The exclusion also applies only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may prescribe). n86.3

[ix] Foreign Currency Matters

A REIT may hold foreign real estate or other foreign-based assets, provided it meets the 75-percent and 95-percent income tests and the other requirements for REIT qualification. n86.4 A REIT that holds foreign real estate or other foreign-based assets may have foreign currency exchange gain under foreign currency transaction rules of the Code. n86.5

Certain foreign currency gain recognized under *IRC Section 987* or *IRC Section 988* is excluded from the computation of qualifying income for purposes of the 75-percent income test or the 95-percent income test, respectively. The exclusion is solely for purposes of the computations under these tests. n86.6

There are two categories of income for purposes of the REIT foreign currency gain exclusion rules: "real estate foreign exchange gain" and "passive foreign exchange gain." n86.7 Real estate foreign exchange gain is excluded from gross income for purposes of both the 75-percent and 95-percent income tests. n86.8 Passive foreign exchange gain is excluded for purposes of the 95-percent income test but is included in gross income and treated as non-qualifying

income to the extent that it is not real estate foreign exchange gain, for purposes of the 75-percent income test. n86.9

Real estate foreign exchange gain includes foreign currency gain n86.10 which is attributable to any of the following:

- Any item of income or gain described in the 75-percent income test; n86.11
- The acquisition or ownership of obligations secured by mortgages on real property or interests in real property; or
- Becoming or being the obligor under obligations secured by mortgages on real property or on interests in real property. n86.12

Real estate foreign exchange gain also includes *IRC Section 987* gain attributable to a qualified business unit ("QBU") of the REIT if the QBU itself meets the 75-percent income test for the taxable year, and meets the 75-percent asset test at the close of each quarter of the REIT that has directly or indirectly held the QBU. The QBU is not required to meet the 95-percent income test in order for this *IRC Section 987* gain exclusion to apply. n86.13 Real estate foreign exchange gain also includes any other foreign currency gain as determined by the Secretary of the Treasury. n86.14

Passive foreign exchange gain includes all real estate foreign exchange gain, and in addition includes foreign currency gain which is attributable to the following: n86.15

- Any item of income or gain described in the 95-percent REIT income test; n86.16
- The acquisition or ownership of obligations;
- Becoming or being the obligor under obligations; and
- Any other foreign currency gain as determined by the Secretary of the Treasury.

Notwithstanding the foregoing rules, however--except in the case of certain income that is excluded under the hedging rules of *IRC Section 856(c)(5)(G)*--any *IRC Section 988* gain derived from engaging in dealing, or substantial and regular trading, in securities n86.17 is gross income that does not qualify under either the 75-percent or 95-percent income test. n86.18

In the case of a *IRC Section 988* transaction, the exclusion under *IRC Section 856(n)* is intended to apply only to foreign currency gain that is directly attributable to income items that otherwise are treated as qualifying income for purposes of the 75-percent and 95-percent income tests, n86.19 respectively, (or directly attributable to the acquisition or ownership of, or to becoming the obligor under, obligations secured by mortgages on real property or on interests on real property). n86.20 For example, foreign currency gain attributable to exchange rate fluctuations between the time of the accrual of interest income on a foreign-currency denominated obligation secured by a mortgage on real property and the time of payment, would constitute excluded income for purposes of both the 75-percent and 95-percent income tests. However, any additional foreign currency gain arising from subsequent disposition of the foreign currency received upon payment of the accrued interest would be attributable to holding the foreign currency after its receipt and would not constitute excluded income under either test; rather it would be non-qualifying income. n86.21

Similarly, in the case of *IRC Section 987* foreign currency gain on remittances, only *IRC Section 987* gain as of the time of, and resulting from, the remittance is attributable to the QBU and is excluded income. Any currency gain arising from holding currency after remittance is not attributable to the QBU. Therefore, that gain is not excluded income for purposes of the 75-percent or 95-percent REIT income tests and is not qualifying income for purposes of those tests. n86.22

The following examples demonstrate the operation of the distinction between "real estate foreign exchange gain", which is excluded for purposes of both the 75-percent and 95-percent REIT income tests, and "passive foreign exchange gain," which is excluded only for purposes of the 95-percent REIT income test and which is non-qualifying income for purposes of the 75-percent REIT income test: n86.23

Example 1.

Assume that a REIT whose functional currency is the U.S. dollar holds an obligation that is secured by a mortgage on real property, and the instrument pays interest at a date later than the date the interest is accrued by the REIT. The obligation is denominated in a foreign currency. The REIT's interest income accrued on the mortgage obligation is qualified income for purposes of the 75-percent and 95-percent REIT income tests. Any *IRC Section 988* gain attributable to currency fluctuations between the time the interest is accrued by the REIT and the time the interest is paid to the REIT is real estate foreign exchange gain because it is directly attributable to the qualified interest income, and thus that *IRC Section 988* gain is excluded for purposes of the 75-percent and 95-percent income tests. n86.24

Example 2.

Assume the same facts as in Example 1, except that the instrument held by the REIT is a debt instrument that is not an obligation secured by a mortgage on real property or an interest in real property. Interest income accrued by the REIT is qualified income for purposes of the 95-percent REIT income test but is not qualified income for purposes of the 75-percent REIT income test. Any *IRC Section 988* gain attributable to currency fluctuations between the time the interest is accrued and the time the interest is paid is passive foreign exchange gain because it is directly attributable to the interest income that is qualified for purposes of the 95-percent income test. That passive foreign exchange gain is excluded for purposes of the 95-percent REIT income test but is not excluded (and is not qualified income) for purposes of the 75-percent REIT income test. n86.25

Example 3.

Assume the same facts as in Example 1, and further assume that the REIT receives a repayment of the principal on the obligation. Any *IRC Section 988* gain attributable to the receipt of principal is real estate foreign exchange gain because it is attributable to the acquisition or ownership of an obligation secured by a mortgage on real property. Therefore, that gain is excluded for purposes of both the 75-percent and 95-percent REIT income tests. n86.26

Example 4.

Assume the same facts as in Example 2, and further assume that the REIT receives a repayment of the principal on the obligation. Any *IRC Section 988* gain attributable to the receipt of principal is passive foreign exchange gain because it is attributable to the acquisition or ownership of an obligation not secured by a mortgage on real property or an interest in real property. Therefore, that gain is excluded for purposes of the 95-percent REIT income test but is not excluded, and is not qualified income, for purposes of the 75-percent REIT income test. n86.27

Note:

Prior to the enactment of the above statutory rules, foreign currency exchange gain was not explicitly included in the statutory definitions of qualifying income for purposes of the 75-percent and 95-percent income tests. The IRS had issued guidance that allowed foreign currency gain to be treated as qualified

income in certain circumstances. n86.28 The above statutory rules change the result given in the prior IRS guidance in the case of foreign currency gain attributable to an item of REIT income that qualifies under the 95-percent or 75-percent income tests n86.29 because under those rules, that foreign currency gain is *excluded* (solely for purposes of the relevant income test) rather than treated as qualified income for purposes of those tests. n86.30 The IRS had also issued guidance as to when foreign currency gain under *IRC § 987* would be qualifying income under the REIT income tests. n86.31 The above statutory rules also supersede that guidance in the case of remittances from a QBU that uses a functional currency other than the U.S. dollar. This is because *IRC Section 856(n)* excludes *IRC Section 987* gain on a remittance from such a QBU to the REIT from the computation of both the 75-percent and the 95-percent income tests of the REIT, provided the QBU itself both meets the 75-percent income test for the taxable year and meets the 75-percent asset test at the close of each quarter of the taxable year. n86.32 If the QBU meets these requirements, the *IRC Section 987* gain is excluded entirely for purposes of the REIT gross income tests; therefore, and tracing-type rules set forth in *Notice 2007-42* no longer apply. For this purpose, the QBU is tested as if it were a separate entity that is independently required to meet the 75-percent income test and the 75-percent asset test applicable to REIT qualification. However, the QBU need not meet any of the other REIT requirements, nor itself be treated as a REIT. It is expected that the Treasury Department will use its regulatory authority n86.33 to provide appropriate rules with respect to the treatment of *IRC Section 987* currency gain for purposes of the REIT gross income tests if a QBU does not meet the requirements of *IRC Section 856(n)*.

An additional statutory rule applies for hedging transactions entered into by REITs to manage currency fluctuations. Except to the extent determined by the Secretary of the Treasury, income of a REIT from a transaction entered into by the REIT primarily to manage risk of currency fluctuations with respect to any item of income or gain that would be qualified income under the 75-percent or 95-percent income tests, (or any property which generates that income or gain) is excluded from gross income for purposes of both the 75-percent and 95-percent income tests. The exclusion applies only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may prescribe). n86.34

[x] Failure to Meet REIT Income Tests

If an entity fails to meet either the 75- or 95-percent REIT income test, n86.35 or both, for a taxable year, it will generally be disqualified as a REIT for that year. n86.35.1 An entity that fails to meet those tests, however, may nevertheless be considered to have met them if the following requirements are met: n86.35.2

- Following the REIT's identification of the failure to meet the relevant income test(s) for a taxable year, a description of each item and its gross income described in those tests is set forth in a schedule for the taxable year filed in accordance with regulations; and
- The failure to meet the 75- or 95-percent test, n86.36 or both, is due to reasonable cause and not to willful neglect.

If the above conditions are met, the REIT does not lose its REIT status, but it must pay a tax. The tax is imposed on the greater of (1) the excess of 95 percent n86.37 of the REIT's gross income (not counting gross income from prohibited transactions) over the amount of gross income from sources permitted under the 95-percent income test; or (2) the amount by which the REIT failed the 75-percent income test. The amount of the tax is equal to 100 percent of the greater amount, multiplied by a fraction. The numerator of the fraction is REIT taxable income (before the dividends paid deduction and this 100-percent tax, and before any net operating loss and any net capital gain); the denominator of the fraction is gross income (adjusted for certain gains). n86.38

[c] Asset Requirements

[i] Overview

In addition to limitations on the source of a REIT's income, a REIT is also restricted as to the nature of its assets. To qualify and to maintain its status as a REIT, an entity must satisfy several asset diversification tests. n87 These asset tests must be satisfied at the close of each quarter of each fiscal year for which a REIT election is made. n88

These quarterly tests are designed to ensure passive real estate investment throughout the year and to minimize the extent to which a REIT can invest in a nonqualifying asset. Failure to meet the quarterly tests cannot occur merely because of changes in the market value of assets, but must result from an acquisition of a security or other property. n89 As a relief measure, the REIT is given 30 days after the close of a quarter in which an acquisition is made to eliminate the discrepancy and meet the asset tests for that quarter. n90 A REIT that fails to meet the REIT asset tests n90.1 must dispose of non-complying assets and, if the failure exceeds a de minimis amount, pay a specified tax. n90.2

Some assets may be ignored in determining whether the asset tests are met. In one case, a REIT was allowed to exclude from the tests a state franchise tax refund attributable to the state tax credits received by the REIT for cleaning up contaminated property. The IRS ruled that the refund would not be considered to be an "asset" for purposes of applying the REIT asset tests. Its rationale was that the state tax credits were intended to promote the remediation and development of contaminated real estate and the furtherance of this public policy did not interfere with or impede the policy objectives of Congress in enacting the REIT qualification tests. n90.3

[ii] The 75 Percent Asset Test

At the close of each quarter of the taxable year a REIT must have at least 75 percent of the value of its total assets represented by real estate assets, cash and cash items (including receivables) and government securities. n91 Certificates of deposit are treated as "cash" for this purpose, n91.1 and the ABA Tax Section has made a strong appeal for treating interests in money market mutual funds as "cash" for this purpose as well. n91.2 The term "cash" for purposes of the REIT asset qualification rules includes foreign currency, if the REIT or its QBU uses that currency as its functional currency. Foreign currency qualifies as cash, however, only to the extent that it is held for use in the normal course of the activities of the REIT or the QBU giving rise to income or gain that is included in the REIT income tests n91.3 or directly related to acquiring or holding real estate or other assets that qualify under the REIT asset tests. n91.4 Foreign currency that is held in connection with a trade or business of trading or dealing in securities n91.5 cannot be treated as "cash." n91.6 "Value" means, with respect to securities for which market quotations are readily available, the market value of such securities and, with respect to other securities and assets, fair value as determined in good faith by the trustees of the REIT. n92 "Total Assets" means the gross assets of the REIT determined in accordance with generally accepted accounting principles. n93

[A] Real Estate Assets

The term "real estate assets" means real property (land and improvements, including undivided interests in real property), interests in mortgages on real property (including interests in mortgages on leaseholds of land and improvements) and shares of other qualified REITs. n94 Interests in real property include fee ownership and co-ownership of land or improvements on it, leaseholds of land or improvements on it, options to acquire land, or improvements on it, and options to acquire leasehold of land or improvements on it. n94.1 The IRS has ruled that this includes fee, leasehold, easement, and license interests in rooftop sites which the taxpayer leased to wireless telecommunication services providers. n94.2 Airspace rights also qualify as interests in real property. n94.3 Standing timber and timberlands are also included within the term. n94.4 The IRS has ruled that voting rights in condominium associations n95 and voting interests in property owner associations acquired indirectly through the acquisition of other real estate constitute real estate assets. n96 The term also includes any property attributable to the temporary investment of equity or public debt offering proceeds in portfolio assets. n97 The term "real property" includes improvements, such as buildings and other inherently permanent structures. n98 Cold storage warehouses and central refrigeration systems

may also constitute real property and real estate assets under the REIT provisions. n99 Loans secured by manufactured homes and loans to purchasers of interests in timeshare residential dwelling units are also treated as real estate assets. n99.1

Loans to a partnership (or an LLC that is treated as partnership for federal tax purposes) that are secured by interests in the borrowing partnership also qualify as "real estate assets," but only to the extent that the fair value of the pledged partnership interests' share of the real property owned by the partnership equals the amount of the loans secured by the real property. n99.2 The same is true for loans to pass-through entities that are secured by interests in other pass through-entities that own real estate. n99.3 As discussed in § 16.02[2][c][ii][E], below, the IRS has also provided a safe harbor under which a loan from a REIT that is secured by an interest in a partnership or by the sole membership interest in a disregarded entity will also be treated as a real estate asset for purposes of the REIT asset limitation requirements. n99.4

A building's wiring, plumbing systems and central heating or air conditioning are considered real property; however, accessory assets, such as office equipment, individual air conditioning units, counters, furnishings and the like do not qualify, even though these items may be termed fixtures under local law. n99.5 Thus, when a REIT invests in both realty and personalty (or a mortgage secured by both realty and personalty), an allocation between the realty and the personalty, based on the relative fair market values, will be required, because the investment attributable to the personalty will not qualify as a "real estate asset." When applying the methodology to second mortgages, the loan value of the real property must be reduced by the amount of all senior encumbrances on the real property. n100 Mineral, oil or gas royalty interests are also excluded from the definition of real estate assets. n101

A regular or residual interest in a REMIC is generally treated as a real estate asset, and any amount includable in gross income with respect to that interest is treated as interest on an obligation secured by a mortgage on real property. If less than 95 percent of the REMIC's assets are real estate assets, however, the REIT is then treated as holding and receiving directly its proportionate share of the assets and income of the REMIC. n102

In a series of rulings, the Service has held that if a REIT owns mortgage pass-through certificates and mortgage participation certificates issued by or guaranteed by the Government National Mortgage Association, Federal National Mortgage Association or Federal Home Loan Mortgage Corporation, it is considered to own real estate assets for REIT purposes. n103 The interest income received with respect to such certificates constitutes interest on obligations secured by mortgages on real property for REIT purposes. The Service has ruled similarly with respect to privately-issued mortgage-backed certificates. n104

Otherwise-qualifying assets may be foreign. Neither the code nor the regulations thereunder restrict the term "real estate assets" to those located within the United States. n104.1 Accordingly, real property for purposes of meeting the REIT asset requirements includes land or improvements thereon located outside the United States. Similarly, the term "mortgages on real property" includes a security interest which, under the laws of the jurisdiction in which the property is located, is the legal equivalent of a mortgage or deed of trust in the United States. n104.2 Thus, foreign situs of a REIT's assets also does not necessarily prevent the REIT from satisfying the REIT income and asset tests n104.3

[B] Repurchase Agreements

The Service has ruled that a repurchase obligation between a bank and a REIT is properly a loan from the REIT to the bank and not a receivable, cash, cash item or Government security. n105 In a repurchase obligation transaction, the REIT "purchases" United States Treasury obligations from a bank agreeing to "resell" them to the bank on a fixed date at the "purchase price" plus an agreed upon amount of interest, while assuming no benefits and risking no losses from changes in the market value or interest rate of the obligations. Although repurchase agreements outstanding at the end of a fiscal quarter cannot be used to satisfy the 75 percent asset test, if the REIT owns a mortgage loan, which is a real estate asset, it can finance the loan by entering into a repurchase obligation with a bank or other lender. In this instance,

the "sale" and "repurchase" are ignored for income tax purposes, the REIT is treated as continuing to own the mortgage loan, and the asset can be used to satisfy the 75 percent asset test.

[C] Government Securities

Although the Code does not define "Government securities," it provides that terms not defined in the REIT provisions have the same meanings as when used in the *Investment Company Act of 1940*. n106 The *Investment Company Act of 1940* defines "Government securities" as:

any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to the authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing. n107

The Service has ruled that securities of the following agencies constitute "Government securities" for REIT purposes: Federal Housing Administration, Federal National Mortgage Association, Federal Home Loan Bank, Federal Land Bank, Federal Intermediate Credit Banks, Banks for Cooperatives, Public Housing Administration, United States Postal Service and Small Business Administration. n108 The Service has also ruled, pursuant to Section 851(b)(3) of the Code dealing with regulated investment companies, that certain enumerated types of securities constitute "Government securities" when issued by the following agencies: Student Loan Marketing Association, Commodity Credit Corporation, Federal Agricultural Mortgage Corporation, Farm Credit System Financial Assistance Corporation and Federal Home Loan Mortgage Corporation. n109 Because the term "Government securities" under Section 851(b)(3) of the Code depends upon the *Investment Company Act of 1940* for its definition, n110 these rulings related to regulated investment companies should also apply to REITs.

[D] Qualified REIT Subsidiaries

Many business trusts and corporations prefer to hold separate parcels of real estate in separate companies to limit liability. For REITs, however, the stock of a corporation other than another REIT is generally a nonqualifying asset for REIT qualification purposes. The "qualified REIT subsidiary" was created to address this concern. A qualified REIT subsidiary is any corporation whose stock is 100 percent owned by the REIT. The term does not, however, include any taxable REIT subsidiary. n111 For tax years beginning before August 6, 1997, the stock ownership requirement generally had to be met at all times during the subsidiary's existence. n112

If the statutory ownership requirement is met, the subsidiary will not be treated as a separate corporation for most tax purposes, and all of the subsidiary's income, deductions, credits, assets and liabilities will be treated as those of the REIT. n113

A qualified REIT subsidiary, even though it is otherwise not treated as a corporation separate from the REIT, is treated as a separate corporation for the following purposes: n113.1

- Federal tax liabilities of the qualified REIT subsidiary with respect to any taxable period for which the qualified REIT subsidiary was treated as a separate corporation.
- Federal tax liabilities of any other entity for which the qualified REIT subsidiary is liable.
- Refunds or credits of Federal tax.

This "separate corporation" status can affect the subsidiary's liability for taxes, and also affect who must sign a consent to extend the statute of limitations. n113.1.1

Example:

X, a calendar year taxpayer, is a domestic corporation 100 percent of the stock of which is acquired by Y, a REIT, in Year 2. X was not a member of a consolidated group at any time during its taxable year ending in December of Year 1. Consequently, X is treated as a qualified REIT subsidiary for Year 2 and later periods. n113.2 In Year 4, the IRS seeks to extend the period of limitations on assessment for X's Year 1 taxable year. Because X was treated as a separate corporation for its Year 1 taxable year, X is the proper party to sign the consent to extend the period of limitations.

Assume instead that upon Y's acquisition of X in Year 2, Y and X jointly elect to treat X as a taxable REIT subsidiary of Y. n113.3 In Year 3, Y and X jointly revoke that election. Consequently, X is treated as a qualified REIT subsidiary for Year 3 and later periods. In Year 4, the IRS determines that X miscalculated and underreported its income tax liability for Year 1. Because X was treated as a separate corporation for its Year 1 taxable year, the deficiency may be assessed against X and, in the event that X fails to pay the liability after notice and demand, a general tax lien will arise against all of X's property and rights to property. n113.4

If a REIT sells all of the stock of a qualified REIT subsidiary to any purchaser, then the subsidiary is treated as a new corporation that is formed and receive its properties in exchange for its stock, immediately after which the subsidiary corporation is owned by the purchaser. n114 Because the stock is deemed transferred immediately after the exchange, such transfer will not qualify as a tax-free exchange under Code Section 351. n115

Although for tax years beginning before August 6, 1997, the REIT is required to own 100 percent of the stock of a qualified REIT subsidiary at all times during the subsidiary's existence, the legislative history describes a limited exception. If a REIT purchases all of the stock of the subsidiary and makes an election under Code Section 338 with respect to the purchased stock, then the subsidiary is deemed to be a newly-formed corporation pursuant to the Section 338 election and will qualify as a qualified REIT subsidiary as of the time that the newly-formed corporation is deemed to come into existence under Code Section 338. n116

In several private rulings involving law applicable to tax years beginning before August 6, 1997, the IRS also allowed existing parent corporation to elect REIT status when it has wholly-owned direct and indirect subsidiaries, even if before the election the parent corporation had not always owned 100 percent of the outstanding stock of the subsidiaries. n117 The Service has held that the parent in this situation will be viewed as having completely liquidated each of the subsidiaries into itself under Code Section 332. n118 These deemed liquidations will occur immediately before the effective date of the parent's REIT election. The Service reasoned that if the existing subsidiaries could not be treated as qualified REIT subsidiaries following the effective date of the REIT election, then the parent would be required to actually liquidate its subsidiaries so that it could satisfy the REIT asset tests under Code Section 856(c)(5) concerning the asset requirements described under this Section 16.02[2][c]. This approach would force the parent to forego the business advantages associated with the ownership of properties through wholly-owned subsidiaries. The Service concluded that this approach would be contrary to the legislative purpose underlying the enactment of Code Section 856(i) concerning qualified REIT subsidiaries. n119

[E] Safe Harbor for Loans Secured by Interest in Partnership or Disregarded Entity

Many REITs invest in real estate by making loans that are secured by real property. In certain cases because of financing arrangements and restrictive loan covenants, REITs make loans to the owners of entities that hold real property instead of making loans that are secured directly by real property. These loans are secured by a pledge of the borrowers' ownership interests in the property-owning entities. The IRS has issued a revenue procedure that sets forth a safe harbor under which (1) these loans will qualify as "real estate assets" n119.1 and (2) the interest on them will qualify as interest on obligations secured by mortgages on real property or on an interest in real property. n119.2

A loan by a REIT qualifies under the safe harbor only if it meets the following requirements: n119.3

- The borrower is either a partner in a partnership or the sole member of an eligible entity (such as an LLC) that has not elected to be treated as a corporation for federal tax purposes and is therefore disregarded as an entity separate from its owner. n119.4
- The loan is nonrecourse, secured only by the partner's interest in the partnership, or the member's interest in the disregarded entity; thus, in the event of default, the sole recourse is against the pledged ownership interest.
- The lender is granted a first priority security interest in the pledged ownership interest. This security interest will place the lender's claim as lender ahead of the claims of other creditors of the partner or LLC member. The pledged ownership interest cannot be further encumbered unless the security interest created is subordinate to the lender's security interest.
- Upon default and foreclosure on the secured loan, the lender will replace the borrower as a partner in the partnership or as the sole member of the disregarded entity. In the case of a loan secured by a partnership interest, the other partners in the partnership must have agreed that upon default and foreclosure they will not unreasonably oppose the admission of the lender as a partner.
- On the date the commitment by the lender to make the loan becomes binding on the lender, the partnership or disregarded entity must hold real property within the meaning of *Regulation Section 1.856-3(d)*. (Under that regulation real property includes land or improvements on it, such as buildings. The term also includes interests in real property. If all or part of this real property is subsequently sold or otherwise transferred, the loan will become due and payable upon the sale or transfer of the real property.)
- On each testing date, the value of the real property held by the partnership or disregarded entity must be at least 85 percent of the value of all of the assets of the partnership or disregarded entity. For this purpose, a testing date means the close of the first quarter of the lender's taxable year following the date on which the commitment by the lender to make the loan becomes binding on the lender, and the close of each subsequent quarter in which the partnership or disregarded entity acquires any assets other than real estate assets, cash and cash items (including receivables), or government securities, n119.5 or reasonable quantities of equipment and materials customarily used for the maintenance and repair of real property. For this purpose, asset acquisitions by a partnership or disregarded entity include additional partnership or member contributions.
- The loan value of the real property owned by the partnership or disregarded entity must equal or exceed the amount of the loan. The loan value of the real property is the fair market value of the property, determined on the date the commitment by the trust to make the loan becomes binding on the trust. n119.6 For this purpose, the loan value is reduced by any liens encumbering the real property, as well as by any other liabilities of the partnership or disregarded entity on the date the commitment by the lender to make the loan becomes binding on the lender. If the real property is owned by a partnership, only the proportionate share of the loan value attributable to the interest that secures the lender's loan is taken into account. n119.7
- Interest on the loan must include only an amount that constitutes compensation for the use or forbearance of money, and, subject to the exception for interest based on a fixed percentage of receipts or sales of the debtor, n119.8 the determination of the amount of interest cannot depend in whole or in part

on the income or profits of any person. n119.9

[iii] The 25 Percent Asset Test

At the close of each quarter of the taxable year of a REIT, not more than 25 percent of the value of its total assets may be represented by securities (other than those includable under [the 75 percent asset test]). This test will always be satisfied if the 75-percent test is satisfied. n120

[iv] The 5 Percent Asset Test

An entity can qualify as a REIT for a tax year only if, at the close of each quarter of the taxable year, not more than 5 percent of the value of its total assets is represented by securities of any one issuer. n121 This test is applied without regard to a taxable REIT subsidiary and securities includable under the 75 percent test. n122 Securities are defined by reference to the *Investment Company Act of 1940*. n123

Example:

R, a calendar-year REIT, sells a parcel of real estate for \$100,000 on March 16. R invests the proceeds in commercial paper issued by B. As of March 31 of the year, the value of R's assets are as follows: real estate--\$500,000; cash--\$50,000; B's commercial paper--\$100,000.

R fails the 5 percent asset test for the year and will lose its REIT status, because B's commercial paper at the end of the calendar quarter constitutes over 5 percent of the value of R's total assets ($100,000/650,000 = 15.38$ percent). n124

To continue to qualify as a REIT, R must, by April 30 of the year, either acquire additional real estate and other assets *or* reduce its investment in B's commercial paper so that B's commercial paper comprises no more than 5 percent of R's total assets. n125

[v] The 10 Percent Voting Securities Test

An entity can qualify as a REIT for a tax year only if, at the close of each quarter of the tax year, it does not hold securities possessing more than 10 percent of the total voting power of the outstanding securities of a single corporate issuer. n126

The term "voting securities" is defined by reference to the *Investment Company Act of 1940*. n127 The term includes any security presently entitling the owner or holder thereof to vote for the election of directors of a company pursuant to the *Investment Company Act of 1940*. n128

Voting rights in condominium associations n129 or homeowners' associations n130 that are acquired by a REIT through acquisition of real property are generally treated as real estate assets and are not considered "voting securities."

The 10 percent voting securities test is applied without regard to a taxable REIT subsidiary and securities includable under the 75 percent test. n131 For example, a REIT may form a separate finance entity subsidiary to issue securities and raise capital for the REIT's operations. The REIT's interest in that entity may be treated as not violating the requirement that a REIT not own more than 10 percent of the voting securities of a single issuer. If the finance entity's securities represent the REIT's interest in its own obligations, the securities are not treated as assets that must be diversified for investor benefit. n132

The terms "value" and "total assets" are defined in the Regulations as discussed above in *Section 16.02[2][c][ii]*.

[vi] The 10 Percent Value of Securities of a Single Issuer Test

Effective generally for tax years beginning after December 31, 2000, n133 a REIT, at the close of each quarter of the tax year, generally cannot own more than 10 percent of the total value of securities of a single issuer. n134 This test is applied without regard to a taxable REIT subsidiary and securities includable under the 75 percent test. n135

For purposes of the 10-percent test, n136 there is a safe harbor for straight debt. n137 "Straight-debt" includes any written unconditional promise to pay on demand or on a specified date a sum certain in money if: n138

- the interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors; and
- there is no convertibility, directly or indirectly, into stock.

The general rule that interest rate and interest payment dates cannot be contingent has several exceptions under the REIT provisions, provided that one of several factors applies. n139 The first type of contingency that is permitted is one that does not have the effect of changing the effective yield to maturity, as determined under *IRC Section 1272*, other than a change in the annual yield to maturity, but only if (1) any such contingency does not exceed the greater of 1/4 of one percent, or five percent of the annual yield to maturity, or (2) neither the aggregate issue price nor the aggregate face amount of the debt instruments held by the REIT exceeds \$1 million and not more than 12 months of unaccrued interest can be required to be prepaid under those instruments. n140

The second permitted contingency is that the time or amount of any payment is permitted to be subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, provided that the contingency is consistent with customary commercial practice. n141

"Look-through" rules are used to determine a REIT partner's share of partnership securities, generally treating debt to the REIT as part of the REIT's partnership interest for this purpose, except in the case of otherwise qualifying debt of the partnership. n142 The following partnership debt instruments are not treated as securities in applying the 10-percent test: n142.1

- any debt instrument issued by a partnership and not otherwise treated as a security n142.2 to the extent of the REIT's interest as a partner in the partnership; and
- any debt instrument issued by a partnership and not otherwise treated as a security n142.3

if at least 75 percent of the partnership's gross income (excluding gross income from prohibited transactions) is derived from sources of income that can satisfy the statutory 75 percent income test. n142.4

Certain corporate or partnership issues that otherwise would be permitted to be held without limitation under the special straight debt rules described above will not be permitted if the REIT holding those securities, and any of its taxable REIT subsidiaries, holds any securities of the issuer that are not permitted securities (prior to the application of this rule) and have an aggregate value greater than one percent of the issuer's outstanding securities. n142.5

A transition rule, however, allows certain securities owned by a REIT on October 22, 2004 to be treated as not held by the REIT for purposes of the requirement that a REIT cannot own more than 10 percent of the value of the outstanding securities of a single issuer. n142.6 The transition rule applies if the REIT owns the securities continuously, the securities were issued by a partnership and they wouldn't be taken into account under the prior-law straight debt safe harbor that applied if the REIT had a 20 percent profits interest in the issuing partnership. n142.7 The transition rule applies only until the maturity date of the security. n142.8 Certain successors of the REIT may also take advantage of

the transition rule. n142.9

Except as provided in the regulations, the following also are not considered "securities" for purposes of the rule that a REIT cannot own more than 10 percent of the value of the outstanding securities of a single issuer: n142.10

- any loan to an individual or an estate;
- any *IRC Section 467* rental agreement (as defined in *IRC Section 467(d)*), other than with an entity in which the REIT holds at least a qualifying 10-percent interest; n143
- any obligation to pay rents from real property;
- any security issued by a state or any political subdivision thereof, the District of Columbia, a foreign government, or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under that security does not depend in whole or in part on the profits of any entity not described in this category, or payments on any obligation issued by such an entity;
- any security issued by a REIT; and
- any other arrangement that the IRS determines is not a security.

[vii] The 25 Percent Asset Test for REIT Subsidiaries

An entity can qualify as a REIT for a tax year only if, at the close of each quarter of the taxable year, not more than 25 percent of the value of its total assets is represented by securities of one or more taxable REIT subsidiaries. n143.1

[viii] Failure to Meet REIT Asset Tests

A REIT that fails to meet the REIT asset tests n144 may avoid disqualification in some cases. n144.1 First, a REIT that has met the asset tests as of the close of any quarter will not fail them solely because of a discrepancy due to variations in value that are not attributable to the acquisition of investments (including a discrepancy caused solely by the change in the foreign currency exchange rate used to value a foreign asset). n144.2 In addition, a REIT that fails to meet the asset tests for a quarter (other than certain de minimis failures, discussed below) is deemed to satisfy the tests for that quarter if the following requirements are met: n144.3

- Following the REIT's identification of the failure to satisfy the asset requirements for a particular quarter, a description of each asset that causes the failure to satisfy those requirements is set forth in a schedule for the quarter, and is filed in accordance with regulations;
- The failure to meet the asset requirements for the particular quarter is due to reasonable cause and not due to willful neglect; and
- The REIT either (1) disposes of the assets set forth on the schedule within 6 months after the last day of the quarter in which the REIT identified its failure to meet the asset test, or (2) meets the asset tests within that period. The Treasury may prescribe another time period for the disposal, and may also prescribe the manner in which the property must be disposed of.

In any year in which a REIT fails to meet the REIT asset tests (other than a de minimis failure, discussed below), it must also pay a tax. The tax must be paid even if the REIT takes the above steps and avoids disqualification as a REIT.

The tax is the greater of (1) \$50,000, or (2) an amount determined under regulations by multiplying the highest rate for corporate income tax n144.4 by the net income generated by the assets that caused the REIT to fail the REIT asset tests for a prescribed period. n144.5 The prescribed period begins on the date that the REIT first fails to meet the asset test and ends on the earlier of the date the REIT disposes of the assets or the end of the first quarter when it no longer fails to meet the REIT asset tests. n144.6 Any REIT penalty tax is treated as an excise tax to which the deficiency procedures of the Code apply. n144.7

If there is a de minimis failure of the 5-percent or 10-percent asset tests during a quarter, n144.8 a REIT will not lose its REIT status if the failure is due to the ownership of assets the total value of which does not exceed the lesser of (1) one percent of the total value of the REIT's assets at the end of the quarter for which the measurement is done, or (2) \$10 million; provided in either case that the REIT either disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury), or otherwise meets the requirements of those rules by the end of that time period. n144.9

[d] Classification of Certain Assets and Related Income

[i] Partnership Interests

If a REIT owns an ownership interest (i.e., a partnership interest) in an entity taxable for federal income tax purposes as a partnership, the REIT will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to each such share. n145 The regulations provide that for purposes of Code section 856 (dealing with the income and asset qualification tests for a REIT), a REIT's interest in a partnership is determined in accordance with its capital interest in the partnership. n146 Also, for purposes of the REIT qualification tests, the character of the assets in the hands of the partnership and the items of gross income of the partnership will retain the same character in the hands of the REIT partner. n147 Therefore, a REIT that is a partner in a partnership must consider its proportionate share of the partnership's assets and income in determining if it satisfies the REIT qualification tests. IRS letter rulings sometimes rule on how to determine a REIT's capital interest in partnerships and other related entities for purposes of the REIT gross income and asset tests. n147.1 However, for purposes of determining REIT taxable income, as described below in *Section 16.02 [3]*, the partnership income taxable to the REIT should be determined pursuant to Code Section 704 and the other provisions of subchapter K. This distinction could be relevant where, under the applicable partnership agreement, there is a special allocation of income to the partners, including the REIT. A special allocation of income could also be required under Code Section 704(c) if property having "built-in gain or built-in loss" has been contributed by a partner. If a partnership sells real property or if a REIT sells an interest in a partnership, gross income realized from the sale and attributable to the real property is considered gross income from the sale of real property held for either the period that the partnership held the real property or the period that the REIT was a member of the partnership, whichever period is shorter. n148 See also *Section 16.02[6]*, below, for a discussion of "umbrella partnership REITs" (also known as "UPREITs").

[ii] Qualified Temporary Investment Income and Assets

As discussed above in *Sections 16.02[2][b]* and *16.02[2][c][ii]*, at least 75 percent of the value of a REIT's assets and at least 75 percent of a REIT's income must come from real estate investments. Whenever a new or existing REIT raises capital, it may take a significant amount of time to invest the proceeds in qualifying investments. In the interim, qualification under the income and asset tests may be jeopardized. To avoid this problem, for a period of one year the qualified temporary investment rules treat the proceeds of stock offerings (other than dividend reinvestment plans) and certain public offerings of debt securities that are invested in portfolio assets as real estate assets for purposes of the assets requirements. n149 Similarly, the income from such qualified temporary investments will be treated as qualifying income for purposes of the 75 percent income test for the one-year period beginning on the date on which the new capital is received. n150

[iii] Foreclosure Property

In response to real estate failures that occurred in the 1970s, Congress added provisions to the Code which are designed to alleviate a REIT's problem with holding property which the REIT has obtained by foreclosure. Property that is acquired through foreclosure or similar means may be held for sale or operated by the REIT, in certain circumstances and for a limited period of time, without jeopardizing REIT status. n151 Further, the income derived from foreclosed property will be considered "qualified" for both the 75 percent and the 95 percent income tests, and any gain on the sale of such property will not be taxed as a prohibited transaction. n152

Foreclosure property is any real property or personal property incident to such real property acquired by a REIT as a result of the default or imminent default on the mortgage loan secured by the property. n153 This definition is subject to a limitation stated in the regulations. Under the limitation, property does not qualify as foreclosure property if the loan with respect to which the default occurs was acquired by the REIT with an intent to foreclose, or if the REIT knew or had reason to know that default would occur. n154 A REIT may own and operate a health care facility for at least two years and treat it as foreclosure property if the facility is acquired by the termination or expiration of a lease of the property (other than a termination by reason of a default, or the imminence of a default, on the lease). n155 Extensions of the two-year period may be granted, n156 but not beyond the sixth year after the tax year in which the REIT acquired the property. n157

In exchange for this favorable treatment, a REIT must pay taxes on its net income from foreclosure property at the highest corporate tax rate. n158 "Net income from foreclosure property" is the excess of (1) gain (including any foreign currency gain) from the sale or disposition of foreclosure property and the gross income derived from that property, over (2) deductions directly connected with the production of that income. Gross income from foreclosure property is included, however, only to the extent that it is not included in income under the REIT 75-percent income test in a category other than income or gain derived from foreclosure property. Foreign currency gains are included only to the extent they are not attributable to income under the REIT 75-percent income test in a category other than income or gain derived from foreclosure property. n158.1

To be eligible for this treatment, the REIT must elect to treat the property as "foreclosure property" in the year of the acquisition. n159 A REIT may revoke an election to treat property as foreclosure property for any tax year by filing a revocation on or before the due date for filing its tax return for that year. If a revocation is filed, no election may be made by the REIT with respect to the property for any later year. n160

Property for which such an election is made will retain its foreclosure property status until the close of the third taxable year following the taxable year in which the REIT acquired the property. n161 The grace period may be extended for an additional three years by filing a request with the IRS. n162

Property for which an election is made will immediately lose its status as foreclosure property, however, if:

- the property is leased and the income would not otherwise qualify under the 75 percent income test (but for the special rule that states the income from foreclosure property qualifies for the 75 percent income test); n163

- any construction occurs on the property, other than completion of structures that were more than 10 percent completed before default became imminent; n164 or

- the property is operated by the REIT as a trade or business other than through an independent contractor more than 90 days after the foreclosure has occurred. n165 Property is not treated as used in a trade or business by the REIT to the extent the REIT's activities do not result in amounts received with respect to the property being treated as other than rents from real property. n166

[iv] Prohibited Transaction Tax Imposed on Property Held for Sale in the Ordinary Course of Business

REITs must pay a tax of 100 percent of the gain from the sale of any property held for sale in the ordinary course of business. n167 However, the law contains a "safe harbor" rule that permits a REIT to modify its portfolio position without paying the 100 percent tax, if certain conditions are met. n168

If the following conditions are satisfied, the sale of a real estate asset does not constitute a prohibited transaction:

- (1) the REIT has held the property for at least two years; n169
- (2) capitalized expenditures by the REIT or any of its partners during the preceding two years do not exceed 30 percent of the net selling price; n170
- (3) either (a) during the taxable year the REIT does not make more than seven sales of non-foreclosure property (excluding property that was involuntarily converted), (b) the adjusted bases of non-foreclosure property sold during the year does not exceed ten percent of the bases of the REIT's assets at the beginning of the year, or (c) the fair market value of the property (other than sales of foreclosure property or involuntary conversions) sold during the taxable year does not exceed 10 percent of the fair market value of the REIT's assets as of the beginning of the year; n171

NOTE:

Because the effective date of the fair market value exception n171.1 is expressed in terms of sales made after a particular date, the IRS has issued a revenue procedure explaining how to interpret it in terms of sales during a taxable year that begins on or before July 30, 2008, and ends on or after July 31, 2008. The exception is satisfied for that taxable year if: n171.2

- the REIT satisfies the 7-sales test (for the entire taxable year);
 - the REIT satisfies the 10-percent adjusted bases test (for the entire taxable year); or
 - the REIT satisfies both (1) the 10-percent adjusted bases test as if the portion of the taxable year ending on July 30, 2008, were an entire taxable year; n171.3 and (2) the 10-percent fair market value test (for the entire taxable year).
- (4) in the case of land or improvements not acquired by foreclosure or lease termination, the REIT has held the property for at least two years for production of rents; n172 and
 - (5) if clause (3)(a), above, is not satisfied, substantially all of the marketing and development expenditures for the property were made through an independent contractor. n173

The failure of a sale of property to qualify under one of the above safe harbors does not necessarily make the sale a prohibited transaction. n173.1 Taxpayers may request a ruling that particular sales are not prohibited transactions subject to the tax. In two private rulings, the IRS has ruled that a REIT's sale of investment property due to "extreme economic conditions" is not subject to the tax. In one, the taxpayer used most of the proceeds of the sale to repay debt, establish a cash reserve for other maturing mortgage debt, and increase its working capital position, and some to repurchase its stock. n173.1.0.1 In the other, the taxpayer needed liquidity, had made no affirmative efforts to sell the property, and had made minimal property sales in prior years. n173.1.0.2

There is also a prohibited transaction safe harbor for timber REITs. n173.1.1 Under the safe harbor, a sale of a real estate asset by a REIT will not be a prohibited transaction if the following requirements are met: n173.2

- the asset must have been held for at least two years in the trade or business of producing timber;
- the aggregate expenditures made by the REIT (or a partner of the REIT) during the two-year period preceding the date of sale that are includible in the basis of the property (other than timberland acquisition expenditures) and that are directly related to the operation of the property for the production of timber or for the preservation of the property for use as timberland must not exceed 30 percent of the net selling price of the property;
- the aggregate expenditures made by the REIT (or a partner of the REIT) during the two-year period preceding the date of sale that are includible in the basis of the property and that are not directly related to the operation of the property for the production of timber or the preservation of the property for use as timberland must not exceed five percent of the net selling price of the property;
- the REIT either (a) does not make more than seven sales of property (other than sales of foreclosure property or sales which *IRC Section 1033* applies), (b) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property sold during the year (other than sales of foreclosure property or sales to which *IRC Section 1033* applies) does not exceed 10 percent of the aggregate bases (as determined for purposes of computing earnings and profits) of property of all assets of the REIT as of the beginning of the year, or (c) the fair market value of the property (other than sales of foreclosure property or involuntary conversions) sold during the taxable year does not exceed 10 percent of the fair market value of the REIT's assets as of the beginning of the year;

NOTE:

Because the effective date of the fair market value exception n173.2.1 is expressed in terms of sales made after a particular date, the IRS has issued a revenue procedure explaining how to interpret it in terms of sales during a taxable year that begins on or before July 30, 2008, and ends on or after July 31, 2008. The exception is satisfied for that taxable year if either: n173.2.2

- the REIT satisfies the 7-sales test (for the entire taxable year);
- the REIT satisfies the 10-percent adjusted bases test (for the entire taxable year); or

Both--

- the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which *IRC Section 1033* applies) sold during the portion of the taxable year ending on July 30, 2008, did not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year (that is, the REIT satisfies the 10-percent adjusted bases test as if the portion of the taxable year ending on July 30, 2008, were an entire taxable year); and

- the REIT satisfies the 10-percent fair market value test (for the entire taxable year).

- if the REIT makes more than seven sales of property during the taxable year (see the clause immediately above), substantially all of the marketing expenditures with respect to the property are made through independent contractors

n173.3 from whom the REIT does not derive any income under a temporary provision, this safe harbor is also met when the marketing is done by a taxable REIT subsidiary of the REIT; n173.4 and

- the sales price on the sale of the property cannot be based in whole or in part on income or profits of any person, including income or profits derived from the sale or operation of those properties.

NOTE:

Any gain that is eligible for the timber property safe harbor is considered for all tax purposes as not being from the sale of stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REITs trade or business. n173.5

[e] Election, Reporting, and Recordkeeping Requirements

In order to be treated as a REIT for a taxable year, a taxpayer must file an election to be a REIT with its return for that year. n173.6 No election need be filed if an election has been made for a previous taxable year, and that election has not been terminated or revoked. n173.7 A taxpayer makes the "election" simply by computing taxable income as a REIT in its return for the first taxable year for which it desires the election to apply. n173.8 The IRS may treat a late-filed request for an extension for filing a return and a resulting late-filed return as timely made for purposes of having a valid REIT election. n173.9

A REIT is required to comply with regulations that are prescribed for the purposes of ascertaining the actual ownership of the outstanding shares or certificates of beneficial interest in the REIT. n174 For tax years beginning before August 6, 1997, a REIT was disqualified in any year in which it failed to issue a shareholder demand letter to determine ownership of its shares. n175 For tax years beginning after August 5, 1997, a REIT's failure to ascertain its ownership does not result in disqualification. Instead, a penalty of \$25,000 (\$50,000 for intentional violations) is imposed on the REIT for any year in which the REIT does not comply with the ownership regulations. n176 No penalty is imposed if the failure to ascertain ownership is due to reasonable cause and not to willful neglect. n177 A REIT is also required to take any other curative actions to ascertain ownership of its shares when requested by the IRS. n178

Planning Note:

A REIT that complies with regulations for ascertaining its ownership, n179 and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, is treated as meeting the requirement that it not be a personal holding company. n180

If the REIT elects to distribute any or all of its long-term capital gains, it must designate, in writing, the portion of any distribution that is capital gain within 30 days after the close of the tax year in which the distribution takes place. n181 The REIT's federal income tax returns must also include data on any rent received directly or indirectly from a lessee in which the REIT has an ownership interest. n182 Also required with the return is information about any independent contractor and any REIT shares owned by any person having an interest in the independent contractor. n183 Form 1120-REIT is used by a REIT for reporting its federal taxable income.

The REIT may revoke its status if an election is made on or before the 90th day of the taxable year for which the revocation is to be effective. n184 If this election is made, the entity may not make a new REIT election until five years after the termination of its REIT status. n185

[f] Issues Related to Self-Management

A REIT's activities are limited such that the majority of the REIT's income is from passive income sources and not from active participation in a trade or business. To insure that this criteria is satisfied, Congress set specific standards as to the sources of income permitted to be included in the definition of "rents from real property" for purposes of the various

income tests discussed in *Section 16.02[2] [b]*, above. Generally, if a REIT intends to include 100 percent of the income from its properties as "rents from real property," the REIT cannot actively manage the properties. n186 The REIT may perform passive management activities, but it must employ an independent contractor to perform any duties related to the active management of real estate. The extent of management activities that will be considered passive when performed by a REIT has been discussed extensively in numerous private letter rulings, a limited number of revenue rulings and statutory history.

[i] "Rents From Real Property" Defined

The definition of "rents from real property" includes:

- (1) rents from interests in real property;
- (2) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and
- (3) rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease. n187

The definition of "rents from real property" is, however, restricted by Section 856(d)(2) of the Code, which specifically excludes certain items from the definition of rents from real property, including any impermissible tenant service income. n188 "Impermissible tenant service income" means amounts received by a REIT for: (1) services furnished or rendered by the REIT to the tenants of rental property; or (2) managing or operating that property. n189 In one ruling, a REIT received minimal amounts of income from an approved company program, in which it publicly awarded a seal of approval to designated businesses. The IRS ruled that this income would be impermissible tenant service income. n189.1 A REIT may render a *de minimis* amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rents from real property. The value of the impermissible services may not exceed 1 percent of the gross income from the property. For these purposes, the services may not be valued at less than 150 percent of the REIT's direct cost of the services. If a REIT provides more than the above *de minimis* amount of services, all amounts received for those services are treated as impermissible tenant service income and are not treated as rents from real property. n190

Certain items are not included in impermissible tenant service income, including the following: n191

- (1) amounts received for services rendered by independent contractors; See § 16.02[2][f][iii][J], below, for a discussion of independent contractors.
- (2) amounts that would be excluded from unrelated business taxable income under *IRC Section 512(b)(3)* if received by a tax-exempt entity (generally rents from real property and incidental amounts received for the rental of personal property, as discussed below); and
- (3) income from a taxable REIT subsidiary. n192-195

Section 512(b)(3) of the Code identifies those revenues that are specifically excluded from the definition of unrelated business taxable income, including any rents from real property. For purposes of this Code section, the regulations state that rents from real property do not include "payments for the use or occupancy of rooms and other space where services are also rendered to the occupant." n196 Services are considered to be rendered to the occupant if such services are primarily for the convenience of the occupant and are services other than those usually or customarily rendered. For

example, maid service is a service rendered primarily for the convenience of the occupant, whereas providing heat and light, cleaning public entrances, exits, stairways, and lobbies, and collecting trash, are not considered services rendered to the occupant. Applying these rules, payments for the use or occupancy of hotel rooms, boarding houses, tourist camps, tourist homes, motor courts, motels, parking lots, warehouses and storage garages do not constitute rent from real property. Alternatively, payments for the use or occupancy of private residences or living quarters in duplexes or multiple housing units and offices in any office building are generally rent from real property.

Thus, the Code and the related regulations establish a two-point analysis with respect to services rendered by a REIT. First, for rental income to qualify as rents from real property, services rendered to the tenants must be "services customarily furnished or rendered in connection with the rental of real property." n197 Services furnished to tenants are considered customary if "in the geographic market in which the building is located, tenants in buildings which are of a similar class ... are customarily provided with the service." n198 To the extent a REIT furnishes services which are not considered customary to its tenants, it must use an independent contractor or taxable REIT subsidiary, or render only a *de minimis* amount of impermissible services to tenants. n199 Any independent contractor used must:

- (1) bear the cost of the services;
- (2) bill the tenants directly; and
- (3) directly receive and retain the revenues generated from such services. n200

The second step in the analysis entails a determination as to whether the REIT itself may perform the services or if the REIT must use an independent contractor to perform the services. As discussed above, a REIT may perform a *de minimis* amount of impermissible services to tenants. n201 It may also perform services that are not specifically "rendered to the occupant." However, for other than *de minimis* services, the REIT must hire an independent contractor to perform any services that are considered to be "rendered to the occupant."

[iii] Revenue Rulings

In Revenue Ruling 69-178 , the Service held that revenue derived from the occasional rental of a meeting hall by an exempt organization to outside individuals and groups qualifies as rent from real property within the meaning of section 512(b)(3) of the Code. n202 The Service based this ruling on the fact that the revenues collected were specifically for the use and occupancy of space and that the only services provided to the renters by the organization were utilities and janitorial services. Thus, by analogy, a REIT would be permitted to lease facilities such as a meeting hall on an occasional basis provided the only services furnished are utilities and janitorial services.

Revenue Ruling 80-297 also addressed the issue of defining rents from real property. This Revenue Ruling considered two situations: (1) School 1 used its tennis facilities to operate a tennis club during the summer months, with the school itself providing services, including tennis lessons and administrative functions for the tennis club; and (2) School 2 leased its tennis facilities to an unrelated individual during the summer months for use as a tennis club. The Service held in the first case that School 1's income was not considered rents from real property because, in addition to furnishing the tennis facilities, School 1 furnished services for the convenience of the tennis facility users. Whereas, in the second case, the Service found that School 2's income was considered rents from real property because the school furnished no personal services to the users of the tennis facilities; rather, the revenues were generated solely from the use of the tennis facilities. n203

The Service has also held that a university's rental income from the leasing of its stadium to a professional football team for several months of the year did not constitute rents from real property because the university provided substantial services to the football team for its convenience. Under the lease agreement with the football team, the university was responsible for providing extensive grounds maintenance, including maintaining the playing surface and providing

dressings rooms, linens and stadium security services. The security services included "crowd and traffic control, guarding the stadium and maintaining the privacy of practice session." n204 In its holding, the Service stated that the university was "furnishing substantial services for the convenience of the lessee that go beyond those usually rendered in connection with the rental of space for occupancy only." n205 Accordingly, the rental income was not considered rents from real property.

[iii] Private Letter Rulings

The Service has issued numerous private letter rulings in connection with determining what activities a REIT is permitted to undertake and still fall within the passive income guidelines. While a private letter ruling is addressed only to the taxpayer requesting it and should not, therefore, be relied upon as general authority, private letter rulings do provide guidance as to the position of the Service on the subjects addressed therein.

[A] Parking

The position of the Service as to when and to what extent REITs are permitted to provide parking facilities and services to tenants is not clear. Regulation 1.512(1)-1(c)(5) specifically excludes payments "for the use or occupancy of space in parking lots" from the definition of "rent from real property." n206

The IRS has over the years issued numerous private letter rulings to taxpayers regarding whether a REIT's income from providing parking facilities can qualify as rents from real property under *IRC Section 856*. The critical inquiry in nearly all the rulings is the extent of services the REIT can provide without having income from the parking being treated as impermissible tenant service income. n207

The extent of permitted services is not completely clear. In an effort to clarify its position in a broader context than in private letter rulings, the IRS has issued a revenue ruling on that matter. The ruling provides the statutory framework for resolving the issue and details a 1986 conference report on the legislative intent in this area. n208

The conference report states that a REIT may provide customary services in connection with the operation of parking facilities for the convenience of tenants of an office, apartment building, or shopping center, provided that the parking facilities are made available on an unreserved basis without charge to the tenants and their guests or customers. Any income derived from the rental of parking spaces on a reserved basis to tenants, or income derived from the rental of parking spaces to the general public, cannot qualify as rents from real property unless all services are performed by an independent contractor. If services are performed by an independent contractor, however, then the income from the rental of parking facilities is considered to be rents from real property (and not merely income from services). n209 The statutory framework and regulations are in accordance with this intent.

Revenue Ruling 2004-24 analyzes three situations and clarifies the following: n210

- A REIT may provide unattended parking facilities for the use of tenants, guests, and customers of its real properties and provide basic maintenance, repair, and lighting services with respect to the parking facilities. It may also deal with taxes and insurance for the parking areas in conjunction with its managerial and fiduciary functions. Provided the parking facility is proximate to the tenants and appropriate in size for the number of tenants, guests, customers, or subtenants who were expected to use the facility, the activities performed by the REIT will not give rise to impermissible tenant service income. Therefore, amounts received by the REIT for furnishing these services would qualify as rents from real property.
- In addition to the above activities, a REIT may also provide reserved parking spaces for particular tenants and assign and mark the reserved spaces in connection with leasing activities. Doing so is

considered a customary service and will not cause amounts received by the REIT for furnishing these services to be other than rents from real property. Any recurring functions unique to the reserved spaces (such as enforcement), however, would have to be provided by an independent contractor from whom the REIT did not derive any income. n211

- A REIT may make parking facilities with attendants available to the general public in addition to tenants and customers without causing amounts it receives to be other than rents from real property. An independent contractor, however, and not the REIT, must provide the attendants and must manage and operate the parking facility. In the ruling, the independent contractor was a separate corporation that remitted the parking fees from the lots to the REIT and received arms-length compensation under the terms of its management contract. The REIT did not derive or receive any income from the independent contractor. n212 Finally, the corporation employed all of the individuals who managed and operated the attended parking facilities and was directly responsible for providing all their salary, wages, benefits, administration, and supervision.

Revenue Ruling 2004-14 comports with past private letter rulings that have gradually expanded the type of services a REIT may provide in conjunction with parking facilities, particularly in the area of reserved parking, n213 and general maintenance, repair, cleaning, lighting, and security services. n214

An independent contractor or taxable REIT subsidiary, n215 however, must be used to provide towing or other enforcement services, n216 parking attendants, n217 valet parking services, n218 and the operation of public parking garages. n219-220

[B] Marketing, Leasing and Accounting

Employees of REITs may provide marketing and promotional activities, including advertising campaigns, special promotional events, shows and displays, sponsoring and distributing promotional literature and collecting fees for and providing services in conjunction with merchants' associations. n221 Such marketing services are not considered to be rendered for the convenience of the tenants, but presumably for the benefit of the REIT itself.

Administrative duties such as soliciting tenants, negotiating leases, billing, bookkeeping, collecting and depositing rents are also considered passive activities and may be performed by REIT employees. n222

[C] Repair and Maintenance

The Service has consistently recognized that the customary repair and maintenance of common areas, including pest control, landscaping, lighting, painting, background music, snow and trash removal and general janitorial services may be performed by REIT employees. n223 Additionally, the repair and replacement of heating, ventilation and air conditioning units, fire protection systems, security alarms, storm and sanitary drainage and other utility systems is customary and consistent with the concept of passive income. n224

In addition to repair and maintenance in common areas, repair and maintenance with respect to individual units is also recognized as passive activity to a certain extent. For example, minor remodeling of individual units in order to lease or renew existing leases is considered passive activity, n225 as is installing new carpeting in an individual unit, at the tenant's request, in exchange for a higher rent. n226

[D] Utility Service

The Service has recognized as passive activity the providing of utility services, such as electricity, gas, water, sewer, and garbage collection by REITs to their tenants. Accordingly, the furnishing of these services will not cause income to

be treated as other than "rents from real property," and any amounts derived from the furnishing of those services may qualify as "rents from real property." n227 The provision of utility services may include either the use of a master meter or individual meters, and payment for utility services may be billed separately or may be included in the rent, but such services are typically billed to the tenant at cost. n228 Certain telecommunication services, including purchasing local and long-distance telephone line access on a wholesale basis and reselling such services to tenants at a profit, but at a cost less than that for which the tenants could otherwise contract, have also been deemed a passive activity by the Service. n229 Other telecommunication services specifically approved as passive activity by the Service include a common switch box and a switchboard operator to take messages for tenants and announce guests, n230 and telephone/internet access, computer networking, electronic and voice mail, teleconferencing, business news and electronic clipping, security and safety alarms, and access to environmental control systems. n230.1 REITs are also permitted to collect and remit charges for cable television, but the cable television service must be provided by an independent contractor. n231

[E] Security

The Service has provided minimal discussion of security in the context of what is considered a passive activity; however, on-site security through a security guard employee has been specifically recognized as passive activity in geographic areas where vandalism or other crime is a concern. n232 In other private letter rulings, security and guard services have been briefly mentioned along with a litany of other services, all of which were deemed passive activities. n233

[F] Pay Telephones and Vending Machines

By subletting particular areas of a property, a REIT may be able to provide certain services to its tenants while still collecting only passive income. In particular, the Service has consistently permitted vending machines and pay telephones to be available to tenants of REIT-owned properties when the service is structured as a lease of space and any actual services provided to the tenants are actually supplied by independent contractors. n234 Typically, the REIT provides space and furnishes utilities to third party suppliers who are solely responsible for installing, maintaining, repairing, stocking and collecting money from the machines, in exchange for a rental or licensing fee. Additionally, since the pay telephones and vending machines are usually located in a common area, the REIT is permitted to provide general janitorial services in the surrounding areas. In one private letter ruling the Service did not disallow as rents from real property the revenues generated by the lease of space for pay telephones and vending machines even though the REIT's employees maintained and repaired the pay telephones and vending machines on at least some of the properties owned by the REIT. n235

[G] Laundry Machines

REITs may provide coin-operated laundry facilities, or an independent contractor can lease space for laundry equipment at properties owned by a REIT. n236 If an independent contractor provides the laundry machines, the REIT may provide any utility services necessary for the operation of the equipment. n237

In addition, a REIT may provide washing machines and dryers in individual apartments and collect a higher rent for apartments with such machines than for comparable units without such machines. n238

[H] Recreational Facilities

The operation of exercise facilities by a REIT may be considered a passive activity, but the REIT is limited in the services it may provide with respect to such facilities. In one private letter ruling, a REIT provided exercise rooms, which included exercise equipment, a pool, a sauna and showers, for the use of its tenants. n239 The REIT did not collect any additional revenues directly attributable to the exercise rooms, and the Service held that the revenues collected with respect to the property satisfied the criteria for rents from real property. n240 In other private letter

rulings, the Service has permitted REITs to provide swimming pools with lifeguards, tennis courts, basketball courts, playgrounds and exercise equipment, when such amenities are made available at no additional charge. n241

Another ruling allowed a REIT to provide to its manufactured home communities golf courses, boat docks/ramps, exercise rooms, whirlpools, libraries and car wash areas. All these facilities were free and available only to tenants and their guests. The only services provided in connection with the facilities were ordinary maintenance. n241.1

Other services included trash collection, utilities (sometimes purchased separately and sold to tenants, and sometimes provided by the taxpayer's own water and sewage treatment facilities), provision of ATMs operated by independent third-party lessees, and a variety of telecommunications systems provided by third-party providers. The taxpayer would derive income from the telecommunications services in one of several ways--by a flat fee paid by the operator expressed as a specific amount, or a percentage of gross receipts, or some combination of the two, or a fee paid by tenants to the taxpayer or LP, or through the taxpayer's or LP's proportionate ownership in an entity providing those services.

However, if an additional fee is collected with respect to the property, such income is not considered rents from real property. In a recent private letter ruling, a REIT provided a gymnasium for use by its tenants for a nominal annual charge. n242 The gymnasium consisted of exercise equipment, locker rooms with saunas, steam rooms, locker facilities and racquetball courts. There were no attendants present in the gym, and no significant services, other than lighting, heating, air conditioning, cleaning and maintenance, were performed in connection with the gymnasium. The Service ruled that while providing the exercise facilities did not taint the tenant rents, the nominal annual charge collected with respect to the use of the exercise room did not constitute qualifying income. n243 Similarly, fees collected for the use of a swimming pool by guests are not considered rents from real property. n244

A REIT may furnish clubhouse facilities to its tenants, provided the clubhouse is available on a first-come, first-served basis, and no more than a nominal fee to defray utility, security and janitorial expenses is charged. n245 Additionally, a REIT may hold seasonal parties in or around the clubhouse or pool area, if there is no charge to the tenants for such parties. n246

[I] Miscellaneous Services

Rulings can present novel situations involving miscellaneous services. In one, a REIT's tenants were able to use photocopy and fax machines in the REIT's executive offices for an additional fee. Provision of some office equipment to tenants was usual in the market place where the property was located, and the rent attributable to the use of the equipment was minimal. No services were provided to the tenants with the office equipment, and all maintenance and repairs on the equipment were performed by independent contractors. The IRS ruled that the use of the machines was not made available primarily for the convenience of the tenants, n247 and that income from them was therefore not impermissible tenant service income. n248 The IRS made similar rulings with respect to the following:

- A REIT's contracting out with an LLC in which it held an interest to provide internet access, telephone, cable television, and security services to tenants that were typically provided in similar residential rental buildings. n248.1
- A REIT's contracting with independent contractors to provide various telecommunication services to tenants, including the following: Installation, servicing, repair, and upgrade of, and access to, communication lines to obtain telecommunication services, Internet access, high-speed data services, computer networking, electronic mail, voice mail, teleconferencing, business news and electronic clipping, security and safety alarms, and access to environmental control systems. The taxpayer would derive income by either charging a flat fee to tenants and paying an agreed upon charge to the provider, or collecting from the provider a flat fee or percentage fee based on the provider's gross revenues from the services. n248.2

- Administrative and marketing functions with respect to multi-family properties and tenant leases, repair and maintenance of the apartments, provision of laundry machines, and--through third-party operators who leased space--vending machines, and public telephones. Utilities were also provided, sometimes as part of the overall rent, and sometimes separately metered. Third parties provided a range of telecommunications services to tenants, either directly to tenants in exchange for a flat fee, or a fee based on gross revenues generated by the provider from the tenants. The taxpayer also planned to equip certain of its properties with high-speed data and phone lines, cable television service, Internet access services, and home theater surround sound. None of the telecommunications services would be customized to fit the specific needs of particular tenants. Party rooms were also provided to tenants for a minimal clean-up fee. n248.3

- A REIT anticipated charging a lower per-square-foot rental to food service providers in its suburban office parks than to other tenants. The food service providers would operate independently from the taxpayer, and the tenants of the buildings would not be given preference in terms of the food services provided. The IRS ruled that charging a lower rental to these tenants would not cause otherwise qualifying amounts received from other tenants to be other than rents from real property. n249

[J] Services Requiring an Independent Contractor

It is important to note that income from certain services, even if customary in the area, may not qualify as "rents from real property" if such services are rendered by a REIT primarily for the benefit of the tenants. n249.1 This income may qualify as rents from real property, however, if the services are furnished or rendered through an independent contractor from whom the REIT itself does not derive or receive any income. n249.2 The relationship between the independent contractor and the REIT must be arm's-length, and the independent contractor must be adequately compensated for any services rendered to the REIT. The prohibition against the REIT deriving or receiving any income from the independent contractor generally applies regardless of the source from which the income was derived by the independent contractor. n249.3 The prohibition, however, does not prevent a REIT from renting office space to an independent contractor at a fair market rental where the independent contractor's presence in an office on the REIT's premises is conducive to better management of the REIT's property. n249.4

Maid service is an example of the type of services that must be provided by an independent contractor in order for income from the service to qualify as rents from real property. Because providing maid service is considered a service rendered primarily for the benefit of the occupant, n250 a REIT wishing to provide maid service must do so through an independent contractor. Other, less obvious, examples can be found in various private letter rulings where the REITs requesting such private letter rulings have identified several specific services that will be performed by an independent contractor, presumably because such services would be deemed services rendered for the benefit of the tenants and, as such, would cause rental income to fail the "rents from real property" criteria if performed by the REIT itself. Thus, it is assumed that an independent contractor is necessary if a REIT is providing the following services to its tenants:

- scheduling and supervising the maintenance of a teleconference center, a board room or an art gallery in an office building; n251
- providing food services for receptions, parties and executive dining rooms; n252
- operating a health club or providing aerobics instruction; n253
- providing linen service in relation to recreational facilities; n254
- providing dry cleaning services; n255

- providing day care facilities; n256
- maintaining and repairing pay telephones and vending machines; n257
- remodeling and other construction activities; n258
- operating a shuttle bus between the property and public transportation; n259
- providing parking attendants or public access garages; n260 or
- operating a restaurant in a building owned by a REIT; n261
- providing private shuttle service for tenants; n261.1 and
- providing a variety of services connected with the taxpayer's operation of a self-storage facility, including transportation services for picking up and delivering stored items, and conducting truck-leasing operations for customers and the facility. n261.2

In exchange for a fee, a REIT may supervise work provided by independent contractors for tenants. If the supervisory services are customary, doing so will not cause otherwise qualifying amounts received from tenants to be excluded from the definition of "rents from real property." In addition, any amounts received by the taxpayer from tenants for tenant improvement work that is paid to independent contractors performing the work will constitute rents from real property. n262

Only a person who meets both of the following requirements qualifies as an "independent contractor": n263

- the person does not own, directly or indirectly, more than 35 percent of the shares or certificates of beneficial interest in the REIT; and
- if the person is a corporation, not more than 35 percent of its voting power or total shares of all classes of its stock is owned by one or more persons owning at least 35 percent of the REIT. If the person is not a corporation, then not more than 35 percent of the interests in its assets or net profits is owned by one or more persons owning at least 35 percent of the REIT.

If any class of stock of the REIT or the person being tested as an independent contractor is traded on an established securities market, only persons who directly or indirectly own at least 5 percent of such class of stock are counted in determining whether the 35 percent ownership limitations have been exceeded. n264

[K] Services Performed by REIT Tenants

Letter rulings sometimes involve services provided by entities unrelated to a REIT that lease space in REIT properties. The services are typically provided to other tenants of the REIT properties, and often to non-tenants as well. The issue that arises is whether the REIT, because of its lease with the entity providing the services, is thereby deemed to be providing the services to the other tenants. The resolution in any particular ruling depends on several factors--whether the lease with the service-providing entity is unrelated to the rental of space to other tenants, whether the service-providing entity's agreements with other tenants are unrelated to the REIT's leases with those tenants, and the particular services provided. n264.1

In one ruling, the IRS held that a REIT would not be treated as providing certain services to tenants because one of its

tenants provided those services. One of the services involved providing background music in the common areas of malls. Tenant leases did not require the REIT to provide the background music, and the music was not considered a service rendered primarily for the convenience of the tenants. Other services included cleaning and maintenance of common areas of a shopping center, repair and maintenance of HVAC systems, and landscaping. The common-area charges were allocated among the tenants, and charges were negotiated directly with the service provider and not the REIT. These services were also not considered to be rendered to the tenants. Thus, the IRS ruled that the services performed for other tenants were not treated as services provided directly or indirectly by the REIT. n264.2

[iv] Consequences of Rendering Impermissible Services

If a REIT offers a non-customary service, through an independent contractor, any revenues collected by the REIT in connection with such services do not qualify as rents from real property. If a REIT directly provides services (customary or non-customary) that should be performed by an independent contractor, all income from the property for which such services are provided becomes tainted, and none of the revenue is considered rents from real property. n265

[g] Termination of REIT Election

A taxpayer's election to be treated as a REIT generally terminates if the taxpayer fails to qualify as a REIT for the tax year in which the election is made or for a later tax year. The termination is effective for the tax year the entity fails to qualify as a REIT and for all succeeding tax years. n266 There is a reasonable cause exception to this loss of REIT status for failure to satisfy statutory requirements. n267 If a REIT fails to satisfy one or more requirements for REIT qualification, other than the 95-percent and 75-percent gross income tests and other than the rules provided for failures of the asset tests, n268 the REIT may retain its REIT qualification if the failures are due to reasonable cause and not willful neglect, and if the REIT pays a penalty of \$50,000 for each failure. n269

A REIT also may revoke its status if an election is made on or before the 90th day of the taxable year for which the revocation is to be effective. n270 If this election is made, the entity may not make a new REIT election until five years after the termination of its REIT status. n271

[3] Taxation of a REIT

[a] Taxation of REIT Taxable Income

A qualified REIT is taxed in much the same manner as any corporation, but there are a few exceptions. n272 If an entity fails to qualify as a REIT in a particular taxable year, the entity is taxable as a regular corporation for that year. If an otherwise qualified REIT distributes at least 90 percent (95 percent for tax years beginning before 2001) of "REIT taxable income" as dividends, it is allowed a deduction for these dividends. The remaining REIT taxable income is taxed at regular corporate rates. n273 To the extent that long-term capital gains in excess of short-term capital losses are not distributed, they may be taxed to the REIT as capital gains. n274

REITs are subject to the corporate alternative minimum tax (AMT). n275 REITs are not, however, subject to the "adjusted current earnings" adjustment for AMT. n276 Items that are treated differently for AMT purposes must be apportioned between the REIT and its shareholders or beneficiaries. n277 However, regulations which are to describe this apportionment have not yet been issued.

Certain adjustments are made to corporate "taxable income" to arrive at "REIT taxable income" to which the 95 percent test is applied: n278

- No dividends-received deduction is allowed. n279
- The deduction for dividends paid n279.1 is allowed, but is computed without regard to that portion

of the deduction that is attributable to net income from foreclosure property. n279.2

- *IRC Section 443(b)* is disregarded. Thus, the taxable income for a period of less than 12 months is not placed on an annual basis, even though the short taxable year results from a change in accounting method. n279.3

- Net income from foreclosure property is excluded. n279.4

- Net income from prohibited transactions is excluded. n279.5 Regulations clarify that a net loss from prohibited transactions, is included. Because the amount of the net loss derived from prohibited transactions is taken into account in computing taxable income before the adjustments required by *IRC Section 857(b)(2)*, however, the effect of including an amount to the amount of the loss is to disallow a deduction for the loss. n279.6

- A deduction is allowed for the tax imposed upon the REIT for failure to meet the income source tests. n279.7

- A deduction is allowed for the 100-percent excise tax imposed for amounts improperly allocated between a REIT and a taxable REIT subsidiary. n279.8

- A deduction is allowed for the tax imposed if a REIT fails to meet any of the asset test requirements for a particular quarter and the failure exceeds the *de minimis* threshold. n279.9

- A deduction is allowed for the tax imposed in order to avoid termination of REIT status when a taxpayer meets the reasonable cause exception for its failure to satisfy statutory REIT requirements. n279.10

A REIT may carry over a net capital loss to each of the five taxable years following the loss year, regardless of whether the corporation qualifies as a REIT in the year of the capital loss or the year to which the capital loss is carried. n280 However, a corporation that is not a REIT may not carry back a net capital loss to a taxable year for which it was a REIT. n281

In summary, a REIT may be subject to the following taxes:

- A tax at the regular corporate rates on its REIT taxable income. n282

- An alternative tax on net undistributed capital gains, if that tax is lower than the regular tax on such gains determined by including them in REIT taxable income. n283

- A tax on income from prohibited transactions. n284 See *Section 16.02[2][b]*, above.

- A 100 percent tax on certain income if the REIT fails to meet the income source tests. n285 See *Section 16.02[2][b]*, above.

- A 100 percent excise tax imposed with respect to amounts improperly allocated between a REIT and a taxable REIT subsidiary. n286 See *Section 16.02[3][d]*, below, for a discussion.

- A tax on net income from foreclosure property. n287 See *Section 16.02[2][d][iii]*, above.

- A four percent excise tax for failure to distribute sufficient income in the year in which it is earned.

n288 See *Section 16.02[3][c]*, below.

- The alternative minimum tax. n289

[b] REIT Capital Gain Designations

Treasury has issued *Notice 97-64*, regarding the application of *IRC Section 1(h)* to long-term gains from sales or exchanges by (or of interests in) pass-through entities, including REITs. The Notice describes temporary regulations to be issued under *IRC Section 1(h)*. REITs and their shareholders must use the guidance set forth in *Notice 97-64* until further guidance is issued n290 in regulations. *Notice 97-64* was augmented by *Notice 2004-39*. n290.1 *Notice 2004-39* provides guidance to REITs and their shareholders in applying *IRC Section 1(h)* to REIT capital gain dividends in light of changes made to that provision by 2003 legislation. n290.2 *Notice 2004-39* applies to REIT capital gain dividends paid (or accounted for as if paid) in taxable years that end on or after May 6, 2003. *Notice 2004-39* also contains a detailed transition rule explaining how the mid-year reduction in tax resulting from 2003 legislation applies to capital gain dividends of REITs for taxable years that include May 6, 2003. n290.3

For individuals, estates, and trusts, differing rates of tax apply for various transactions depending on the types of transactions giving rise to net capital gains. n290.4 For transactions taken into account during taxable years ending before May 6, 2003, a taxpayer's long-term capital gains and losses generally were separated into three tax-rate groups: a 20-percent group, a 25-percent group, and a 28-percent group. n290.5 For certain taxpayers, transactions in the 20-percent group could be taxed at a 10-percent rate, or at an 8-percent rate if the gain was qualified 5-year gain. n290.6

For transactions taken into account during taxable years ending on or after May 6, 2003, and beginning before January 1, 2009, the 20-percent rate is reduced to 15 percent, the 10-percent rate is reduced to 5 percent (0 percent for taxable years beginning after 2007), and the rules dealing with qualified 5-year gain are repealed. n290.7 For a taxable year that includes May 6, 2003, the reduction in rates and the repeal of the rules dealing with qualified 5-year gain apply to gain or loss properly taken into account for the portion of the taxable year on or after May 6, 2003. Because this effective date generally occurs sometime during a taxpayer's taxable year, the amount of capital gain that benefits from the reduced 15-percent (or 5-percent) rate is generally the lesser of the net capital gain for the entire taxable year or the net capital gain determined using only gain and loss properly taken into account for the portion of the taxable year on or after May 6, 2003. n290.8 In applying this 2003 transition rule with respect to a pass-through entity, the determination of when gains and losses are properly taken into account is made at the entity level. n290.9

To the extent that a REIT has net capital gain for a taxable year, it may designate as capital gain dividends the dividends that it pays during the year, the dividends it is deemed to pay during the year, n290.10 or deficiency dividends that it pays for that year. n290.11

Notice 2004-39 describes how the reduction in rates made by 2003 legislation and the transition rule (for taxable years that include May 6, 2003), apply to capital gain dividends of REITs. The same rules described in *Notice 97-64* continue to apply to a REIT's capital gain dividends, with appropriate modifications to take into account the post-1997 amendments to *IRC Section 1(h)*. Thus, if a REIT designates a dividend as a capital gain dividend, it may make an additional designation of the dividend as a 15-percent rate gain distribution, subject to the limitations set forth below in *Notice 97-64*, including the limitation that the additional designation of a class of capital gain dividend not exceed the maximum distributable amount in that class. In general, a REIT determines the maximum distributable amounts that may be designated in each class of capital gains dividends by performing the computation required by *IRC Section 1(h)* as if the REIT were an individual whose ordinary income is subject to a marginal tax rate of at least 28 percent. The maximum distributable gain in each class of capital gain dividends is equal to the amount that, in the computation under *IRC Section 1(h)*, is multiplied by the corresponding rate gain percentage. The computation under *Section 1(h)*, however, is modified in the following ways: n290.12

- The REIT disregards qualified dividend income. That is, net capital gain is not increased by qualified dividend income, and qualified dividend income is disregarded in determining the amount of gain properly taken into account for the portion of a taxable year on or after May 6, 2003. (Qualified dividend income received by the RIC or REIT may contribute to a separate designation of other RIC or REIT dividends). n290.13

- The REIT makes the deferral adjustment or bifurcation adjustment described in *Notice 97-64*. n290.14

- The computation takes into account, if applicable, the transition rule for taxable years that contain May 6, 2003. This rule, however, interacts with the deferral adjustment in a way that differs from the interaction between that adjustment and the transition rule for the 1997 reductions in capital gains rates. That is, for purposes of the 2003 transition rule, the deferral adjustment is applied in determining whether a gain or loss is taken into account before May 6, 2003, or after May 5, 2003.

The 2003 transition rule applies at both the entity level in determining how capital gain dividends may be designated and at the shareholder level in determining the tax rate that applies to the dividends. In taxable years beginning on or after May 6, 2003, some taxpayers may receive a REIT distribution amount that is designated as a 20-percent rate gain distribution and that includes a portion constituting 5-year gain. As a result of the repeal of the separate rules for 5-year gains, the 5-year gain portion of that 20-percent rate gain distribution is not subject to the prior law 8-percent rate for 5-year gain. Rather, the 5-year gain portion will be treated the same as any other 20-percent rate gain distribution that is received in a taxable year beginning on or after May 6, 2003, and therefore will be taxed at a rate no higher than 15 percent (5 percent for certain taxpayers). *Notice 2004-39* gives detailed examples of the transitional rule and the application of tax rates on dividends including a 5-year gain portion. n290.15

For taxable years ending before May 6, 2003, the guidance set forth in *Notice 97-64* applies, subject to the legislative changes made by post-1997 legislation. Under *Notice 97-64*, to the extent that a REIT has a net capital gain for a tax year, dividends that it pays or is deemed to pay during the year may be designated by it as capital gain dividends. Subject to limitations discussed below, if a REIT designates a dividend as a capital gain dividend for a tax year ending after May 6, 1997, before May 6, 2003, it may also designate the dividend as a 20 percent rate gain distribution, an unrecaptured *IRC Section 1250* gain distribution, or a 28 percent rate gain distribution. If no additional designation is made regarding a capital gain dividend, it is a 28 percent rate gain distribution. n291

If any capital gain dividend is received on or after May 7, 1997, before May 6, 2003, but is treated as paid during a tax year that ends on or before that date, the dividend is a 28 percent rate gain distribution. For purposes of *Notice 97-64*, a designation of undistributed capital gains under *IRC Section 857(b)(3)(D)* is considered to be the designation of a dividend as a capital gain dividend. n292

Additional designations of capital gain dividends for a tax year are effective only to the extent that they do not exceed the limits below, and only to the extent that they comply with principles of *Revenue Ruling 89-81*, n293 which requires that distributions made to different classes of shares must not be composed disproportionately of dividends of a particular type. Designations of capital gain dividends for a REIT must also comply with *IRC Section 857(b)(3)(C)*, which makes designations ineffective to the extent they exceed the net capital gain for the year. n294

Subject to a deferral adjustment or bifurcation adjustment (discussed below), a REIT determines the maximum amounts that may be designated in each class of capital gains dividends by performing the computation required by *IRC Section 1(h)* as if the REIT were an individual whose ordinary income was subject to a marginal tax rate of at least 28 percent. Then, the maximum distributable 20 percent rate gain is equal to the amount multiplied by 20 percent in performing that computation, and the maximum distributable unrecaptured Section 1250 gain is equal to the amount multiplied by 25 percent in performing that computation. The maximum distributable 28 percent rate gain is the net capital gain minus

the amount of unrecaptured Section 1250 gain distributions and 20 percent rate gain distributions that have been properly designated. n295

Example:

A REIT has a net capital gain in the tax year of \$100, of which \$60 would be multiplied by 20 percent and \$5 would be multiplied by 25 percent in performing the computations required by *IRC Section 1(h)*. The maximum distributable 20 percent rate gain is \$60, and the maximum unrecaptured Section 1250 gain is \$5. If the REIT properly designates the maximum permissible unrecaptured Section 1250 gain distribution and 20 percent rate gain distribution, then its maximum distributable 28 percent rate gain is \$35; i.e., the net capital of \$100 less the properly designated unrecaptured Section 1250 gain distribution of \$5 and 20 percent rate gain distribution of \$60. n296

The deferral adjustment required by *IRC Section 857(b)(3)(C)* for a fiscal year REIT with post-December capital losses must be made before calculating the limitations on the various classes of capital gain dividends for the REIT's tax year. n297

A REIT must make the bifurcation adjustment described below if: (1) its tax year is not the period used to determine capital gain net income for purposes of the excise tax imposed by *IRC Section 4981* (i.e., its taxable year is not the calendar year); (2) it has a net capital gain during the pre-January portion of its taxable year; and (3) it is not required to make the deferral adjustment. n298

If a REIT is required to make a bifurcation adjustment, it must calculate the maximum distributable 20 percent rate gain and the maximum distributable unrecaptured Section 1250 gain separately for the pre-January portion of the year and for the post-December portion of the year, as if the two portions of the year were separate taxable years. Then, the maximum distributable 20 percent rate gain and the maximum distributable unrecaptured Section 1250 gain for the taxable year equals the sum of the maximum distributable amounts for gains in that group determined for each portion of the year. The Notice provides examples of deferral and bifurcation adjustments. n299

[c] Deduction for Dividends Paid and Related Issues

[i] In General

In addition to the organizational requirements and reporting and recordkeeping requirements, in order for a corporation to be taxable as a REIT it must make certain minimum distributions. Each year its deduction for dividends paid (determined without regard to capital gain dividends) must be at least equal to:

(1) the sum of--

(a) 90 percent (95 percent for tax years beginning before 2001) of the REIT taxable income determined without regard to distributions and net capital gain, and

(b) 90 percent (95 percent for tax years beginning before 2001) of the excess of net income from foreclosure property over the tax on such income,

(2) minus any excess noncash income as described in the following paragraph. n300

A number of provisions of the tax law require taxpayers to recognize income before it is received. Because a REIT must distribute its income currently in cash, the recognition of noncash income can put the REIT in a cash bind. A REIT may reduce its distribution requirement by a portion of the amount of certain noncash income consisting of:

- (1) rent or interest income from deferred rent agreements includable in gross income under *IRC Section 467*;
- (2) original issue discount and coupon interest imputed under the deferred payment for property rules; n301
- (3) gain required to be recognized because of an inadvertent failure of a transaction to qualify as a tax-deferred exchange; n302 and
- (4) effective for tax years beginning after August 5, 1997, cancellation of indebtedness income.

To the extent that such noncash income exceeds five percent of REIT taxable income before the deduction for dividends paid, it will reduce the distribution requirement below 90 percent (95 percent for tax years beginning before 2001) of taxable income. n303 This provision only reduces the amount required to be distributed. It does not reduce REIT taxable income for other purposes. Therefore, the REIT must pay tax on the reduction amount as if it were retained income.

Distributions by a REIT are only included in the deduction for dividends paid to the extent they constitute "dividends" for tax purposes. n304 A "dividend" means a distribution out of current or accumulated earnings and profits. n305 However, three special rules apply. The earnings and profits of a REIT for any taxable year (but not its accumulated earnings) are not reduced by any amount which is not deductible in arriving at its taxable income for the taxable year. n306 Also, a REIT is treated as having sufficient earnings and profits to treat as a dividend any distribution which is treated as a dividend by the REIT, but only to the extent of the distribution required to avoid the excise tax on the REIT for noncurrent distributions. n307 Finally, for purposes of the requirement that newly-electing REITs distribute earnings and profits accumulated in non-REIT years, distributions are treated as made first from earnings and profits which, but for the distribution, would result in a failure to meet those requirements (and allocated to such earnings on a first-in, first-out basis). n308 For distributions before 2001, distributions are treated as made first from the entity's earliest accumulated earnings and profits accumulated in any tax year in which the entity was not a REIT rather than from the most recently accumulated earnings and profits. n309 In addition, these distributions are not treated as distributions for purposes of calculating the dividends paid deduction, n310 or, effective for distributions after 2000, for purposes of distributions made by a REIT after the close of the tax year to meet qualification requirements. n311

The amount of a dividend paid in property is not entirely clear. The regulations provide that the deduction is equal to the adjusted basis of the property in the hands of the REIT at the time of the distribution. n312 However, all distributions by corporations of appreciated property trigger gain to the corporation as if the property were sold for its fair market value. n313 Therefore, either the above referenced regulation should be declared obsolete by the Treasury Department or the adjusted basis should be increased by the gain recognized. n314

A REIT may not deduct a "preferential dividend." A dividend must be pro rata, with no preference to any share of stock as compared with other shares of the same class and must have no preference to one class of stock compared with another class except to the extent the former is entitled (without reference to waivers of their rights by shareholders) to that preference. n315 A corporation treated as a REIT (i.e. a publicly traded REIT) may avoid having certain distributions treated as a preferential dividend if specified requirements are met. If some shareholders receive a combination of stock and money that differs from the combination received by other shareholders, and if the fair market value of the stock on the date of distribution differs from the amount of money which could have been received instead, those differences do not cause the distribution to be a preferential dividend. n315.1 Only distributions that meet all of the following requirements are eligible for this remedial characterization: n315.2

- (1) The distribution is made by the corporation to its shareholders with respect to its stock.

- (2) Stock of the corporation is publicly traded on an established securities market in the United States.
- (3) The distribution is declared on or before December 31, 2012, with respect to a taxable year ending on or before December 31, 2011.
- (4) Pursuant to the declaration, each shareholder may elect to receive its entire entitlement under the declaration in either money or stock of the distributing corporation of equivalent value subject to a limitation on the amount of money to be distributed in the aggregate to all shareholders (the "cash limitation"), provided that (a) the cash limitation is not less than 10% of the aggregate declared distribution, and (b) if too many shareholders elect to receive money, each shareholder electing to receive money will receive a *pro rata* amount of money corresponding to the shareholder's respective entitlement under the declaration, but in no event will any shareholder electing to receive money receive less than 10% of the shareholder's entire entitlement under the declaration in money. The value of the shares to be distributed shall be determined by using the formula described in described in (5), below.
- (5) The calculation of the number of shares to be received by any shareholder will be determined, over a period of up to two weeks ending as close as practicable to the payment date, based upon a formula utilizing market prices that is designed to equate in value the number of shares to be received with the amount of money that could be received instead. and
- (6) With respect to any shareholder participating in a dividend reinvestment plan ("DRIP"), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in money.

If a REIT recognizes net capital gain in a taxable year, it may elect to designate a portion of its dividends as a capital gain dividend, thus allowing its shareholders to obtain the benefit of any preferential treatment of net capital gain. The election is made by designating the amount in a written notice mailed to its shareholders within 30 days after the end of the REIT's taxable year (or mailed with its annual report for such year). n316 If a REIT has two classes of stock, presumably in order to avoid a preferential dividend, a capital gain dividend should be allocated *pro rata* to the amount of the dividends paid on each class. A REIT may also elect to retain and pay income tax on net long-term capital gains it receives during the year. n317

For purposes of determining the time a dividend is paid for the dividends paid deduction, special rules apply. As a general rule, a dividend is considered paid when it is received by the shareholder. n318 However, any dividend declared by a REIT in October, November or December, payable to shareholders of record on a specified date in such a month and actually paid in the following January, is treated as: (1) having been received by each shareholder on December 31 of the year the dividend is declared; and (2) having been paid by the REIT on December 31 in the same year. n319

In addition, if a REIT (1) declares a dividend before the due date of its tax return (including extensions) for a taxable year, and (2) distributes the dividend to shareholders in the year following that taxable year and not later than the first regular dividend payment made after that declaration, the amount of that dividend will, to the extent and dollar amount the REIT elects in its tax return, be considered as having been paid during that prior taxable year. n320 Making the election can allow a REIT to meet the statutory distribution requirements n320.1 and reduce its taxable income for the prior taxable year. However, the REIT's shareholders are treated as receiving the dividend in the year in which it is paid. n321 No "special" dividend must be declared and paid. If a REIT makes regularly scheduled monthly or quarterly dividends, the election will be made for the first dividends paid. The "first regular dividend payment" is merely the first dividend for which the election is not made. n322

As described in the previous paragraph, a REIT may pay out a dividend a year after it receives the effective benefit of

the dividends paid deduction even though the shareholders report the income in the year received. As a result, there is a mismatching of income and deductions. To encourage REITs to pay dividends in the same year as the income is earned, the Service has imposed a four percent excise tax on certain income that is not distributed in the year earned. The tax is four percent of the excess of the "required distribution" over the "distributed amount." n323 The required distribution is equal to the sum of:

- (1) 85 percent of the REIT ordinary income for the year;
- (2) 95 percent of the REIT capital gain net income; and
- (3) the "grossed up required distribution," which is the taxable income of the prior years that has been treated as not distributed. n324

The distributed amount is equal to:

- (1) the deduction for dividends paid for such year (other than that portion allocable to foreclosure income);
- (2) the REIT taxable income for such year; and
- (3) any "over distribution" for the prior year. n325

The dividends paid deduction is determined without regard to dividends declared and paid after year end. n326

[ii] Deficiency Dividends

A REIT may take a deduction for deficiency dividends in computing its dividends-paid deduction n327 if there is a determination that results in an adjustment for any taxable year. n327.1 A deficiency dividend may be an ordinary dividend or a capital gain dividend. It is a distribution of property made on or after the date of a determination which would have been includable in the dividends-paid deduction for the year with respect to which the determination was made if it had been distributed in that year. n328

Planning Tip:

Paying a deficiency dividend can allow the REIT to avoid losing its REIT status and also secure a deduction for the dividends paid, but the REIT is liable for interest and additions to tax determined with respect to the amount of the deficiency dividend deduction that is allowed. n328.1

A REIT is allowed a deduction for a deficiency dividend only if, among other things, there is a "determination" that results in an "adjustment" n328.2 for the taxable year for which the deficiency dividend is paid. The "determination" may be in the form of a decision of the Tax Court, a closing agreement, n328.3 or an agreement signed by the Secretary of the Treasury. n328.4

In addition, a REIT may declare a deficiency dividend on its own if it has identified a failure to pay the relevant amount. n328.5 To do so, it must file a Form 9927, *Determination Under Section 860(e)(4) by a Qualified Investment Entity*, with its amendment or supplement to a return for the relevant year. The statement serves as the necessary "determination" under *IRC Section 860*. n328.6

An "adjustment" is any of the following: n328.7

- Any increase in the sum of the REIT's taxable income (determined without regard to the

dividends-paid deduction and excluding capital gains) and the excess of net income from foreclosure property over the tax on that income;

- Any increase in the amount of the excess of net capital gain over the deduction for capital gains dividends paid; n328.8 or
- Any decrease in the dividends-paid deduction determined without regard to capital gains dividends.

A "deficiency dividend" is a distribution of property that meets the following requirements: n328.9

- It is made by a REIT (or a RIC);
- It is made on or after the date of the determination and before the filing of a claim; n328.10 and
- It would have been includible in the computation of the dividends-paid deduction n328.11 for the taxable year with respect to which the liability for tax resulting from the determination exists, if that distribution had been made during that taxable year.

A deficiency dividend, however, cannot exceed the net adjustment to ordinary income or capital gain resulting from the determination. n328.12

Several timing requirements apply with respect to the distributions. To qualify as a deficiency dividend, the distribution of property must be made within 90 days of the date of the determination. n328.13 In addition, a deduction for the deficiency dividend is allowed only if the taxpayer files a claim for the deduction within 120 days after the date of the determination. n328.14 The claim is made by filing Form 976, *Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust*. n328.15

The "date of the determination" when a taxpayer files a Form 8927 is determined by the manner of mailing. If the form is sent by U.S. mail or by proper use of a PDS, the date of the determination is generally the postmark date. n328.16 If sent by other means, the date of determination is the date the Form 8927 is received by the IRS. n329

[iii] Treatment of Stock Dividends

In response to the financial and credit market crisis beginning in 2008, the IRS has issued guidance that enables REITs to temporarily satisfy statutory distribution requirements n329.1 with distributions of REIT stock in lieu of cash, provided that cash makes up at least 10 percent of the distribution. Compliance with requirements will also allow the distributions to avoid being treated as a preferential dividend. The same guidance applies for regulated investment companies (RICs). n329.2 Under the guidance, a distribution of stock by a REIT will be treated as a dividend, and the amount of that distribution of stock will be considered to equal the amount of the money the REIT or RIC shareholder could have received instead, if the following requirements are met: n329.3

- (1) the distribution is made by the corporation to its shareholders with respect to its stock;
- (2) stock of the corporation is publicly traded on an established securities market in the United States;
- (3) the distribution is declared on or before December 31, 2012, with respect to a taxable year ending on or before December 31, 2011
- (4) pursuant to the declaration, each shareholder may elect to receive its entire entitlement under the declaration in either money or stock of the distributing corporation of equivalent value subject to a

limitation on the amount of money to be distributed in the aggregate to all shareholders (the "cash limitation"), provided that (a) the cash limitation is not less than 10% of the aggregate declared distribution, and (b) if too many shareholders elect to receive money, each shareholder electing to receive money will receive a pro rata amount of money corresponding to their respective entitlement under the declaration, but in no event will any shareholders electing to receive money receive less than 10% of their entire entitlement under the declaration in money; the value of the shares to be distributed must be determined in accordance with the formula in item (5), *below*;

(5) the calculation of the number of shares to be received by any shareholder will be determined, as close as practicable to the payment date, based upon a formula using market prices that is designed to equate in value the number of shares to be received with the amount of money that could be received instead; and

(6) with respect to any shareholder participating in a dividend reinvestment plan (DRIP), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in money under item (4), above.

NOTE:

The IRS guidance allows REITs (and RICs) to keep up to 90 percent of their income for the payment of mortgage and other obligations incurred in their operations. The guidance amounts to a temporary nullification of the statutory REIT/RIC distribution requirements, and is likely to disgruntle REIT and RIC shareholders who were expecting cash dividends. n329.4

[d] 100 Percent Tax on Improperly Allocated Amounts

Effective generally for tax years beginning after 2000, n330 certain amounts that are improperly allocated between a REIT and a REIT subsidiary are subject to a 100 percent excise tax. The tax is imposed on the REIT and is equal to 100 percent of re-determined rents, re-determined deductions, and excess interest. n331 If any amount of interest, rent, or other deductions of a taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arms' length, the tax is imposed on the portion that is excessive. n332

"Redetermined rents" means rents from real property n332.1 to the extent the amount of the rents would, but for *IRC Section 857(b)(7)(E)* [which imposes the 100 percent tax in lieu of *IRC § 482* adjustments], be reduced in distribution, apportionment, or allocation under *IRC Section 482* to clearly reflect income as a result of services furnished by a taxable REIT subsidiary of the REIT to a tenant of the REIT. n332.2 Safe harbors are provided for the following items:

- de minimis rental payments; n333
- charges for services rendered by a taxable REIT subsidiary to a tenant of the trust for which there is specified evidence that charges to unrelated parties are substantially comparable; n334
- certain charges for services from the taxable REIT subsidiary to a tenant of the trust that are separately stated; n335 or
- any service performed by a taxable REIT subsidiary if its gross income from the service is not less than 150 percent of its direct cost in furnishing the service. n336

For tax years beginning before October 23, 2004, there was also a safe harbor allowing rents received by a REIT to be exempt from the 100 percent excise tax if the rents were for customary services performed by a taxable REIT subsidiary or were from a taxable REIT subsidiary and would be treated as unrelated business taxable income if received by a

charitable organization. n336.1 Those payments are now free only if they satisfy the safe harbor that applies if the REIT pays the taxable REIT subsidiary at least 150 percent of the cost to the taxable REIT subsidiary providing any services. n336.2 "Redetermined deductions" means deductions (other than redetermined rents) of a taxable REIT subsidiary of a REIT to the extent the amount of those deductions would, but for *IRC Section 857(b)(7)(E)* [which imposes the 100 percent tax in lieu of *IRC Section 482* adjustments], be decreased on distribution, apportionment, or allocation under *IRC Section 482* to clearly reflect income as between the REIT subsidiary and the REIT. n336.3 "Excess interest" means any deductions for interest payments by a taxable REIT subsidiary of a REIT to that REIT to the extent that the interest payments exceed a commercially reasonable rate. n336.4

The IRS is authorized to waive the 100 percent excise tax if the REIT establishes that rents charged to tenants were established on an arms'-length basis, even though a taxable REIT subsidiary of the trust provided services to the tenants. n337 In determining whether rents are arms' length rents, the failure of the rents to meet the above safe harbors is not taken into account. In addition, rent received by a REIT does not fail to qualify as rents from real property n338 simply because all or any portion of that rent is subject to the 100 percent excise tax. n339

The IRS has issued a ruling providing guidance regarding the treatment under *IRC Sections 856* and *857(b)(7)* of *non* customary services provided by a taxable REIT subsidiary to tenants of a REIT, when no service charges are separately stated from the rents paid by the tenants to the REIT. n339.1 The ruling poses two fact situations. In one, a REIT owned residential apartment buildings and formed a taxable REIT subsidiary to provide housekeeping services to tenants. The services did not qualify as customary under the regulations. n339.2 Employees of the subsidiary performed all of the housekeeping services rendered. The subsidiary paid all costs connected with the services. To carry out operations, the subsidiary also rented space in the REIT's apartment building in accordance with *IRC Section 856(d)(8)(A)*. The subsidiary made no payments to the REIT other than its rental payments. The annual value of the housekeeping services provided exceeded one percent of the total annual amount received by the REIT from the property. Charges to the tenants for the housekeeping services were not separately stated from the rents that tenant paid to REIT for the use of the apartments. The subsidiary did not enter into contracts with the tenants for the services, and the REIT compensated subsidiary for providing the services by paying the subsidiary an amount that was 160 percent of the subsidiary's direct cost of providing the services. The subsidiary reported the full amount of the REIT's payment as gross income. n339.3

For this situation, the IRS ruled that the housekeeping services were considered to be rendered by the subsidiary rather than by the REIT. n339.4 Accordingly, the services did not give rise to impermissible tenant service income and did not cause any portion of the rents received by the REIT to fail to qualify as rents from real property. n339.5 The IRS ruled that the safe harbor of *IRC Section 857(b)(7)(B)(vi)* protected the REIT from the imposition of the 100 percent tax on redetermined rents n339.6 because the gross income of the subsidiary from the service exceeded 150 percent of the subsidiary's direct cost of furnishing the service. n339.7 The IRS noted, however, that if the amount paid by the REIT to the subsidiary represented less than an *IRC Section 482* arm's length charge for the services, income could be allocated from the REIT to the subsidiary. Income so allocated would be deductible by the REIT and would reduce the REIT's taxable income, but not its gross income. The allocation would not cause any portion of the rents received by the REIT to fail to qualify as rents from real property. n339.8

The second fact situation in the ruling was the same as the first, except that the REIT compensated the subsidiary by paying the subsidiary an amount that was 125 percent of the subsidiary's direct cost of providing the services. This payment was less than the arm's length charge under *IRC Section 482* for providing the services. For this situation, the IRS ruled that the housekeeping services would still be considered to be rendered by the subsidiary rather than by the REIT. n339.9 Accordingly, as in the first situation, the services did not give rise to impermissible tenant service income and did not cause any portion of the rents received by the REIT to fail to qualify as rents from real property. n339.10 Here, however, the statutory safe harbor was not met because the gross income of the subsidiary from the service was less than 150 percent of the subsidiary's direct cost of furnishing the service. n339.11 The REIT was therefore subject to the 100 percent tax on redetermined rents. n339.12 The IRS ruled that imposition of that tax was in lieu of allocation of that amount from the REIT to the subsidiary under *IRC Section 482* and did not cause any portion of the rents received

by the REIT to fail to qualify as rents from real property under *IRC Section 856(d)*. n339.13

[e] Taxable Year

A REIT must use the calendar year as its taxable year. n340

[f] REIT Classification Under Entity Classification Rules

Under the federal entity classification rules, an election by an eligible entity to be a REIT is treated as a deemed election to be classified as an association (taxable as a corporation). The election is effective for the entire period during which REIT status is claimed. n341-343

[g] State Taxation

There is no uniformity among the states regarding the taxation of REITs. Therefore, careful attention should be paid to the tax rules in every state or local jurisdiction where the REIT owns property or has property securing its mortgages. Additionally, some states do not change their laws to conform to amendments to the federal REIT provisions, thus increasing the need for careful attention.

[4] Taxation of Shareholders

[a] Distributions in General

The taxability of distributions to shareholders is dependent on whether the distributions are made out of current and accumulated earnings and profits (E&P) of the REIT. Distributions from E&P will be taxable to the shareholders, and any excess thereof is considered a return of capital. The return of capital will reduce the shareholder's basis in his shares. Once the basis has been reduced to zero, the shareholder will recognize capital gain. n344 Dividends of a REIT, other than those identified by the REIT as capital gain dividends, are taxable to the shareholders as ordinary income, provided there is sufficient E&P.

[b] Capital Gain Dividends

Long-term capital gains of the REIT that are distributed are taxable to the beneficiaries as long-term capital gains, if the REIT has designated such distribution as a capital gain dividend. n345 If a REIT mistakenly designates an amount greater than its net capital gain for the year as a capital gain dividend, the actual capital gain distribution must be proportionately reduced. n346 A capital gain dividend also can only be declared from a REIT's current year net capital gain and not from any net capital gain accumulated in prior years.

An exception to capital gains dividends treatment applies to certain dividends paid to foreign investors. Capital gains dividends paid to a foreign investor are treated as a REIT dividend to that investor, and taxed as a REIT dividend that is not a capital gain, provided that (1) the distribution is received with respect to a class of stock that is regularly traded on an established securities market located in the United States, and (2) the foreign investor does not own more than five percent of the class of stock at any time during the taxable year within which the distribution is received. n346.1

The tax rate that applies to a REIT capital gain dividend received by a taxpayer depends on the tax year in which it was paid and the designation of the gain given to the dividend by the REIT. n346.2 A capital gain dividend received from a REIT in a tax year of the shareholder ending after May 7, 1997, and before May 6, 2003, is treated as follows: n347

- (1) a 20 percent rate gain distribution is an amount of long-term capital gain in the 20-percent group;
- (2) an unrecaptured Section 1250 gain distribution is an amount of long-term capital gain in the

25-percent group; and

(3) a 28 percent rate gain distribution is an amount of long-term capital gain in the 28 percent group.

For certain taxpayers, transactions in the 20-percent group could be taxed at a 10-percent rate, or at an 8-percent rate if the gain was qualified 5-year gain. n347.1

Notice 2004-39 explains the various tax rates and groupings that can apply to REIT capital gain dividends paid (or accounted for as if paid) in taxable years that end on or after May 6, 2003. *Notice 2004-39* also contains a detailed transition rule explaining how the mid-year reduction in tax made by 2003 legislation applies to capital gain dividends of REITs for taxable years that include May 6, 2003. n347.2

For REIT capital gain dividends received in tax years beginning on or after May 6, 2003, and beginning before January 1, 2009, the 20-percent rate is reduced to 15 percent, the 10-percent rate is reduced to 5 percent (0 percent for taxable years beginning after 2007), and the rules dealing with qualified 5-year gain are repealed. n347.3

Notice 2004-39 describes how the reduction in rates made by 2003 legislation and the transition rule (for taxable years that include May 6, 2003), apply to capital gain dividends of REITs. The same rules described in *Notice 97-64* continue to apply to a REIT's capital gain dividends, with appropriate modifications to take into account the post-1997 amendments to *IRC Section 1(h)*. For example, some taxpayers may receive a REIT distribution amount that is designated as a 20-percent rate gain distribution and that includes a portion constituting 5-year gain. As a result of the repeal of the separate rules for 5-year gains, the 5-year gain portion of that 20-percent rate gain distribution is not subject to the prior law 8-percent rate for 5-year gain. Rather, the 5-year gain portion will be treated the same as any other 20-percent rate gain distribution that is received in a taxable year beginning on or after May 6, 2003, and therefore will be taxed at a rate no higher than 15 percent (5 percent for certain taxpayers). *Notice 2004-39* gives detailed examples of the transitional rule and the application of tax rates on dividends including a 5-year gain portion. n347.4

Any loss on the sale of REIT stock, the holding period of which begins after July 18, 1984, and is six months or less, is required to be classified as long-term to the extent that the shareholder received a prior long-term capital gain distribution on the stock. n348 This rule does not apply to losses incurred pursuant to a plan that provides for periodic liquidations. n349

[c] Credit for Tax Paid by REIT on Retained Capital Gains

A REIT may elect to retain and pay income tax on net long-term capital gains it receives during the year. If a REIT makes this election, the REIT shareholders must include in their income, as long-term capital gains, their proportionate share of the undistributed long-term capital gains as designated by the REIT. n350 Each shareholder is deemed to have paid his or her share of the tax on that amount, and a proper credit or refund of that amount must be made to each shareholder. n351 The basis of each shareholder's shares is also increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains. n352

For foreign investors, the amount that they would otherwise treat as long-term capital gains under this rule must be treated as a REIT dividend, and not treated a long-term capital gain, provided that (1) the class of stock with respect to which the undistributed capital gains occur is regularly traded on an established securities market located in the United States, and (2) the foreign investor does not own more than five percent of the class of stock at any time during the taxable year within which the capital gains occur. n352.1 The REIT must designate the amounts it will retain in a written notice mailed to its shareholders at some time before the 60 days following the close of its taxable year (or mailed to its shareholders or holders of beneficial interests with its annual report for the taxable year). n353 The tax imposed on the retained capital gains n354 must actually be paid by the REIT within 30 days after the close of its

taxable year. n355

[d] Estimated Tax Rules for Dividends from Closely Held REITs

In the case of a REIT that is closely held, any person owning at least 10 percent of the vote or value of the REIT is required to accelerate the recognition of year-end dividends attributable to the closely-held REIT for purposes of that person's estimated tax payments. The computation of the annualized income installments is determined in a manner similar to that in which partnership income installments are taken into account. n356 A closely-held REIT is one in which at least 50 percent of the vote or value is owned by five or fewer persons. Attribution rules apply to determine ownership. n357

[e] No Dividends-Received Deduction for REIT Dividends

Dividends from REITs are not eligible for the dividends-received deduction. n358

[f] Limitation on Capital Gain Treatment for REIT Dividends

Qualified dividends received by an individual shareholder are taxed at the same rates that apply to net capital gain. n359 Qualified dividend income that is eligible for capital gains tax rates include dividends received during the taxable year from domestic corporations or qualified foreign corporations. n359.1 A special distribution rule limits the amount of REIT dividends that are treated as qualified dividend income and that thereby qualifies for taxation at capital gains rates under *IRC Section 1(h)(11)*. n359.2 For any dividend (other than a capital gain dividend) received from a REIT that met the requirements as a REIT n359.3 for the taxable year during which it paid that dividend, qualified dividend income includes only that portion of the dividend that is designated by the REIT as qualified dividend income. n359.4

The amount a REIT may designate as qualified dividend income is limited. The aggregate amount designated as qualified dividend income cannot exceed the sum of the following: n359.5

- the REIT's qualified dividend income for the taxable year; plus;
- the excess of the sum of the REIT's taxable income for the preceding taxable year n359.6 and the income subject to tax by reason of the application of the regulations under *IRC Section 337(d)* for that preceding taxable year, over the sum of the taxes imposed on the REIT for that preceding taxable year under *IRC Section 857(b)(1)* and by reason of the application of those regulations; n359.7 plus;
- the amount of any earnings and profits that were distributed by the REIT for that taxable year and accumulated in a taxable year with respect to which the taxpayer was not a REIT.

NOTE:

The final item allows all distributions by a REIT of earnings and profits from its C corporation years to be treated as qualifying dividends eligible for the lower capital gains rate. n359.8

One further limitation applies. The amount of any distribution by a REIT that may be taken into account as qualified dividend income cannot exceed the amount designated by the REIT in a written notice to its shareholders. The notice must be mailed not later than 60 days after the close of the REIT's taxable year. n359.9

[g] Apportionment of Items Treated Differently for AMT Purposes

For purposes of the alternative minimum tax, a REIT must apportion tax preference items and other items it treats differently for alternative minimum tax purposes than for regular tax purposes. The items are to be apportioned between

the REIT and REIT shareholders in accordance with regulations prescribed by the IRS. n359.10 No regulations, however, have yet been issued.

[5] Special Taxpayers

[a] Pension Plans and Other Tax-Exempt Shareholders

In general, a tax-exempt entity that is a shareholder of a REIT will not be subject to tax on distributions from the REIT or gain realized on the sale of shares of stock. The Service has specifically confirmed that a REIT's distributions to a tax-exempt employees' pension trust did not constitute unrelated business taxable income. n360 A tax-exempt entity may be subject to tax, however, to the extent that it has financed the acquisition of its shares of REIT stock with "acquisition indebtedness" within the meaning of Section 514(c) of the Code. The *Revenue Reconciliation Act of 1993* modified the rules for tax exempt employees' pension and profit-sharing trusts which qualify under Code Section 401(a) and are exempt from tax under Code Section 501(a) (qualified trusts) for taxable years beginning after December 31, 1993. n361 Under the new rules, in determining the number of shareholders a REIT has for purposes of satisfying the 50 percent shareholder test set forth above under Section 16.02[2][a], generally, any stock held by a qualified trust will be treated as held directly by its beneficiaries in proportion to their actuarial interests in such trust and will not be treated as held by such trust. This general rule will not apply if certain persons related to the qualified trust (disqualified persons) hold in the aggregate more than 5 percent of the value of the REIT and the REIT has accumulated earnings and profits attributable to any period for which it did not qualify as a REIT.

A qualified trust owning more than 10 percent of a REIT must treat a percentage of dividends from the REIT as unrelated business taxable income. n362 The percentage is determined by dividing the REIT's gross income (less direct expenses related thereto) derived from an unrelated trade or business for the year by the gross income of the REIT for the year in which the dividends were paid; however, if this percentage is less than 5 percent, dividends are not treated as unrelated business taxable income. n363 These unrelated business taxable income rules apply only if the REIT qualifies as a REIT because of the change in the 50 percent shareholder test discussed above and if the trust is "predominantly held" by a qualified trust. n364 A real estate investment trust is predominantly held by a qualified trust if at least one pension trust owns more than 25 percent of the value of the REIT, or a group of pension trusts individually holding more than 10 percent of the value of the REIT collectively own more than 50 percent of the value of the REIT. n365

For social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts and qualified group legal service plans exempt from Federal income taxation under Sections 501(c)(7), (9), (17) and (20) of the Code, respectively, income from an investment in a REIT will constitute unrelated business taxable income unless the organization is able to deduct an amount properly set aside or placed in reserve for certain purposes so as to offset the unrelated business taxable income generated by the investment in the REIT. n366

[b] Foreign Shareholders

[i] Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)

FIRPTA was enacted to tax foreign investors on the gain from the disposition of a United States real property interest (USRPI). In general, a USRPI is any interest in real property located in the United States or the Virgin Islands or any equity interest in a domestic corporation whose United States real property interests equal or exceed 50 percent of its total interests in real property and any other of its assets which are used in a trade or business, determined based on fair market value. n367 The tax is imposed by treating gains from disposition of USRPIs as "effectively connected" with the conduct of a United States trade or business engaged in by the foreign investor. n368 This income is taxable at regular federal tax rates as if the foreign investor was a United States person or entity. n369 The effect of the application of FIRPTA on dividends from, and gain from the sale of, REIT stock owned by foreign investors is discussed below.

[ii] Dividend Distributions

Dividends that are not attributable to gain from sales or exchanges by a REIT of USRPIs and cannot be designated by the REIT as capital gain dividends will be treated as dividends of ordinary income to the extent that they are made out of current or accumulated earnings and profits of the REIT. Such dividends ordinarily will be subject to a withholding tax equal to 30 percent of the gross amount of the dividend unless an applicable tax treaty reduces or eliminates that tax. n370 However, if income from the investment in the shares of REIT stock is treated as effectively connected with the foreign investor's conduct of a United States trade or business, the foreign investor generally will not be subject to federal withholding tax n371 but will be subject to a tax at graduated rates, in the same manner as United States shareholders are taxed with respect to such dividends n372 (and may also be subject to the 30 percent branch profits tax in the case of a foreign investor that is a foreign corporation). n373 As with United States shareholders, dividends in excess of current and accumulated earnings and profits of the REIT will not be taxable to a shareholder to the extent that they do not exceed the adjusted basis of the shareholder's shares of stock, but rather will reduce the adjusted basis of such shares. To the extent that such dividends exceed the adjusted basis of a foreign investor's shares of the REIT's stock, the dividends will give rise to a tax liability if the foreign investor would otherwise be subject to tax on any gain from the sale or disposition of his shares, as described below. Apparently, withholding is required even though a portion of a distribution by a REIT may be treated as a return of basis or capital gain because it is in excess of current and accumulated earnings and profits; n374 however, the foreign investor may seek a return from the Service of excess withholdings.

Certain capital gains dividends that are paid by a REIT to a nonresident alien individual or a foreign corporation are treated--not as capital gain--but as dividends that are not effectively connected with a US trade or business. These distributions instead are treated as dividend distributions and are subject to 30 percent (or lower treaty rate) dividend withholding. n375 The dividends would not be subject to the branch profits tax. n376 Distributions qualify for this treatment only if made with respect to any class of stock that is regularly traded on an established securities market located in the US, and only if that individual or corporation did not own more than 5 percent of that class of stock at any time during the 1-year period ending of the date of the distribution. n377

Withholding is required on REIT distributions to foreign persons that are attributable to the sale of US real property interests. The required withholding rate is 35 percent or, to the extent provided by regulations, 15 percent (or 20 percent in tax years beginning after December 31, 2010). n378 No withholding is required, however, with respect to a disposition that is treated as a disposition of a US real property interest solely because of the FIRPTA wash sale rule. n378.1

The regulations include a special rule, which provides that if a REIT makes an actual designation of a prior distribution, in whole or in part, as a capital gain dividend, such prior distribution will not be subject to the 35 percent withholding. Instead, the REIT must characterize and treat as a capital distribution (solely for purposes of 35 percent withholding) each distribution made on or after such distribution as a capital gain dividend until the recharacterized amounts equal the amount of the prior designated capital gain. n379 This rule is necessary because a REIT often does not designate capital gain dividends until after the fact or even after the year end in which the dividend was paid. The amount withheld may be credited against the foreign investor's FIRPTA tax liability. n380

[iii] Gains on Sale of REIT Shares

A REIT is a "qualified investment entity" under the FIRPTA provisions. n381 Any gain from the sale of shares of a domestically controlled qualified investment entity is not subject to tax under FIRPTA because a US real property interest does not include any interest in a domestically controlled qualified investment entity. n382 A domestically controlled qualified investment entity is one in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons. n382.1 The testing period is the 5-year period ending on the date of the distribution or disposition, or, if shorter, the period during which the qualified investment entity was in existence. n382.2

Gain from the sale of stock in a REIT or other qualified investment entity that is not domestically controlled is treated as effectively connected income n382.3 and the foreign investor will be subject to the same treatment as United States shareholders with respect to such gain n382.4 (subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals, n382.5 and subject to the 30 percent branch profits tax in the case of a shareholder that is a foreign corporation). n383

[6] Umbrella Partnership REITs

[a] Overview

A relatively new structure which has generated considerable interest is the "Umbrella Partnership REIT" (UPREIT). n384 This structure combines partnership ownership with REIT ownership. As described more fully below, the advantages of the UPREIT structure include the ability to provide liquidity to existing investors in real estate partnerships and to allow a transfer of real property without the recognition of gain. The ability of the existing partners to time the conversion of their partnership interests to REIT shares at the most tax-efficient point provides significant individual flexibility. The UPREIT concept also has disadvantages, including the complexity of the structure and the potential for a conflict of interest between the partnership and the UPREIT. n385

One of the historical problems for investors in real estate has been trying to raise capital and obtain liquidity of their real estate assets without incurring an income tax liability. Unfortunately, in the case of a REIT, the general rule providing for nonrecognition of gain upon transfer of real estate to a corporation usually does not apply. Assets can generally be transferred tax-free to a controlled corporation in exchange for the corporation's stock; n386 however, if the corporation is an "investment company" and the transfer results in diversification of the transferor's interest, n387 gain or loss is recognized by the transferors. For this purpose, an investment company means either (1) a REIT, (2) a regulated investment company or (3) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or REITs. n388 Generally, if there are two or more transferors of nonidentical assets, the transfer is considered to result in diversification. n389

Effective for tax years ending after March 26, 1998, n390 a REIT or stapled entity that owns an UPREIT partnership interest is treated as holding all of the real property interests, mortgages, activities and gross income of that UPREIT partnership. n391 This rule applies, however, only if: (1) an exempt REIT or stapled entity owned directly or indirectly at least a 60-percent interest in the partnership as of March 26, 1998; and (2) 90 percent or more of the interests in the partnership (other than those held by the exempt REIT or stapled entity) are or will be redeemable or exchangeable for consideration with a value determined with reference to the stock of the REIT or stapled entity, or both. n392 The above rule also applies to an otherwise qualifying interest in an UPREIT partnership formed after March 26, 1998, where the partnership was formed to mirror the stapling of an exempt REIT and a stapled entity in connection with an acquisition agreed to or announced on or before March 26, 1998. n393 If, as of January 1, 1999, more than one partnership owned by a REIT or stapled entity meets the requirements of the above provision, only the largest such partnership (determined by aggregate asset bases) is treated as meeting those requirements. n394

[b] Structure

The UPREIT structure generally allows investors in real estate partnerships to effectively have many of the benefits of a direct REIT incorporation while deferring most or all of any gain in their investment in the partnership. n395 Usually multiple partnerships will be combined to obtain a larger, more diversified portfolio and one more appropriate for a publicly-traded REIT. The partners in the existing partnerships contribute their partnership's interests in exchange for interests in a new partnership, the umbrella partnership. Under *IRC Section 721*, the partners generally do not recognize gain or loss on the exchange. n396 Alternatively, real estate may be contributed to the umbrella partnership or an

existing partnership may be used in which the REIT becomes a partner. Note that in the case of a contribution of partnership interests, any partner can avoid participation in the umbrella partnership by not contributing his partnership interest.

The REIT becomes a partner in the umbrella partnership by contributing cash typically received from a public offering. This cash is used either to pay down outstanding debt of the existing partnerships or to acquire new properties. The original partners obtain liquidity by converting their partnership interests in the umbrella partnership to shares in the REIT. Often this conversion is limited by contract to conversions only after a specified period following the REIT's public offering. The conversion is a taxable transaction and consequently a conversion is often postponed until an ultimate sale of the REIT stock for cash is desired. The REIT usually has a qualified REIT subsidiary n397 that owns an interest in the umbrella partnership. This structure avoids dissolution of the partnership if all the original non-REIT partners convert their interests to REIT shares. n398 The IRS has issued several Technical Advice Memoranda detailing the tax effect of contributions of property by partnerships to UPREITs in exchange for UPREIT interests, the distribution by the partnerships of the UPREIT interests to partners, and the refinancing of debt securing the contributed properties. n398.1

[c] Reduction of Liabilities

When the existing owners of real estate or partnership interests have their interests in the real estate diluted by the REIT's contribution of cash, the contributing partners may recognize gain because of the reduction of their share of liabilities secured by the real estate. A reduction in a partner's share of liabilities is treated as a distribution of cash to him and will result in gain recognized to the extent the deemed distribution exceeds his basis in the partnership interest. n399

This problem is partially ameliorated in the case of appreciated property secured by nonrecourse debt. Under the regulations dealing with allocation of liabilities, nonrecourse liabilities are allocated first to partners who contributed appreciated property to the extent of the built-in gain. n400

Example:

Existing owners of real estate having a basis of \$40 million, a fair market value of \$120 million and subject to nonrecourse liabilities of \$90 million form a 50-50 umbrella partnership with a REIT that contributes \$120 million of cash. The existing owners are first allocated \$80 million of liabilities (the built-in gain of \$120 million less \$40 million) plus 50 percent of the excess or \$5 million for a total of \$85 million. The existing owners are treated as receiving a cash distribution of \$5 million (\$90 million original liabilities less an \$85 million share after formation of the umbrella partnership). This distribution reduces their basis from \$40 million to \$35 million. Without the special allocation of liabilities, the existing owners would have had a reduction in liabilities to 50 percent of \$90 million or a reduction of \$45 million. This would have reduced their basis to zero and created a \$5 million gain.

If the cash contributed by the REIT is used to pay down any of the debt, this would also result in a reduction of the share of liabilities of the original partners.

[d] Reduction in Minimum Gain

When a partnership has nonrecourse debt, deductions attributable to the nonrecourse debt increase "minimum gain." Minimum gain is the amount of debt that would be recognized if the real property were sold for an amount equal to the related nonrecourse debt. n401 This minimum gain must be allocated to the partners in accordance with the regulations, n402 and if there is any net decrease in a partnership's minimum gain, items of income or gain must be allocated to each partner to the extent of that partner's share of the net decrease in partnership minimum gain (a "minimum gain

chargeback"). n403 Upon formation of the umbrella partnership or repayment of nonrecourse debt, a partner's share of minimum gain might be decreased. To prevent or minimize a minimum gain chargeback, the assets of the existing partnership are revalued and a corresponding increase is made in the partner's capital accounts. n404

[e] Deemed Sale

If cash or other property is distributed to a partner upon his contribution of property to a partnership, the partner is treated as having sold part or all of the property. n405 As described above, a decrease in a partner's share of liability is treated as a cash distribution. In general, if the liability was incurred within two years before the earlier of the date the partner agrees in writing to contribute the property or the date the partner transfers such property, there is a rebuttable presumption that there has been a deemed sale to the partnership. n406 However, generally, if the liability was incurred more than two years before such period, a sale is deemed to occur only if actual cash or other property is distributed to the partner and the consideration is subject to a limitation set forth in the regulations. n407

[f] Allocation of Built-In Gain

Special rules apply to the extent the fair market value of the assets exceeds their adjusted basis (built-in gain) in the hands of the transferors to the umbrella partnership. n408 First, this gain must be allocated to and taxed to the original partners when and as the property is sold. In addition, to reduce the difference between the value for book purposes and the related tax basis of the properties, the umbrella partnership will typically disproportionately allocate deductions or tax losses to the REIT.

[7] Stapled REITS

In a stapled REIT structure, both the shares of a REIT and a C corporation may be traded, but are subject to the rule that they may not be sold separately. n409 Thus, they have identical ownership at all times. In 1984, Congress eliminated tax benefits of the stapled or "paired share" REIT structure and provided that stapled entities were generally treated as a single entity for purposes of applying the REIT provisions. n410 The 1984 legislation, however, provided grandfathered relief to the small number of stapled REITs that were then in existence. n411 As of 1998, five stapled REITs continued to exist. The grandfathered relief provided by the 1984 Act is terminated for these stapled REITs, effective generally for interests in real property acquired after March 26, 1998, by the exempt REIT or any stapled entity. n412 Special rules also govern the treatment of leases and property improvements by these stapled entities, n413 transfers of property among the stapled entities, n414 certain mortgages acquired by these entities after March 26, 1998, n415 and property held by 10-percent subsidiaries of exempt REITs or stapled entities. n416

[8] Temporary Timber REIT Provisions

[a] Timber REITs Generally

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. Although no statute specifically addresses the matter, the IRS has traditionally taken the position in private letter rulings that the income from the sale of the trees held for more than one year under *IRC Section 631(b)* can qualify as REIT real property income because the uncut timber and the timberland on which the timber grows is considered real property, and the sale of uncut trees can qualify as capital gain derived from the sale of real property. The IRS has also ruled that timber income under *IRC Section 631(b)* is qualified real estate income even if the one-year holding period is not met. n416.1

Legislation enacted in 2008 provides several rules, discussed in [b]-[d], *immediately below*, that affect the treatment of timber gains realized by REITs. Other provisions affect only "timber REITs" as defined. n416.2 All the provisions apply only for the first taxable year of the REIT that begins after May 22, 2008, and before May 22, 2009. The provisions terminate after that time. n416.3

[b] Temporary Classification of Timber Gain as REIT Income

For purposes of meeting the REIT gross income tests, n416.4 timber gain under *IRC Section 631(a)* is treated as qualifying income from a real estate asset, provided that the cutting is provided by a taxable REIT subsidiary. n416.5 Gain from the disposal of timber that is recognized under *IRC Section 631(b)* is also treated as qualifying income from a real estate asset under the REIT gross income tests. n416.6 For either gain, the income is qualifying income even if the REIT has not held the property for at least one year. n416.7

Comment:

The removal of the one-year holding period allows a REIT to acquire timber property and harvest the timber on the property within one year of the acquisition without jeopardizing its REIT status. n416.8 The resulting income will be qualified real estate income under the REIT gross income tests, n416.9 even though that income is not eligible for long-term capital gain treatment under *IRC Section 631(a)* or *(b)*. For all tax purposes, however, the income is not considered to be gain from the sale of stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REIT's trade or business. n416.10

For purposes of determining the REIT's income, if the cutting is done by a taxable REIT subsidiary, the cut timber is deemed sold on the first day of the taxable year to the taxable REIT subsidiary (with subsequent gain, if any, attributable to the taxable REIT subsidiary). n416.11

The above treatment of timber gains applies only for dispositions in taxable years beginning after May 22, 2008 n416.12 and before May 22, 2009. n416.13

[c] REIT Prohibited Transaction Safe Harbor for Timber Property

A 100-percent excise tax is imposed on income from certain prohibited transactions by a REIT. n416.14 A safe harbor applies for certain sales of property held in connection with the trade or business of producing timber, provided that the REIT held the property for at least two years before the sale. n416.15 Among other limitations, expenditures by the REIT on the property in the two years preceding the date of sale are also restricted. n416.16 In addition, if the REIT makes more than seven sales of property during the year, any marketing must generally be done by an independent contractor. n416.17

Any gain that is eligible for the timber property safe harbor is considered for all tax purposes as not being from the sale of stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REIT's trade or business. n416.18

The above safe harbor rules apply only for dispositions in taxable years beginning after May 22, 2008 n416.19 and before May 22, 2009. n416.20

[d] Other Special Rules for Timber REITs

Several temporary provisions apply only to "timber REITs." A "timber REIT" is a REIT in which more than 50 percent of the value of the REIT's total assets consists of real property held in connection with the trade or business of producing timber. n416.21

First, mineral royalty income from real property owned by a timber REIT and held, or once held, in connection with the trade or business of producing timber by a timber REIT, is included as qualifying real estate income for purposes of the REIT gross income tests. This rule applies only to income earned in the first taxable year of the REIT beginning after May 22, 2008. n416.22

Second, a timber REIT is permitted to hold taxable REIT subsidiary securities with a value up to 25 percent, (rather than 20 percent) of the value of the total assets of the REIT. n416.23 Except for the effective date of this provision for timber REITs, this difference has no significance, because all REITs are allowed to hold taxable REIT subsidiary securities with a value up to 25 percent of the value of the total assets of the REIT for tax years beginning after July 30, 2008. n416.24

FOOTNOTES:

(n1)Footnote 1. See *IRC § 856(a)*.

(n2)Footnote 2. *IRC § 857(b)(2)*.

(n3)Footnote 3. See *IRC § 857(b)(3)*.

(n4)Footnote 4. *IRC § 856(c)*.

(n5)Footnote 5. *IRC §§ 856(c), 857(f)*.

(n6)Footnote 6. See *IRC § 857*.

(n7)Footnote 7. *IRC § 856(a)*.

(n8)Footnote 8. Another possible consideration in selecting the REIT's form is the state law governing the entity. Although all 50 states recognize the formation of business associations, statutory and case law governing business associations is typically less developed than statutory and case law governing corporations and trusts. Thus, depending on the jurisdiction of formation, there is a certain amount of predictability when opting for the corporate or trust form.

(n9)Footnote 9. *IRC § 856(a)(1); Treas Reg § 1.856-1(d)(1)*.

(n10)Footnote 10. *Treas Reg § 1.856-1(d)(1)*.

(n11)Footnote 11. *IRC § 856(a)(2)*.

(n12)Footnote 12. *Treas Reg § 1.856-1(d)(2)*. The Service has considered the permissibility of various restrictions on REIT shares with respect to the transferability criteria in private letter rulings. See Ltr Rul 200052037 (IRS permitted an amendment to a REIT's charter to reduce the maximum allowable stock ownership percentage; the amendment was intended to prevent limits on the use of NOLs under *IRC § 382*); *Ltr Rul 9747034* (issuance of restricted stock by a REIT to its directors and employees and those of its affiliates permitted); *Ltr Rul 9440026* (July 11, 1994); *Ltr Rul 9439005* (June 27, 1994); *Ltr Rul 9430022* (April 29, 1994); *Ltr Rul 9205030* (Nov 5, 1991).

(n13)Footnote 13. *IRC § 856(a)(3)*. This requirement may be satisfied by entities that are not corporations under state law but are associations taxable as corporations for federal tax purposes, such as business trusts.

(n14)Footnote 14. *Treas Reg § 1.856-1(d)(3)*.

(n15)Footnote 15. *IRC § 856(a)(4)*.

(n16)Footnote 16. *IRC § 856(a)(5), (b)*.

(n17)Footnote 17. *Treas Reg § 1.856-1(d)(2)*.

(n18)Footnote 18. *IRC § 856(h)(2)*.

(n19)Footnote 19. *IRC § 856(a)(6), (h)(1)*; see *IRC § 542(a)(2)*. Note that more than 50 percent of the value of the outstanding shares of a REIT may be held by a corporation, provided that the corporation's stock ownership is sufficiently dispersed. See Ltr Rul 200403027 (IRS ruled that certain tax-exempt entities owning stock in the REIT would not be treated as individuals for purposes of these statutory tests).

(n20)Footnote 20. *IRC §§ 856(h)(1), 544; Treas Reg § 1.856-1(d)(5)*.

(n21)Footnote 21. See *IRC § 856(h)(1)(B)(i)*.

(n22)Footnote 22. See *IRC § 856(h)(3)*. A pension or profit-sharing trust is treated as only one person if disqualified persons with respect to the trust hold, in the aggregate, 5 percent or more in value of interests in the REIT and the REIT has accumulated earnings and profits for any period for which it was not a REIT. Disqualified persons are those persons described in the excise tax provisions of *IRC § 4975(e)(2)*, without regard to subparagraphs (B) and (I) thereof.

(n23)Footnote 23. See *IRC § 856(h)(3)(C)*.

(n24)Footnote 24. *IRC § 856(h)(2)*.

(n25)Footnote 25. See *IRC § 857(f)(1)*; see § 16.02[2][e], below.

(n26)Footnote 26. *IRC § 856(k)*; see *IRC § 856(a)(6)*, eff for tax years beginning after 8/5/97.

(n27)Footnote 27. *IRC § 859(a)(2)*.

(n28)Footnote 28. *IRC § 859(b)*.

(n29)Footnote 29. *IRC § 857(a)(2)*; *Treas Reg § 1.857-11*. See Ltr Rul 200352015 (IRS ruled on the proper charge to earnings and profits resulting from a redemption distribution by a REIT under *IRC § 302(b)*).

(n30)Footnote 30. *Ltr Rul 200403030*.

(n31)Footnote 30.1. *Treas Reg §§ 1.337(d)-6, 1.337(d)-7*; the final regulations replace prior temporary regulations (see Temp *Treas Reg §§ 1.337-6T, 1.337-7T*; see *TD 8975*).

(n32)Footnote 30.2. *Treas Reg § 1.337(d)-6(e)*.

(n33)Footnote 30.3. *Treas Reg § 1.337(d)-7(f)*.

(n34)Footnote 30.4. *Treas Reg § 1.337(d)-7(a)*.

(n35)Footnote 30.5. *Treas Reg § 1.337(d)-7(b)(1)(i)*.

(n36)Footnote 30.6. See *IRC § 1374(d)(7)(A)*.

(n37)Footnote 30.7. *IRC § 1374(d)(7)(B)*.

(n38)Footnote 30.8. *Treas Reg § 1.337(d)-7(b)(1)(ii)*.

(n39)Footnote 30.9. See *Treas Reg § 1.1374-2(a)(l)*.

(n40)Footnote 30.10. *Treas Reg § 1.337(d)-7(b)(2)(i)*.

(n41)Footnote 30.11. See *IRC § 856(c)(2), (3), (6)*; for purposes of the modification required under the -7

regulations, the computation of the REIT's recognized built-in gain subject to the tax under *IRC* § 857(b)(5) differs depending on whether the tax imposed is computed by reference to *IRC* § 857(b)(5)(A) or *IRC* § 857(b)(5)(B). See *Treas Reg* § 1.337(d)-7(b)(2)(i)(A)(1), (2).

(n42)Footnote 30.12. *IRC* § 857(b)(4), (5), (6), or (7).

(n43)Footnote 30.13. *Treas Reg* § 1.1374-2(a)(2).

(n44)Footnote 30.14. *Treas Reg* § 1.337(d)-7(b)(2)(i)(B).

(n45)Footnote 30.15. *Treas Reg* § 1.337(d)-7(b)(2)(ii).

(n46)Footnote 30.16. *Treas Reg* § 1.337(d)-7(b)(2)(ii).

(n47)Footnote 30.17. See *IRC* § 852(b)(2).

(n48)Footnote 30.18. See *IRC* § 857(b)(2).

(n49)Footnote 30.19. See *IRC* §§ 852(b)(2)(D), 852(b)(3)(A), 857(b)(2)(B), 857(b)(3)(A).

(n50)Footnote 30.20. *Treas Reg* § 1.337(d)-7(b)(3)(i).

(n51)Footnote 30.21. *Treas Reg* § 1.337(d)-7(b)(3)(ii).

(n52)Footnote 30.22. *Treas Reg* § 1.337(d)-7(b)(4).

(n53)Footnote 30.23. *Treas Reg* § 1.337(d)-7(c)(1).

(n54)Footnote 30.24. *Treas Reg* § 1.337(d)-7(c)(2).

(n55)Footnote 30.25. *Treas Reg* § 1.337(d)-7(c)(3).

(n56)Footnote 30.26. *Treas Reg* § 1.337(d)-7(c)(4).

(n57)Footnote 30.27. *Temp Treas Reg* § 1.337(d)-7(e).

(n58)Footnote 30.28. See *Treas Reg* § 1.337(d)-7(e).

(n59)Footnote 30.29. *Treas Reg* § 1.337(d)-7(c)(5).

(n60)Footnote 30.30. See *Treas Reg* § 1.337(d)-7(a).

(n61)Footnote 30.31. *Treas Reg* § 1.337(d)-7(d)(1). See, e.g. *IRC* §§ 336, 351(b), 351(e), 356, 357(c), 367, 368(a)(2)(F), 1001.

(n62)Footnote 30.32. See *Treas Reg* § 1.337(d)-7(a).

(n63)Footnote 30.33. *Treas Reg* § 1.337(d)-7(d)(2)(i).

(n64)Footnote 30.34. *Treas Reg* § 1.337(d)-7(d)(2)(ii).

(n65)Footnote 30.35. *Treas Reg* § 1.337(d)-7(d)(2)(iii).

(n66)Footnote 30.36. *Treas Reg* § 1.337-6(e).

(n67)Footnote 30.37. *Treas Reg* § 1.337-6(a)(1), (b)(1).

(n68)Footnote 30.38. *Treas Reg* § 1.337-6(b)(2).

(n69)Footnote 30.39. *Treas Reg* § 1.337-6(b)(1).

(n70)Footnote 39.40. Compare *Treas Reg* § 1.337(d)-6 and 1.337(d)-7.

(n71)Footnote 31. *Treas Reg* § 1.337(d)-6(e); see *Treas Reg* § 1.337(d)-5.

(n72)Footnote 31.1. *IRC* § 856(c)(2), (3).

(n73)Footnote 31.2. *Treas Reg* § 1.856-2(c)(1).

(n74)Footnote 31.3. *IRC* § 108(e)(9).

(n75)Footnote 31.4. *Ltr Rul* 200115023 .

(n76)Footnote 31.5. *Ltr Rul* 200236037 .

(n77)Footnote 31.5.1. *Ltr Rul* 200949028 .

(n78)Footnote 31.5.2. *Ltr Rul* 200949028 .

(n79)Footnote 31.6. *Id.*

(n80)Footnote 31.7. *Id.*

(n81)Footnote 31.8. *Ltr Rul* 200624063 (reimbursements of administrative overhead expenses not treated as gross income); *Ltr Rul* 200119010 ; see *IRC* § 856(c).

(n82)Footnote 31.9. *Ltr Rul* 200414025 .

(n83)Footnote 31.10. *Ltr Rul* 200614024 .

(n84)Footnote 31.11. *Ltr Rul* 200403023 .

(n85)Footnote 31.12. *Notice* 2007-42, 2007-21 *IRB* 1288 ; see *IRC* § 856(c)(2), (3).

(n86)Footnote 31.13. See *IRC* § 989(a).

(n87)Footnote 31.14. See *Treas Reg* §§ 1.985-1(c).

(n88)Footnote 31.15. *IRC* § 987(3).

(n89)Footnote 31.16. *Notice* 2007-42, 2007-21 *IRB* 1288 .

(n90)Footnote 31.17. See *Prop Treas Reg* § 1.987-6(b); see 2006-42 *IRB* 698 ; 71 *Fed Register* 52,876 .

(n91)Footnote 31.18. See *Temp Treas Reg* § 1.861-9T(g), as modified by the proposed regulations.

(n92)Footnote 31.19. See *Temp Treas Reg* § 1.861-9T(j).

(n93)Footnote 31.20. *Notice* 2007-21 *IRB* 1288 .

(n94)Footnote 32. *IRC § 856(c)(3)*.

(n95)Footnote 32.1. See Ltr Rul 200052031 (interest earned on loans to purchasers of manufactured homes or purchasers of timeshare residential units qualifies).

(n96)Footnote 32.2. *Rev Proc 2003-65, 2003-2 CB 336* .

(n97)Footnote 33. This category can include certain timber gains and certain mineral royalty income of timber REITs [*IRC § 856(c)(5)(H), 856(c)(2)(I)*]. See § 16.02[8], *below*, for a detailed discussion.

(n98)Footnote 34. *IRC § 856 (c)(3)*; see also § 16.02[2][d], *infra*.

(n99)Footnote 35. *Ltr Rul 199923006* ; see *IRC § 856(c)(3)*.

(n100)Footnote 36. *IRC § 856(c)(5)(J)*.

(n101)Footnote 37. *IRC § 856(c)(2)*.

(n102)Footnote 38. This category can include certain timber gains and certain mineral royalty income of timber REITs [*IRC § 856(c)(5)(H), 856(c)(2)(I)*]. See § 16.02[8], *below*, for a detailed discussion.

(n103)Footnote 39. *IRC § 856(c)(5)(J)*.

(n104)Footnote 40. See *IRC § 856(c)(4)*, before repeal by Pub L No 105-34.

(n105)Footnote 41. *IRC § 856(c)(4)*, before repeal by Pub L No 105-34.

(n106)Footnote 42. *Id.*

(n107)Footnote 43. *IRC § 856(j)(1)*.

(n108)Footnote 44. *IRC § 856(j)(2)(A)*.

(n109)Footnote 45. *IRC § 856(j)(2)(B)*.

(n110)Footnote 46. *IRC § 856(j)(4)*, eff for tax years beginning after 8/5/97.

(n111)Footnote 47. See *IRC § 856(j)(5)(A)*.

(n112)Footnote 48. See *IRC § 856(j)(4)*.

(n113)Footnote 49. *IRC §§ 857(b)(6)(B)(iii), 1221(a)(1)*.

(n114)Footnote 50. *IRC § 857(b)(6)(A)*.

(n115)Footnote 50.1. See *IRC § 988(b)(1), (2)*.

(n116)Footnote 50.2. *IRC § 857(b)(6)(B)(i)*. Only foreign currency gains and deductions recognized after July 30, 2008 are taken into account [Pub Law 110-289, 3071(c)(2)].

(n117)Footnote 51. *IRC § 857(b)(6)(B)(ii)*.

(n118)Footnote 52. *IRC § 856(d)(1)(A), (B)*.

(n119)Footnote 52.1. *Treas Reg § 1.856-4(b)(1)*.

(n120)Footnote 53. *IRC § 856(d)(1)(C)*; *Treas Reg § 1.856-4(b)(2)(i)*; for tax years beginning before 2001, the ratio was based on the adjusted bases of the real and personal property (*IRC § 856(d)(1)*, *before amendment by Pub L No 106-170*, § 542(b)(3)).

(n121)Footnote 54. *IRC § 856(d)(1)(C)*.

(n122)Footnote 55. *IRC § 856(d)(8)*, (9); see [vii], below, for a discussion.

(n123)Footnote 56. *IRC § 856(d)(2)(A)*.

(n124)Footnote 56.1. *Id.*

(n125)Footnote 56.2. *Ltr Rul 200140026* (in exchange for a fee a REIT's operating partnership agreed to include the name of a corporation in a shopping center and cooperate in publicity and advertising for the corporation; the fee was ruled not to be rents from real property).

(n126)Footnote 57. See *IRC § 856(d)(8)*; see [vii], below, for a discussion.

(n127)Footnote 58. *IRC § 856(d)(2)(B)*.

(n128)Footnote 59. *IRC § 856(d)(5)*. See *Ltr Rul 200405007* (the taxpayer held interests in interlocking LLCs through its taxable REIT subsidiaries; the IRS ruled that the taxpayer could avoid double counting of rents paid among the LLCs in computing its gross income under *IRC § 856(c)*).

(n129)Footnote 60. *Ltr Rul 199929010* ; *Ltr Rul 9929023* ; *Ltr Rul 200132008* .

(n130)Footnote 61. *IRC §§ 856(d)(2)(C)*, *Treas Reg § 1.512-1(c)(5)*.

(n131)Footnote 62. *IRC § 856(d)(7)(A)*.

(n132)Footnote 63. *Treas Reg § 1.512(b)*; see *IRC § 512(b)(3)*.

(n133)Footnote 63.1. *Ltr Rul 200410010* .

(n134)Footnote 64. *IRC § 856(d)(7)(C)(i)*, eff for tax years beginning after 2000.

(n135)Footnote 64.1. *Rev Proc 2003-86*, 2003-2 CB 290 .

(n136)Footnote 65. *IRC § 856(d)(7)(B)*, (D).

(n137)Footnote 66. *Rev Rul 98-60*, 1998-51 IRB 6 .

(n138)Footnote 67. *Rev Rul 98-60*, 1998-2 CB 751 ; see *IRC § 856(d)(7)(B)*, (D).

(n139)Footnote 68. *IRC § 856(d)(7)*.

(n140)Footnote 69. *Rev Rul 98-60*, 1998-2 CB 751 ; see *IRC § 856(d)(2)(C)*, (7)(B) & (D).

(n141)Footnote 70. *IRC § 856(d)(2)(C)*, *before amendment by Pub L No 105-34*.

(n142)Footnote 71. HR Rep No 2020, 86th Cong, 2d Sess 7 (1960).

(n143)Footnote 72. *IRC § 856(d)(6)*; S Rep No 99-313, 99th Cong, 2d Sess 775 (1986).

(n144)Footnote 72.1. See *IRC § 856(c)*.

(n145)Footnote 72.2. *Rev Rul 2001-29, 2001-1 CB 1348* .

(n146)Footnote 73. *IRC § 856(d)(2)(B)(i)*.

(n147)Footnote 74. *IRC § 856(d)(8), (9)*.

(n148)Footnote 75. *IRC § 856(d)(8)(A)*.

(n149)Footnote 75.1. *IRC § 856(d)(8)(A)(iii)*.

(n150)Footnote 75.2. See *IRC § 856(d)(8)(A)(iv)*.

(n151)Footnote 75.3. *IRC § 856(d)(8)(A)(v)*; see *IRC § 856(d)(2)(B)*.

(n152)Footnote 75.4. *IRC § 856(d)(8)(A)(vi)*.

(n153)Footnote 75.5. *IRC § 856(d)(8)(B)*. The extension of the exception to health care property applies to tax years beginning after July 30, 2008 [Pub Law 110-289, § 3071(a)].

(n154)Footnote 76. *IRC § 856(d)(8)(B)*.

(n155)Footnote 77. *IRC § 856(d)(9)(D)(i)*. The IRS eased the lodging facility requirements to allow accommodations to persons affected by Hurricanes Katrina and Rita [see *Notice 2005-89, 2005-2 CB 1077* ; *Notice 2006-58, 2006-2 CB 59*].

(n156)Footnote 77.1. *IRC § 856(d)(9)(D)(ii)*.

(n157)Footnote 77.2. *IRC § 856(e)(6)(D)(i)*; see *IRC § 856(d)(8)(B)*.

(n158)Footnote 78. *IRC § 856(d)(8)(B),(9)(B)*.

(n159)Footnote 78.1. *IRC § 856(d)(8)(B)*, effective for tax years beginning after 7/30/08 [Pub Law 110-289, § 3071(a)].

(n160)Footnote 79. *IRC § 856(d)(9)(A)*.

(n161)Footnote 80. *IRC § 856(d)(9)(B)(iii),(C)*.

(n162)Footnote 81. See *IRC § 163(j)(3)*.

(n163)Footnote 81.1. *Rev Proc 2003-66, 2003-2 CB 364* ; see *IRC § 856(c)(2),(3)*.

(n164)Footnote 81.2. *Rev Proc 2003-66, 2003-2 CB 364* ; see *IRC § 856(d)(2)*.

(n165)Footnote 81.3. See *IRC § 856(d)(2)(B)* for a definition of related parties (generally at least a 10 percent stock ownership in a corporation or a 10 percent interest in the assets or net profits of a person other than a corporation). Attribution rules apply in determining status as a related party [see *IRC §§ 856(d)(5), 318(a)*].

(n166)Footnote 81.4. *Rev Proc 2003-66, 2003-2 CB 364* .

(n167)Footnote 82. *IRC § 856(l)(1)*.

(n168)Footnote 82.1. Instructions to Form 8875; see *Ltr Rul 200152010* .

(n169)Footnote 82.2. *Treas Reg §§ 301.9100-1 through 301.9100-3*; *Ltr Rul 201016039* (REIT's chief financial

officer in charge of making election resigned); *Ltr Rul 201007048* (adviser was unaware election was necessary until advised by new accountant); *Ltr Rul 200922011* (accounting firm failed to file election); *Ltr Rul 200952003* (each of two law firms thought the other had made the election); *Ltr Rul 200951030* (prior election improper because taxpayer had not started business by effective date of election); *Ltr Rul 200835004* ; *Ltr Rul 200748002* ; *Ltr Rul 200747004* ; *Ltr Rul 200743008* ; *Ltr Rul 200719009* ; *Ltr Rul 200615013* ; *Ltr Rul 200539018* ; *Ltr Rul 200419010* ; *Ltr Rul 200403005* ; *Ltr Rul 200351025* ; *Ltr Rul 200304011* ; *Ltr Rul 200152010* .

(n170)Footnote 82.3. See *Ltr Rul 200941006* (date and company information in initial REIT subsidiary election were in error). *Ltr Rul 200951030* (initial REIT subsidiary election made for year in which parent did not commence operations or elect REIT status).

(n171)Footnote 83. *IRC § 856(l)(2)*.

(n172)Footnote 83.1. See *IRC § 856(l)(2)(B)*.

(n173)Footnote 83.2. See *IRC § 856(m)(2)(A)*.

(n174)Footnote 83.3. *IRC § 856(l)(2)*.

(n175)Footnote 84. *IRC § 856(l)(3)(A)*. The IRS has ruled that a taxable REIT subsidiary can own and operate RV parks without violating this restriction (*Ltr Rul 200320018*). See also *Ltr Rul 201016014* (a ruling involving complex interlocking relationships between a REIT and multiple corporations. The REIT and its TRS would provide loans or financial assistance to the corporations or affiliates of a manager or operator of the REIT's lodging or health care facilities. The REIT or its TRS could also receive income from an equity investment in the parent corporation or an affiliate of a company operating or managing the facilities. Finally, a TRS could receive rental income from a parent corporation or affiliate of a company that was a manager or operator of the TRS's facilities. In each situation, the income received by the REIT or its TRS would not be derived from or dependent upon its relationship with the company operating or managing the facilities. All of the agreements entered into by the REIT or its TRS for the management or operation of the facilities were at arm's length and reflecting market terms. The ruling, involving several issues, concluded that neither the REIT nor its TRS would be treated as directly or indirectly operating or managing the facilities within the meaning of *IRC § 856(l)(3)(A)*, and that the various transactions would not cause amounts received by the REIT from the TRS under the lease of the facilities to be treated as other than rents from real property).

(n176)Footnote 85. *IRC § 856(l)(3)(B)*.

(n177)Footnote 86. *IRC § 856(d)(3)*.

(n178)Footnote 86.1. See *IRC § 1221(b)(2)(A)(ii)*, (iii) for a definition.

(n179)Footnote 86.2. *IRC § 856(c)(5)(G)(i)*; the exclusion applies under the 95-percent test effective for tax years beginning after Oct 22, 2004 [Pub Law 108-357, § 243(g)(2)] and under the 75-percent test effective for transactions entered into after July 30, 2008 [Pub Law 110-289, § 3071(b)(2)].

(n180)Footnote 86.3. *IRC §§ 856(c)(5)(G)(i)*, *1221(a)(7)*.

(n181)Footnote 86.4. See Rev Rul 74-191, 1974-1 C.B. 170 .

(n182)Footnote 86.5. See *IRC §§ 985 through 989*.

(n183)Footnote 86.6. *IRC § 856(n)(1)*, (2), (3), effective for gains and items of income recognized after July 30, 2008 [Pub Law 110-289, § 3071(b)(1)]; see *IRC § 856(c)(2)*, (3) (REIT income tests). The excluded amounts are excluded from both the numerator and the denominator in the relevant computations.

(n184)Footnote 86.7. *IRC § 856(n)(1)*.

(n185)Footnote 86.8. *IRC § 856(n)(1), (2), (3)(A)*.

(n186)Footnote 86.9. *IRC § 856(n)(1)(A)*.

(n187)Footnote 86.10. See *IRC § 988(b)(1)* for a definition.

(n188)Footnote 86.11. See *IRC § 856(c)(3)*.

(n189)Footnote 86.12. *IRC § 856(n)(2)(A)*.

(n190)Footnote 86.13. *IRC § 856(n)(2)(B)*.

(n191)Footnote 86.14. *IRC § 856(n)(2)(C)*.

(n192)Footnote 86.15. *IRC § 856(n)(3)*.

(n193)Footnote 86.16. See *IRC § 856(c)(2)*.

(n194)Footnote 86.17. See *IRC § 475(c)(2)*.

(n195)Footnote 86.18. *IRC § 856(n)(4)*.

(n196)Footnote 86.19. See *IRC § 856(c)(2), (3)*.

(n197)Footnote 86.20. See *IRC § 856(n)(2)*.

(n198)Footnote 86.21. See *IRC § 856(c)(2), (c), (n)*.

(n199)Footnote 86.22. See *IRC § 856(c)(2)*, *Treas Reg § 1.567-2(a)(1), (n)*.

(n200)Footnote 86.23. See *IRC § 856(n)(2), (3)*.

(n201)Footnote 86.24. See *IRC § 856(c)(2), (3), (n)(2), (3)*.

(n202)Footnote 86.25. See *IRC § 856(c)(2), (3), (n)(2), (3)*.

(n203)Footnote 86.26. See *IRC § 856(c)(2), (3), (n)(2), (3)*.

(n204)Footnote 86.27. See *IRC § 856(c)(2), (3), (n)(2), (3)*.

(n205)Footnote 86.28. See *Rev Rul 2007-33, 2007-21 IRB 1281* .

(n206)Footnote 86.29. See *IRC § 856(c)(2) or 856(c)(3)*.

(n207)Footnote 86.30. *IRC § 856(n)*; see *Rev Rul 2007-33, 2007-21 IRB 1281* .

(n208)Footnote 86.31. *Notice 2007-42, 2007-21 IRB 1288* .

(n209)Footnote 86.32. *IRC § 856(n)(1), (2)(B)*.

(n210)Footnote 86.33. See eg *IRC § 989(c)*.

(n211)Footnote 86.34. *IRC § 856(c)(5)(G)(ii)*, effective for transactions entered into after July 30, 2008 [Pub Law

110-289, § 3071(b)(2)].

(n212)Footnote 86.35. See *IRC § 856(c)(2), (3)*.

(n213)Footnote 86.35.1. *IRC § 856(c)(2), (3), (6)*.

(n214)Footnote 86.35.2. *IRC § 856(c)(6)*.

(N215)Footnote 86.36. See *IRC § 856(c)(2), (3)*.

(n216)Footnote 86.37. *IRC § 857(b)(5)(A)(i)*, effective for tax years beginning after Oct 22, 2004 or before 2001. For other years the figure was 90 percent [*IRC § 857(b)(5)(A)(i)*, before amendment by Pub Law No 108-357, § 243(e)].

(n217)Footnote 86.38. *IRC § 857(b)(5)*.

(n218)Footnote 87. *IRC § 856(c)(4)*; see [ii]-[vi], below.

(n219)Footnote 88. *Id.*

(n220)Footnote 89. *IRC § 856(c)(4)*; *Treas Reg § 1.856-2(d)(3)*.

(n221)Footnote 90. *IRC § 856(c)(4)*.

(n222)Footnote 90.1. See *IRC § 856(c)(4)*.

(n223)Footnote 90.2. *IRC § 856(c)(7)*; see § 16.02[2][c][viii], below, for a discussion.

(n224)Footnote 90.3. *Ltr Rul 200916014*.

(n225)Footnote 91. *IRC § 856(c)(4)(A)*.

(n226)Footnote 91.1. See GCM 36782 (Jul 6, 1976).

(n227)Footnote 91.2. See ABA Section of Taxation Request for Guidance on the Treatment of Investments in Money Market Mutual Funds as "Cash Items" for Purposes of Section 856(c)(4)(A) (Letter to IRS Commissioner, April 22, 2009).

(n228)Footnote 91.3. See *IRC § 856(c)(2), (3)*.

(n229)Footnote 91.4. *IRC § 856(c)(5)(K)*, effective for tax years beginning after 7/30/08 [Pub Law 110-289, § 3071(a)]; see *IRC § 856(c)(4)*.

(n230)Footnote 91.5. See *IRC § 475(c)(2)*.

(n231)Footnote 91.6. *IRC § 856(c)(5)(K)*.

(n232)Footnote 92. *Treas Reg § 1.856-3(a)*.

(n233)Footnote 93. *Treas Reg § 1.856-2(d)(3)*.

(n234)Footnote 94. *IRC § 856(c)(5)(B)*.

(n235)Footnote 94.1. *IRC § 856(c)(5)(C)*.

(n236)Footnote 94.2. *Ltr Rul 200041024*.

(n237)Footnote 94.3. *Ltr Rul 200041024* ; see *Rev Rul 71-286, 1971-2 CB 263* .

(n238)Footnote 94.4. *Ltr Rul 9945055* ; *Ltr Rul 200052021* .

(n239)Footnote 95. *Rev Rul 76-197, 1976-1 CB 187* .

(n240)Footnote 96. *Ltr Rul 9826049* .

(n241)Footnote 97. See § 16.02[2][d][ii], *infra*.

(n242)Footnote 98. *Treas Reg § 1.856-3(d)*; see *Whitco Indus, Inc v Commr, 65 TC 664 (1975)* ; *Rev Rul 80-151, 1980-1 CB 7* (standards for distinguishing between realty and personal property); *Rev Rul 71-220, 1971-1 CB 210* (mobile home units are real property).

(n243)Footnote 99. *Ltr Rul 200027034* ; *Ltr Rul 199904019* .

(n244)Footnote 99.1. *Ltr Rul 200052031* .

(n245)Footnote 99.2. *Ltr Ruls 200225033 , 200226013* .

(n246)Footnote 99.3. *Ltr Rul 200225034* .

(n247)Footnote 99.4. *Rev Proc 2003-65, 2003-2 CB 336* .

(n248)Footnote 99.5. *Treas Reg § 1.856-3(d)*. See *Rev Rul 75-424, 1975-2 CB 270* (clarifying which components of microwave transmission system qualify as real property); *Rev Rul 73-425, 1973-2 CB 22* (mortgage secured by a shopping center and its expansive total energy system is a real estate asset, regardless of whether the system is housed in the building it serves or in a separate structure); see *Ltr Rul 200921019* (ruling that buildings, along with telecommunications equipment, computing and data storage equipment, and expansive electrical, air conditioning, and security systems within the structures all qualified as real estate assets).

(n249)Footnote 100. *Ltr Rul 9923006* ; see *Treas Reg § 1.856-5(c)* (methodology used for making allocation).

(n250)Footnote 101. *IRC § 856(c)(5)(C)*.

(n251)Footnote 102. *IRC § 856(c)(5)(E)*.

(n252)Footnote 103. *Rev Rul 70-544, 1970-2 CB 6* ; *Rev Rul 70-545, 1970-2 CB 7* ; *Rev Rul 71-399, 1971-2 CB 433* ; *Rev Rul 84-10, 1984-1 CB 155* .

(n253)Footnote 104. *Rev Rul 75-192, 1975-1 CB 384* ; *Rev Rul 77-349, 1977-2 CB 20* .

(n254)Footnote 104.1. See *IRC § 856(c)(4)*.

(n255)Footnote 104.2. *Rev Rul 74-191, 1974-1 CB 170* .

(n256)Footnote 104.3. See *Rev Rul 2007-33, 2007-21 IRB 1281* ; see *IRC § 856(c)*.

(n257)Footnote 105. *Rev Rul 77-59, 1977-1 CB 196* .

(n258)Footnote 106. *IRC § 856(c)(5)(F)*.

(n259)Footnote 107. *15 USC § 80a-2(a)(16)*.

(n260)Footnote 108. *Rev Rul 64-85, 1964-1 (Part 1) CB 230; Rev Rul 71-537, 1971-2 CB 262 ; Rev Rul 76-426, 1976-2 CB 17 .*

(n261)Footnote 109. *Rev Rul 73-548, 1973-2 CB 44 ; Rev Rul 74-440, 1974-2 CB 19 ; Rev Rul 92-89, 1992-2 CB 154 .*

(n262)Footnote 110. *IRC § 851(c)(6).*

(n263)Footnote 111. *IRC § 856(i)(2); see § 16.02[2][b][vii][B] for a definition of taxable REIT subsidiary.*

(n264)Footnote 112. *IRC § 856(i)(2), before amendment by Pub L No 105-34.*

(n265)Footnote 113. *IRC § 856(i)(1).*

(n266)Footnote 113.1. *Treas Reg § 1.856-9(a).*

(n267)Footnote 113.1.1. *See Treas Reg § 1.856-9(b).*

(n268)Footnote 113.2. *See IRC § 856(i).*

(n269)Footnote 113.3. *See IRC § 856(l).*

(n270)Footnote 113.4. *Treas Reg § 1.856-9(b), Exs 1 and 2.*

(n271)Footnote 114. *IRC § 856(i)(3); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 394 (1987).*

(n272)Footnote 115. *Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 394 (1987).*

(n273)Footnote 116. *Id.*

(n274)Footnote 117. *Ltr Rul 9744004 ; Ltr Rul 9421034 (Feb 28, 1994) ; Ltr Rul 9330022 (Apr 30, 1993) ; Ltr Rul 9307018 (Nov 24, 1992) ; Ltr Rul 9205030 (Nov 5, 1991) ; Ltr Rul 9124041 (Mar 19, 1991) .*

(n275)Footnote 118. *Ltr Rul 9124041 (Mar 19, 1991) ; see also Ltr Rul 9744004 ; Ltr Rul 9421034 (Feb 28, 1994) ; Ltr Rul 9330022 (Apr 30, 1993) ; Ltr Rul 9307018 (Nov 24, 1992) ; Ltr Rul 9205030 (Nov 5, 1991) ; Ltr Rul 9808011 .*

(n276)Footnote 119. *Ltr Rul 9124041 (Mar 19, 1991) .*

(n277)Footnote 119.1. *See IRC § 856(c)(4)(A), (c)(5)(B); see § 16.02[2][c][ii][A], above.*

(n278)Footnote 119.2. *Rev Proc 2003-65, 2003-2 CB 336 ; see IRC § 856(c)(3)(B); the revenue procedure is effective August 11, 2003.*

(n279)Footnote 119.3. *Rev Proc 2003-65, 2003-2 CB 336 .*

(n280)Footnote 119.4. *See IRC § 7701; Treas Reg § 301.7701-3(b)(l).*

(n281)Footnote 119.5. *See IRC § 856(c)(4)(A).*

(n282)Footnote 119.6. *See Treas Reg § 1.856-5(c)(2).*

(n283)Footnote 119.7. *See Treas Reg § 1.856-3(g).*

(n284)Footnote 119.8. See *IRC § 856(f)(2)*; *Treas Reg § 1.856-5(d)*.

(n285)Footnote 119.9. See *Treas Reg §§ 1.856-5(a), (b)*.

(n286)Footnote 120. See *IRC § 856(c)(4)*; *Treas Reg § 1.856-2(d)(2)*; see [ii], above, for a discussion of the 75-percent test.

(n287)Footnote 121. *IRC § 856(c)(4)(B)*.

(n288)Footnote 122. *IRC § 856(c)(4)(B)(iii)*; see [i], above, for a discussion of the 75 percent test.

(n289)Footnote 123. *IRC § 856(c)(5)(F)*; see *15 USC §§ 80a-1 et seq.*

(n290)Footnote 124. See *IRC § 856(c)(4)(B)*.

(n291)Footnote 125. *IRC § 856(c)(4)*.

(n292)Footnote 126. *IRC § 856(c)(4)*.

(n293)Footnote 127. *IRC § 856(c)(5)(F)*; see *15 USC § 80a-1 et seq.*

(n294)Footnote 128. *15 USC § 80a-2(a)(42)*. In Revenue Ruling 66-339, 1966-2 CB 274 , the Service interpreted the meaning of "voting securities" for purposes of the regulated investment company provisions of the Code (which also employs the definition under the *Investment Company Act of 1940*). In this revenue ruling, the Service held that shareholders' voting agreements, stock warrants, stock options, stock rights, convertible debentures and similar rights to purchase stock do not constitute voting securities. See also *Ltr Rul 7914056* (Jan 4, 1979) . But see *GCM 36823* (Aug 24, 1976) (Chief Counsel of the Service questioning whether a "voting agreement" constituted a voting security under the facts of *Rev Rul 66-339*).

(n295)Footnote 129. *Rev Rul 76-197, 1976-1 CB 187* . See *Ltr Rul 200352015* (IRS ruled on the proper charge to earnings and profits resulting from a redemption distribution by a REIT under *IRC § 302(b)*)

(n296)Footnote 130. *Ltr Rul 9826049* .

(n297)Footnote 131. *IRC § 856(c)(4)(B)(iii)(II)*; see [i], above for a discussion of the 75 percent test.

(n298)Footnote 132. *Ltr Rul 9832012* ; see *IRC § 856(c)(4)*.

(n299)Footnote 133. Pub L No 106-170, §§ 541(a), 546(a).

(n300)Footnote 134. *IRC § 856(c)(4)(B)(iii)(II)*. See *Ltr Rul 200936026* (mortgage loans by unrelated lenders to lower-tier LLCs that were secured by real property interests, and mezzanine loans by third parties that were secured by pledge of interests in lower-tier LLCs were treated as securities of the corporate parent for purposes of applying the 10-percent value of securities test).

(n301)Footnote 135. *IRC § 856(c)(4)(B)(iii)(II)*; see [i], above for a discussion of the 75 percent test.

(n302)Footnote 136. See *IRC § 856(c)(4)(B)(iii)(III)*.

(n303)Footnote 137. *IRC § 856(m)*; *IRC § 856(m)* was enacted in 2004, but it retroactively applies to tax years beginning after Dec 31, 2000, replacing the prior safe harbor statutory exception of former *IRC § 856(c)(7)*, which was repealed (Pub L No 108-357, § 243(a)).

(n304)Footnote 138. *IRC § 856(m)(2)(A)*; see *IRC § 1361(c)(5)*, without regard to subparagraph (B)(iii) thereof

(limiting the nature of the creditor).

(n305)Footnote 139. *IRC § 856(m)(2)(B)*.

(n306)Footnote 140. *IRC § 856(m)(2)(B)(i)*.

(n307)Footnote 141. *IRC § 856(m)(2)(B)(ii)*.

(n308)Footnote 142. *IRC § 856(m)(3)*; these rules retroactively replace a prior rule requiring a REIT to own a 20-percent equity interest in a partnership in order for debt to qualify as "straight debt" (see former *IRC § 856(c)(7)(C)*, before repeal by Pub L No 108-357, § 243(a).

(n309)Footnote 142.1. *IRC § 856(m)(4)*.

(n310)Footnote 142.2. See *IRC § 856(m)(1)*.

(n311)Footnote 142.3. See *IRC § 856(m)(1)*.

(n312)Footnote 142.4. See *IRC § 856(c)(3)*.

(n313)Footnote 142.5. *IRC § 856(m)(2)(C)*.

(n314)Footnote 142.6. *IRC § 856(m)(6)*; see *IRC § 856(c)(4)(B)(iii)(III)*.

(n315)Footnote 142.7. *IRC § 856(m)(6)(A)*; see *IRC § 856(c)(7)(C)*, before amendment by Pub Law 108-357.

(n316)Footnote 142.8. *IRC § 856(m)(6)(B)*.

(n317)Footnote 142.9. *IRC § 856(m)(6)(C)*.

(n318)Footnote 142.10. *IRC § 856(m)(1)*.

(n319)Footnote 143. See *IRC § 856(d)(2)(B)*.

(n320)Footnote 143.1. *IRC § 856(c)(4)(B)(ii)*, effective generally for tax years beginning after July 30, 2008 [Pub Law 110-289, § 3071(a)]. For tax years beginning before July 31, 2008, a 20-percent rate generally applied. For timber REITs, a 25-percent rate is effective for certain gains for taxable years beginning after May 22, 2008 [Pub Law 110-234, § 15314(b)].

(n321)Footnote 144. See *IRC § 856(c)(4)*; see § 16.02[2][c][i]-[vii], immediately above.

(n322)Footnote 144.1. *IRC § 856(c)(7)*, effective for transactions entered into after 2004 [Pub Law 109-135, § 403(g)(3)].

(n323)Footnote 144.2. *IRC § 856(c)(4)(B)(iii)(III)* (flush language).

(n324)Footnote 144.3. *IRC § 856(c)(7)(A)*.

(n325)Footnote 144.4. See *IRC § 11*; the highest rate of tax is 35 percent [see *IRC § 11(b)(1)*].

(n326)Footnote 144.5. *IRC § 856(c)(7)(C)(i)*.

(n327)Footnote 144.6. *IRC § 856(c)(7)(C)(ii)*.

(n328)Footnote 144.7. *IRC § 856(c)(7)(C)(iii)*.

- (n329)Footnote 144.8. See *IRC § 856(c)(4)(B)(iii)*; see § 16.02[2][c][iv], [v], and [vi] above.
- (n330)Footnote 144.9. *IRC § 856(c)(7)(B)*.
- (n331)Footnote 145. *Treas Reg § 1.856-3(g)*.
- (n332)Footnote 146. *Id.*
- (n333)Footnote 147. *Id.*; see also *Rev Rul 69-40, 1969-1 CB 188*.
- (n334)Footnote 147.1. See *Ltr Rul 200310014*.
- (n335)Footnote 148. *Treas Reg § 1.856-3(g)*.
- (n336)Footnote 149. *IRC § 856(c)(5)(B)*.
- (n337)Footnote 150. *IRC § 856(c)(5)(D)*.
- (n338)Footnote 151. See *IRC § 856(e)*.
- (n339)Footnote 152. See *IRC § 856(c)(2)(F), (3)(F), (e)*.
- (n340)Footnote 153. *IRC § 856(e)*.
- (n341)Footnote 154. *Treas Reg § 1.856-6(b)(3)*.
- (n342)Footnote 155. *IRC § 856(e)(6)(A), (B)(i)*, effective for tax years beginning after 2000.
- (n343)Footnote 156. *IRC § 856(e)(6)(B)(ii)*.
- (n344)Footnote 157. *IRC § 856(e)(6)(B)*.
- (n345)Footnote 158. *IRC § 857(b)(4)*.
- (n346)Footnote 158.1. *IRC § 857(b)(4)(B)(i)*; the inclusion of foreign currency gains applies only to gains recognized after July 30, 2008 [Pub Law 110-289, 3071(c)(1)].
- (n347)Footnote 159. *IRC § 856(e)(5)*.
- (n348)Footnote 160. *IRC § 856(e)(5)*, eff for tax years beginning after 8/5/97.
- (n349)Footnote 161. *IRC § 856(e)(2)*; for tax years beginning before 8/6/97, the grace period was two years from the date of acquisition (*IRC § 856(e)(2), before amendment by Pub L No 105-34*).
- (n350)Footnote 162. *IRC § 856(e)(3)*; for tax years beginning before 8/6/97, the IRS could grant extensions of up to six years (*IRC § 856(e)(3), before amendment by Pub L No 105-34*).
- (n351)Footnote 163. *IRC § 856(e)(4)(A)*.
- (n352)Footnote 164. *IRC § 856(e)(4)(B)*.
- (n353)Footnote 165. *IRC § 856(e)(4)(C)*.
- (n354)Footnote 166. *IRC § 856(e)(4)*.

(n355)Footnote 167. See *IRC § 857(b)(6)(A)*.

(n356)Footnote 168. *IRC § 857(b)(6)(C)*.

(n357)Footnote 169. *IRC § 857(b)(6)(C)(i)*. For sales occurring before July 31, 2008, the minimum holding period was 4 years [Pub Law 110-289 § 3071(d)].

(n358)Footnote 170. *IRC § 857(b)(6)(C)(ii)*.

(n359)Footnote 171. *IRC § 857(b)(6)(C)(iii)*; the fair market value exception applies to sales made after July 31, 2008 [Pub Law 110-289, § 3071(d)].

(n360)Footnote 171.1. See *IRC § 857(b)(6)(C)(iii)*.

(n361)Footnote 171.2. *Rev Proc 2008-69, 2008-48 IRB 1217*.

(n362)Footnote 171.3. The language used in the revenue procedure to set forth this requirement is less than clear. It states that the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which *IRC § 1033* applies) sold during the portion of the taxable year ending on July 30, 2008, cannot exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year [see *Rev Proc 2008-69, 2008-48 IRB 1217*].

(n363)Footnote 172. *IRC § 857(b)(6)(C)(iv)*. For sales occurring before July 31, 2008, the minimum holding period was 4 years [Pub Law 110-289 § 3071(d)].

(n364)Footnote 173. *IRC § 857(b)(6)(C)(v)*.

(n365)Footnote 173.1. *IRC § 856(b)(6)(F)*.

(n366)Footnote 173.1.0.1. *Ltr Rul 200953018*.

(n367)Footnote 173.1.0.2. *Ltr Rul 200945025*.

(n368)Footnote 173.1.1. *IRC § 857(b)(6)(D)*, effective for taxable years beginning after Oct 22, 2004. Private letter rulings, however, have provided similar results (see Ltr Ruls 2000 52 021, 1999 45 055, 88 38 016).

(n369)Footnote 173.2. *IRC § 857(b)(6)(D)*. For sales occurring before July 31, 2008, the minimum holding period was 4 years [Pub Law 110-289 § 3071(d)].

(n370)Footnote 173.2.1. See *IRC § 857(b)(6)(D)(iv)*.

(n371)Footnote 173.2.2. *Rev Proc 2008-69, 1008-48 IRB 1217*.

(n372)Footnote 173.3. See *IRC § 856(d)(3)*.

(n373)Footnote 173.4. *IRC § 857(b)(6)(D)(v)*, effective for dispositions in taxable years beginning after May 22, 2008 and before May 22, 2009. See *IRC §§ 857(b)(6)(H), 856(c)(8)*; Pub Law 110-234, § 15314(e); also see Pub Law 110-289, § 3051(b).

(n374)Footnote 173.5. *IRC § 857(b)(6)(G)*.

(n375)Footnote 173.6. *IRC § 856(c)(1)*.

(n376)Footnote 173.7. *IRC § 856(c)(1)*; see § 16.02[2][g], below, for a discussion of termination of REIT

elections.

(n377)Footnote 173.8. *Treas Reg § 1.856-2(b)*.

(n378)Footnote 173.9. *Ltr Rul 201016041* ; see *Treas Reg § 301.9100-1(c)*.

(n379)Footnote 174. *IRC § 857(f)(1)*.

(n380)Footnote 175. *IRC § 857(a)(2)*, before amendment by Pub L No 105-34.

(n381)Footnote 176. *IRC § 857(f)(2)*.

(n382)Footnote 177. *IRC § 857(f)(2)(D)*.

(n383)Footnote 178. *IRC § 857(f)(2)(C)*.

(n384)Footnote 179. See *IRC § 857(f)(1)*.

(n385)Footnote 180. *IRC § 856(k)*; see *IRC § 856(a)(6)*.

(n386)Footnote 181. *IRC § 857(b)(3)(C)*.

(n387)Footnote 182. *Treas Reg § 1.856-4(b)(4)*.

(n388)Footnote 183. *Treas Reg § 1.856-4(b)(5)(iv)*.

(n389)Footnote 184. *IRC § 856(g)(2)*.

(n390)Footnote 185. *IRC § 856(g)(3)*.

(n391)Footnote 186. *IRC § 856(c)(2), (3), (d)*.

(n392)Footnote 187. *IRC § 856(d)(1)*.

(n393)Footnote 188. *IRC § 856(d)(2)(C), 856(d)(7)*, effective for tax years beginning after Aug 5, 1997.

(n394)Footnote 189. *IRC § 856(d)(7)(A)*.

(n395)Footnote 189.1. *Ltr Rul 200013021* .

(n396)Footnote 190. *IRC § 856(d)(7)(B), (D)*.

(n397)Footnote 191. *IRC § 856(d)(7)(C)*; see *IRC § 512(b)(3)*.

(n398)Footnote 192-195. *IRC § 856(d)(7)(C)(i)*, effective for tax years beginning after 2000. For example, the IRS has ruled that a joint venture between a taxable REIT subsidiary and an independent contractor to provide non-customary services to REIT tenants will not cause rents paid by those tenants to fail to qualify as rents from real property under *IRC § 856* (see *Rev Rul 2003-86, 2003-2 CB 290*).

(n399)Footnote 196. *Treas Reg § 1.512(b)-1(c)(5)*.

(n400)Footnote 197. *IRC § 856(d)(1)(B)*.

(n401)Footnote 198. *Treas Reg § 1.856-4(b)(1)*. Specific examples of services that are considered customary include the following: furnishing utilities such as water, heat, light and air-conditioning; cleaning windows, public

entrances, exits and lobbies; performing general maintenance, janitorial and cleaning services; collecting trash; furnishing elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard services, parking facilities and swimming pool facilities. *Id.*

(n402)Footnote 199. See *IRC § 856(d)(7)*.

(n403)Footnote 200. *Treas Reg § 1.856-4(b)(5)*.

(n404)Footnote 201. See *IRC § 856(d)(7)*.

(n405)Footnote 202. *Rev Rul 69-178, 1969 CB 158*.

(n406)Footnote 203. *Rev Rul 80-297, 1980-2 CB 196*.

(n407)Footnote 204. *Rev Rul 80-298, 1980-2 CB 197*.

(n408)Footnote 205. *Id.*

(n409)Footnote 206. *Treas Reg § 1.512(b)-1(c)(5)*.

(n410)Footnote 207. See *Ltr Ruls 200327048, 200052031, 199930024, 199908023, 9846019, 9825033, 9502037, 9440026, 9436025, 9428033*.

(n411)Footnote 208. *Rev Rul 2004-24, 2004-1 CB 550*.

(n412)Footnote 209. The Report of the Conference Committee on the Tax Reform Act of 1986, HR Conf Rep No 841, 99th Cong, 2nd Sess II-220 (1986), 1986-3 (Vol 4) CB 220.

(n413)Footnote 210. *Rev Rul 2004-24, 2004-1 CB 550*.

(n414)Footnote 211. See *IRC § 856(d)(7)(C)(i); Treas Reg § 1.856-4(b)(5)(i)*.

(n415)Footnote 212. See *IRC § 856(d)(7)(C)(i); Treas Reg § 1.856-4(b)(5)(i)*.

(n416)Footnote 213. See *Ltr Rul 9436025* (REIT could charge tenants an annual or monthly fee for parking privileges or to park a second car in a garage or covered area); *Ltr Rul 9428033*.

(n417)Footnote 214. See *Ltr Rul 200327048; Ltr Rul 9440026; Ltr Rul 9428033*.

(n418)Footnote 215. See *IRC § 856(d)(7)(C)(i)*.

(n419)Footnote 216. See *Ltr Rul 9436025*.

(n420)Footnote 217. See *Ltr Rul 9440026*.

(n421)Footnote 218. See *Ltr Rul 9502037*.

(n422)Footnote 219-220. See *Ltr Rul 9930024; Ltr Rul 9908023; Ltr Rul 9846019*.

(n423)Footnote 221. *Ltr Rul 9508019* (Feb 24, 1995); *Ltr Rul 9506007* (Feb 10, 1995); *Ltr Rul 9502037* (Oct 19, 1994); *Ltr Rul 9431052* (May 12, 1994); *Ltr Rul 9330022* (Apr 30, 1993).

(n424)Footnote 222. *Ltr Rul 9502037* (Oct 19, 1994); *Ltr Rul 9440026* (July 11, 1994); *Ltr Rul 9436025* (June 8, 1994); *Ltr Rul 9431052* (May 12, 1994); *Ltr Rul 9431005* (Apr 22, 1994); *Ltr Rul 9428033* (Apr 20, 1994); *Ltr Rul*

9424033 (Mar 18, 1994) ; *Ltr Rul* 9403012 (Oct 21, 1993) .

(n425)Footnote 223. *Ltr Rul* 200320023 ; *Ltr Rul* 9502037 (Oct 19, 1994) ; *Ltr Rul* 9440026 (July 11, 1994) ; *Ltr Rul* 9436025 (June 8, 1994) ; *Ltr Rul* 9431052 (May 12, 1994) ; *Ltr Rul* 9428033 (Apr 20, 1994) ; *Ltr Rul* 9424033 (Mar 18, 1994) ; *Ltr Rul* 9403012 (Oct 21, 1993) ; *Ltr Rul* 200041024 (taxpayer maintained rooftop sites that were rented out to telecommunications services providers).

(n426)Footnote 224. *Ltr Rul* 9502037 (Oct 19, 1994) ; *Ltr Rul* 9440026 (July 11, 1994) ; *Ltr Rul* 9436025 (June 8, 1994) ; *Ltr Rul* 9431052 (May 12, 1994) ; *Ltr Rul* 9428033 (Apr 20, 1994) ; *Ltr Rul* 9403012 (Oct 21, 1993) .

(n427)Footnote 225. *Ltr Rul* 9502037 (Oct 19, 1994) ; *Ltr Rul* 9440026 (July 11, 1994) . See also *Ltr Rul* 9428033 (Apr 20, 1994) (painting and refurbishing vacated apartments considered passive activity).

(n428)Footnote 226. *Ltr Rul* 9436025 (June 8, 1994) .

(n429)Footnote 227. *Ltr Rul* 200828025 (furnishing of electricity and steam to the tenants); *Ltr Rul* 9502037 (Oct 19, 1994) ; *Ltr Rul* 9440026 (July 11, 1994) ; *Ltr Rul* 9436025 (June 8, 1994) ; *Ltr Rul* 9431052 (May 12, 1994) ; *Ltr Rul* 9431005 (Apr 22, 1994) ; *Ltr Rul* 200052031 .

(n430)Footnote 228. *Ltr Rul* 9436025 (June 8, 1994) ; *Ltr Ruls* 199908023 , 199917039 .

(n431)Footnote 229. *Ltr Rul* 9452032 (Sept 30, 1994) .

(n432)Footnote 230. *Ltr Rul* 9436025 (June 8, 1994) .

(n433)Footnote 230.1. *Ltr Rul* 199935071 ; *Ltr Rul* 200101012 ; *Ltr Rul* 200103033 .

(n434)Footnote 231. *Ltr Ruls* 9835013 ; 9428033 (Apr 20, 1994) ; *Ltr Rul* 200101012 (cable services were provided by an LLC in which the REIT held a proportionate part).

(n435)Footnote 232. *Ltr Rul* 9431005 (Apr 22, 1994) .

(n436)Footnote 233. See, eg, *Ltr Rul* 9502037 (Oct 19, 1994) ; *Ltr Rul* 9440026 (July 11, 1994) .

(n437)Footnote 234. See, eg, *Ltr Rul* 9502037 (Oct.19, 1994) ; *Ltr Rul* 9440026 (July 11, 1994) ; *Ltr Rul* 9436025 (June 8, 1994) ; *Ltr Rul* 9431052 (May 12, 1994) ; *Ltr Rul* 9431005 (Apr 22, 1994) .

(n438)Footnote 235. *Ltr Rul* 9431005 (Apr 22, 1994)

(n439)Footnote 236. *Ltr Rul* 9436025 (June 8, 1994) .

(n440)Footnote 237. *Ltr Rul* 9431005 (Apr 22, 1994) .

(n441)Footnote 238. *Ltr Rul* 9436025 (June 8, 1994) .

(n442)Footnote 239. *Ltr Rul* 9440026 (July 11, 1994) .

(n443)Footnote 240. *Id.*

(n444)Footnote 241. See, eg, *Ltr Rul* 9012032 (Dec 21, 1989) ; *Ltr Rul* 8830076 (May 5, 1988) ; *Ltr Rul* 8750075 (Sept 17, 1987) .

(n445)Footnote 241.1. *Ltr Rul* 200052031 .

(n446)Footnote 242. *Ltr Rul 9510030* (Mar 10, 1995) .

(n447)Footnote 243. *Id.*

(n448)Footnote 244. *Ltr Rul 8830076* (May 5, 1988) .

(n449)Footnote 245. See, eg, *Ltr Rul 9431005* (Apr 22, 1994) ; *Ltr Rul 9014022* (Jan 2, 1990) ; *Ltr Rul 9012032* (Dec 21, 1989) .

(n450)Footnote 246. See, eg, *Ltr Rul 9431005* (Apr 22, 1994) ; *Ltr Rul 9014022* (Jan 2, 1990) ; *Ltr Rul 9012032* (Dec 21, 1989) .

(n451)Footnote 247. See Treas Reg § 1.512-1(c)(5).

(n452)Footnote 248. *Ltr Rul 199908023* ; see *IRC § 856(d)(7)(C)(ii)*.

(n453)Footnote 248.1. *Ltr Rul 200101012* .

(n454)Footnote 248.2. *Ltr Rul 200103033* .

(n455)Footnote 248.3. *Ltr Rul 200052028* .

(n456)Footnote 249. *Ltr Rul 199917039* .

(n457)Footnote 249.1. *IRC § 856(d)(7)(A)*.

(n458)Footnote 249.2. *IRC § 856(d)(7)(C)(i)*; *Treas Reg § 1.856-4(b)(5)(i)*.

(n459)Footnote 249.3. *Treas Reg § 1.856-4(b)(5)(i)*.

(n460)Footnote 249.4. *Rev Rul 66-188, 1966-2 CB 276* ; *Ltr Rul 201014042* .

(n461)Footnote 250. Treas Reg § 1.512(b)-(1)(c)(5).

(n462)Footnote 251. *Ltr Rul 9510030* (Mar 10, 1995) ; *Ltr Rul 199917039* .

(n463)Footnote 252. *Id.*

(n464)Footnote 253. *Ltr Rul 9510030* (Mar 10, 1995) ; *Ltr Rul 9436025* (June 8, 1994) .

(n465)Footnote 254. *Ltr Rul 9440026* (July 11, 1994) ; *Ltr Rul 9316024* (Jan 23, 1993) .

(n466)Footnote 255. *Ltr Rul 9436025* (June 8, 1994) .

(n467)Footnote 256. *Id.*

(n468)Footnote 257. *Ltr Rul 9502037* (Oct 19, 1994) ; *Ltr Rul 9316024* (Jan 23, 1993) ; but see *Ltr Rul 9431005* (Apr 22, 1994) .

(n469)Footnote 258. *Ltr Rul 9316024* (Jan 23, 1993) .

(n470)Footnote 259. *Id.*

(n471)Footnote 260. See § 16.02[2][f][iii][A], *supra*.

- (n472)Footnote 261. *Ltr Rul 199917039* .
- (n473)Footnote 261.1. *Ltr Rul 200101012* .
- (n474)Footnote 261.2. *Ltr Rul 200008036* .
- (n475)Footnote 262. *Ltr Rul 199903027* .
- (n476)Footnote 263. *IRC § 856(d)(3)*.
- (n477)Footnote 264. *IRC § 856(d)(3)*, eff for tax years beginning after 2000.
- (n478)Footnote 264.1. See *Ltr Rul 200013021* .
- (n479)Footnote 264.2. See *Ltr Rul 200013021* .
- (n480)Footnote 265. *IRC § 856(d)(7)*.
- (n481)Footnote 266. *IRC § 856(g)(1)*.
- (n482)Footnote 267. *IRC § 856(g)(1), (5)*, effective for tax years beginning after Oct 23, 2004.
- (n483)Footnote 268. See *IRC § 856(c)(2), (3), (4)*.
- (n484)Footnote 269. *IRC § 856(g)(5)*.
- (n485)Footnote 270. *IRC § 856(g)(2)*.
- (n486)Footnote 271. *IRC § 856(g)(3)*.
- (n487)Footnote 272. See *IRC § 857(b)*.
- (n488)Footnote 273. *IRC § 857(a), (b)(2)(B)*.
- (n489)Footnote 274. *IRC § 857(b)(3)*; see [b], below, for a discussion of REIT capital gain designations.
- (n490)Footnote 275. *IRC §§ 56-59*.
- (n491)Footnote 276. *IRC § 56(g)(6)*.
- (n492)Footnote 277. *IRC § 59(d)(1)(A)*.
- (n493)Footnote 278. *IRC § 857(b)(2); Treas Reg § 1.857-2*.
- (n494)Footnote 279. *Treas Reg § 301.7701*.
- (n495)Footnote 279.1. See *IRC § 561*.
- (n496)Footnote 279.2. *IRC § 857(b)(2)(B)*.
- (n497)Footnote 279.3. *IRC § 857(b)(2)(C); Treas Reg § 1.857-2(a)(4)*.
- (n498)Footnote 279.4. *IRC § 857(b)(2)(D)*.
- (n499)Footnote 279.5. *IRC § 857(b)(2)(F)*.

(n500)Footnote 279.6. *Treas Reg* § 1.857-3(c).

(n501)Footnote 279.7. *IRC* § 857(b)(2)(E); see *IRC* § 857(b)(5).

(n502)Footnote 279.8. *IRC* § 857(b)(2)(E); see *IRC* § 857(b)(7).

(n503)Footnote 279.9. *IRC* § 857(b)(2)(E); see *IRC* § 856(c)(7)(C).

(n504)Footnote 279.10. *IRC* § 857(b)(2)(E); see *IRC* § 856(g)(5).

(n505)Footnote 280. *IRC* § 1212(a)(1)(B).

(n506)Footnote 281. *IRC* § 1212(a)(3)(B).

(n507)Footnote 282. *IRC* §§ 11, 857(b)(1).

(n508)Footnote 283. *IRC* § 857(b)(3)(A).

(n509)Footnote 284. *IRC* § 857(b)(6).

(n510)Footnote 285. *IRC* § 857(b)(5).

(n511)Footnote 286. *IRC* § 857(b)(7).

(n512)Footnote 287. *IRC* § 857(b)(4).

(n513)Footnote 288. *IRC* § 4981(a).

(n514)Footnote 289. *IRC* § 55.

(n515)Footnote 290. *Notice* 97-64, 1997-2 CB 323 .

(n516)Footnote 290.1. *Notice* 2004-39, 2004-1 CB 982 .

(n517)Footnote 290.2. See Pub L No 108-27.

(n518)Footnote 290.3. *Notice* 2004-39 , §§ 3, 4, 2004-1 CB 982 .

(n519)Footnote 290.4. *IRC* § 1(h).

(n520)Footnote 290.5. *IRC* § 1(h), before amendment by Pub L No 108-27; see *Notice* 97-59, 1997-2 CB 309 .

(n521)Footnote 290.6. *IRC* § 1(h)(2), (9), before amendment by Pub L No 108-27.

(n522)Footnote 290.7. *IRC* § 1(h).

(n523)Footnote 290.8. Public L No 108-27, § 301(c)(1), (2).

(n524)Footnote 290.9. Public L No 108-27, § 301(c)(4).

(n525)Footnote 290.10. See *IRC* § 858.

(n526)Footnote 290.11. See *IRC* § 860.

(n527)Footnote 290.12. *Notice* 2004-39 , § 3, 2004-1CB 982.

(n528)Footnote 290.13. *IRC § 857(c)*.

(n529)Footnote 290.14. See Notice 97-64 , § 6, 1997-2 CB 323 .

(n530)Footnote 290.15. *Notice 2004-39* , §§ 3, 4, 2004-1 CB 982 ; see *IRC § 1(h)*.

(n531)Footnote 291. *Notice 97-64*, 1997-2 CB 323 ; if a dividend was designated a capital gain dividend in a written notice mailed to shareholders on or before December 31, 1997, the additional designations could be effected by a written notice, mailed to all shareholders by February 2, 1998.

(n532)Footnote 292. *Notice 97-64*, 1997-2 CB 323 .

(n533)Footnote 293. See Rev Rul 89-81, 1989-1 CB 226 .

(n534)Footnote 294. *Notice 97-64*, 1997-2 CB 323

(n535)Footnote 295. *Notice 97-64*, 1997-2 CB 323

(n536)Footnote 296. *Notice 97-64*, 1997-2 CB 323

(n537)Footnote 297. *Notice 97-64*, 1997-2 CB 323 ; the deferral adjustment is disregarded in determining the group in which any deferred gain or loss belongs if the group depends on whether an item of gain or loss is taken into account before May 7, 1997, after July 28, 1997, or between those dates.

(n538)Footnote 298. *Notice 97-64*, 1997-2 CB 323 .

(n539)Footnote 299. *Notice 97-64*, 1997-2 CB 323 .

(n540)Footnote 300. *IRC § 857(a)(1)*.

(n541)Footnote 301. For tax years beginning before Aug 6, 1997, only cash-method REITs could take this item into account (*IRC 856(e)*, before amendment by Pub L No 105-34.)

(n542)Footnote 302. See *IRC § 857(e)*.

(n543)Footnote 303. See *IRC § 857(a)(1)(B)*, (*e*).

(n544)Footnote 304. *IRC §§ 561(b)*, *562(a)*, 316.

(n545)Footnote 305. *IRC § 316*.

(n546)Footnote 306. *IRC § 857(d)(1)*.

(n547)Footnote 307. *IRC §§ 857(d)(2)*, 4981.

(n548)Footnote 308. *IRC § 857(d)(3)(A)*, eff for distributions after 2000 (see Pub L No 106-170, § 566(d)).

(n549)Footnote 309. *IRC § 857(d)(3)(A)*, eff for tax years beginning after 8/5/97, for distributions before 2001.

(n550)Footnote 310. *IRC § 857(d)(3)(B)*.

(n551)Footnote 311. *IRC § 857(d)(3)(B)*; see *IRC § 858*.

(n552)Footnote 312. *Treas Reg § 1.562-1(a)*; see also *Fulman v. U.S.*, 570 F2d 268 (1st Cir 1976) , *aff'd* 434 US 528 (1978) (upholding the validity of this Treasury Regulation).

(n553)Footnote 313. *IRC § 311(b)*.

(n554)Footnote 314. See Ltr Rul 9335030 (June 4, 1993) (Service holding that: (1) with respect to a personal holding company, *Treas Reg § 1.562-1(a)* is obsolete; and (2) a dividends paid deduction for appreciated property is permissible at an amount equal to the fair market value of the property).

(n555)Footnote 315. *IRC § 562(c)*.

(n556)Footnote 315.1. *Rev Proc 2010-12, 2010-3 IRB 302* , effective for distributions declared on or after Jan 1, 2008.

(n557)Footnote 315.2. *Rev Proc 2010-12, 2010-3 IRB 302* , § 3.02.

(n558)Footnote 316. *IRC § 857(b)(3)(C)*.

(n559)Footnote 317. *IRC § 857(b)(3)(D)(i)*, eff for tax years beginning after 8/5/97; see § 16.02[4][b] and [c], below, for a discussion of capital gain dividends and the credit for tax paid by a REIT on retained capital gain.

(n560)Footnote 318. *Treas Reg § 1.561-2(a)(1)*.

(n561)Footnote 319. *IRC § 857(b)(9)*.

(n562)Footnote 320. *IRC § 858(a)*. The IRS may grant an extension for making the election under *IRC § 858(a)* to treat dividends as paid in the prior year [see *Ltr Rul 201004024*].

(n563)Footnote 320.1. See *IRC § 857(a)(1)*.

(n564)Footnote 321. *IRC § 858(b)*.

(n565)Footnote 322. See *Rev Rul 76-328, 1976-2 CB 216* and *Rev Rul 64-30, 1964-1 CB 232* .

(n566)Footnote 323. *IRC § 4981(a)*.

(n567)Footnote 324. *IRC § 4981(b)*.

(n568)Footnote 325. *IRC § 4981(c)*.

(n569)Footnote 326. *IRC § 4981(c)(3)*.

(n570)Footnote 327. See *IRC § 561*.

(n571)Footnote 327.1. *IRC § 860(a)*.

(n572)Footnote 328. *IRC § 860(f)(1), (2)*.

(n573)Footnote 328.1. See *IRC § 860(c)(2)*.

(n574)Footnote 328.2. See *IRC § 860(d)(2)*.

(n575)Footnote 328.3. See *IRC § 7121*.

(n576)Footnote 328.4. *IRC § 860(e)(1), (2), (3)*.

(n577)Footnote 328.5. *IRC § 860(e)(4)*.

(n578)Footnote 328.6. *IRC § 860(e)(4). Rev Proc 2009-28, 2009-20 IRB 1011 .*

(n579)Footnote 328.7. *IRC § 860(d)(2).*

(n580)Footnote 328.8. *See IRC § 857(b)(3)(A)(ii).*

(n581)Footnote 328.9. *IRC § 860(f)(1).*

(n582)Footnote 328.10. *See IRC § 860(g).*

(n583)Footnote 328.11. *See IRC § 561.*

(n584)Footnote 328.12. *IRC § 860(f)(2).*

(n585)Footnote 328.13. *IRC § 860(f)(1).*

(n586)Footnote 328.14. *IRC § 860(g).*

(n587)Footnote 328.15. *Treas Reg § 1.860-2(a)(2); Rev Proc 2009-28, 2009-20 IRB 1011 .*

(n588)Footnote 328.16. *Rev Proc 2009-28, 2009-20 IRB 1011 ; see Treas Reg § 301.7502-1(c).*

(n589)Footnote 329. *Rev Proc 2009-28, 2009-20 IRB 1011 .*

(n590)Footnote 329.1. *See 641-692.*

(n591)Footnote 329.2. *Rev Proc 2008-68, 2008-52 IRB 1373 , amplified and superseded by Rev Proc 2009-15, 2009-4 IRB 356 , amplified and superseded by Rev Proc 2010-12, 2010-3 IRB 302 ; the guidance liberalizes and extends to REITs and RICs generally guidance given in private letter rulings [see Ltr Rul 200832009 ; Ltr Rul 200817031]. The guidance is effective with respect to distributions declared on or after Jan 1, 2008 and on or before Dec 31, 2012, with respect to a taxable year ending on or before Dec 31, 2011.*

(n592)Footnote 329.3. *Rev Proc 2008-68 , § 3, 2008-52 IRB 1373 , amplified and superseded by Rev Proc 2009-15, 2009-4 IRB 356 , amplified and superseded by Rev Proc 2010-12, 2010-3 IRB 302 .*

(n593)Footnote 329.4. *Rev Proc 2008-68 , § 3, 2008-52 IRB 1373 , amplified and superseded by Rev Proc 2009-15, 2009-4 IRB 356 , amplified and superseded by Rev Proc 2010-12, 2010-3 IRB 302 .*

(n594)Footnote 330. *See Pub L No 106-170, § 546(a).*

(n595)Footnote 331. *IRC § 857(b)(7)(A).*

(n596)Footnote 332. 1381-1383.

(n597)Footnote 332.1. *See IRC § 856(d) for definition of rents from real property.*

(n598)Footnote 332.2. *IRC § 857(b)(7)(B)(i).*

(n599)Footnote 333. *IRC § 857(b)(7)(B)(ii), (d)(7)(A), (B).*

(n600)Footnote 334. *IRC § 857(b)(7)(B)(iii).*

(n601)Footnote 335. *IRC § 857(b)(7)(B)(iv).*

(n602)Footnote 336. *IRC § 857(b)(7)(B)(v).*

- (n603)Footnote 336.1. *IRC § 857(b)(7)(B)(ii)*, before repeal by Pub L No 108-357; see *IRC § 512(b)(3)*.
- (n604)Footnote 336.2. *IRC § 857(b)(7)(B)(v)*.
- (n605)Footnote 336.3. *IRC § 857(b)(7)(C)*.
- (n606)Footnote 336.4. *IRC § 857(b)(7)(D)*.
- (n607)Footnote 337. *IRC § 857(b)(7)(B)(vii)*.
- (n608)Footnote 338. See *IRC § 856(d)*.
- (n609)Footnote 339. See HR Conf Rep No 106-478.
- (n610)Footnote 339.1. *Rev Rul 2002-38, 2002-2 CB 4* .
- (n611)Footnote 339.2. See *Treas Reg § 1.856-4(b)(1)*.
- (n612)Footnote 339.3. See *Rev Rul 2002-38, 2002-2 CB 4* .
- (n613)Footnote 339.4. See *Treas Reg § 301.7701(i)*.
- (n614)Footnote 339.5. See *IRC § 856(d)*.
- (n615)Footnote 339.6. See *IRC § 857(b)(7)(A)*.
- (n616)Footnote 339.7. See *IRC § 857(b)(7)(B)(vi)*; *Rev Rul 2002-38, 2002-2 CB 4* .
- (n617)Footnote 339.8. *Rev Rul 2002-38, 2002-2 CB 4* .
- (n618)Footnote 339.9. See *IRC § 856(d)(7)(C)(i)*.
- (n619)Footnote 339.10. See *Treas Reg § 301.7701(i)*.
- (n620)Footnote 339.11. See *IRC § 857(b)(7)(B)(vi)*.
- (n621)Footnote 339.12. *Rev Rul 2002-38, 2002-2 CB 4* ; see *IRC § 857(b)(7)(A)*.
- (n622)Footnote 339.13. *Rev Rul 2002-38, 2002-2 CB 4* .
- (n623)Footnote 340. *IRC § 859(a)*.
- (n624)Footnote 341-343. *Treas Reg § 301.7701-3(c)(1)(v)(B)*.
- (n625)Footnote 344. See *IRC § 301(c)*.
- (n626)Footnote 345. *IRC § 857(b)(3)(B)*.
- (n627)Footnote 346. *IRC § 857(b)(3)(C)*; *Treas Reg § 1.857-6(e)(1)(ii)*.
- (n628)Footnote 346.1. *IRC §§ 857(b)(3)(F), 897(h)(1)*, effective for taxable years beginning after Oct 22, 2004.
- (n629)Footnote 346.2. See Notice 2004-39, *2004-1 CB 982* ; Notice 97-64, *1997-2 CB 323* ; *IRC § 1(h)*; see § 16.02[3][b], above, for a discussion of REIT capital gain designations.

(n630)Footnote 347. *Notice 97-64, 1997-2 CB 323 .*

(n631)Footnote 347.1. *IRC § 1(h)(2), (9), before amendment by Pub L No 108-27.*

(n632)Footnote 347.2. *Notice 2004-39 , §§ 3, 4, 2004-1 CB 982 .*

(n633)Footnote 347.3. *IRC § 1(h).*

(n634)Footnote 347.4. *Notice 2004-39 , §§ 3, 4, 2004-1 CB 982 ; see IRC § 1(h).*

(n635)Footnote 348. See *IRC § 857(b)(8)*. See *IRC § 857(b)(8)(B)* (rules for determining holding period of REIT stock).

(n636)Footnote 349. *IRC § 857(b)(8)(C).*

(n637)Footnote 350. *IRC § 857(b)(3)(D)(i), eff for tax years beginning after 8/5/97.*

(n638)Footnote 351. *IRC § 857(b)(3)(D)(ii).*

(n639)Footnote 352. *IRC § 857(b)(3)(E)(iii).*

(n640)Footnote 352.1. *IRC §§ 857(b)(3)(F), 897(h)(1), effective for taxable years beginning after Oct 22, 2004.*

(n641)Footnote 353. *IRC § 857(b)(3)(D)(i).*

(n642)Footnote 354. See *IRC § 857(b)(3)(A)(ii).*

(n643)Footnote 355. *IRC § 857(b)(3)(D)(iv).*

(n644)Footnote 356. *IRC § 6655(e)(5)(A).*

(n645)Footnote 357. *IRC § 6655(e)(5)(B).*

(n646)Footnote 358. *IRC § 857(c)(1); see IRC § 243.*

(n647)Footnote 359. *IRC § 1(h)(11).*

(n648)Footnote 359.1. *IRC § 1(h)(11)(B)(i).*

(n649)Footnote 359.2. *IRC § 857(c)(2)(A). IRC § 857(c)(2)(D)* provides that for purpose of this limitation, the term "qualified dividend income" is defined in *IRC § 1(h)(11)(B)*.

(n650)Footnote 359.3. See *IRC § 856(a).*

(n651)Footnote 359.4. *IRC § 857(c)(2)(A).*

(n652)Footnote 359.5. *IRC § 857(c)(2)(B).*

(n653)Footnote 359.6. The REIT's taxable income is computed for this purpose under *IRC § 857(b)(2)*.

(n654)Footnote 359.7. See *Treas Reg § 1.337(d)-7*, discussed in § 16.02[2][a], above.

(n655)Footnote 359.8. See *IRC §§ 1(h)(11)(B), 856(c)(2)(B)(iii).*

(n656)Footnote 359.9. *IRC § 857(c)(2)(C).*

(n657)Footnote 359.10. *IRC § 59(d)*.

(n658)Footnote 360. *Rev Rul 66-106, 1966-1 CB 151* .

(n659)Footnote 361. See *IRC § 856(h)(3)*.

(n660)Footnote 362. *IRC § 856(h)(3)(C)*.

(n661)Footnote 363. *Id.*

(n662)Footnote 364. *Id.*

(n663)Footnote 365. *IRC § 856(h)(3)(D)*.

(n664)Footnote 366. *IRC § 512(a)(3)*.

(n665)Footnote 367. *IRC § 897(c)*.

(n666)Footnote 368. See *IRC § 897(a)*. This makes USRPIs relatively less attractive to foreign investors because capital gains from the sale of other types of assets are generally not subject to United States income tax, unless they are effectively connected with the foreign investor's trade or business in the United States. *Treas Reg §§ 1.871-7(d)(2)(ii), 1.881-2(a)(1)*.

(n667)Footnote 369. See *IRC §§ 871(b), 882*.

(n668)Footnote 370. See *IRC §§ 1441, 1442*. A foreign investor eligible for a lower treaty rate should file IRS Form 1001 with the paying agent for the REIT.

(n669)Footnote 371. *IRC §§ 1441(c)(1), 1442(a)*.

(n670)Footnote 372. *IRC §§ 871(b), 882*.

(n671)Footnote 373. *IRC § 884*. A foreign investor should file IRS Form 4224 with the paying agent for the REIT to claim that a dividend is effectively connected income.

(n672)Footnote 374. See *Rev Rul 72-87, 1972-1 CB 274* . This ruling provides that withholding is required if "[a]t the time of the distribution the corporation *may* not know how much is out of earnings and profits and how much is from other than earnings and profits." (emphasis added) *Id at 275* . It is not clear if the withholding is required if the corporation *knows* that the distribution is not from earnings and profits.

(n673)Footnote 375. *IRC §§ 897(h)(1), 1441(a)*.

(n674)Footnote 376. *IRC § 884(a)*

(n675)Footnote 377. *IRC § 897(h)(1)*.

(n676)Footnote 378. *IRC § 1445(e)(6)*, effective generally for tax years of qualified investment entities (including REITs) beginning after 12/31/05. See *IRC § 897(h)(4)(A)* (definition of qualified investment entity).

(n677)Footnote 378.1. *IRC § 1445(b)(8)*; see *IRC § 897(h)(5)* (FIRPTA wash sale rule); see Chapter 17 for a discussion of the FIRPTA wash sale rule.

(n678)Footnote 379. *Treas Reg § 1.1445-8(c)(ii)(C)*.

(n679)Footnote 380. *Treas Reg § 1.1441-1* to 1.1441-8T.

(n680)Footnote 381. *IRC § 897(h)(4)(A)(i)(I)*.

(n681)Footnote 382. *IRC § 897(h)(2)*.

(n682)Footnote 382.1. *IRC § 897(h)(4)(B)*.

(n683)Footnote 382.2. *IRC § 897(ha)(4)(D)*.

(n684)Footnote 382.3. *IRC § 897(a)(1)*.

(n685)Footnote 382.4. *IRC §§ 871(b)(1), 882(a)(1), 897(a)(1)*.

(n686)Footnote 382.5. *IRC § 897(a)(2)*.

(n687)Footnote 383. See *IRC § 884(a)*. In the case of a liquidating distribution treated as a gain, the foreign investor should be able to offset its stock basis first. See Ltr Rul 9016021 (Jan. 18, 1990) .

(n688)Footnote 384. One of the first, if not the first, UPREITs to issue stock publicly was Taubman Center, Inc., having a prospectus dated November 20, 1992.

(n689)Footnote 385. See *Treas Reg § 1.701-2(d)*, Ex 4.

(n690)Footnote 386. *IRC § 351(a)*.

(n691)Footnote 387. *Treas Reg § 1.351-1(c)(1)*.

(n692)Footnote 388. *Id.*

(n693)Footnote 389. *Treas Reg § 1.351-1(c)(5)*.

(n694)Footnote 390. See Pub L No 105-206, § 7002(g).

(n695)Footnote 391. Pub L No 105-206, § 7002(c)(5).

(n696)Footnote 392. Pub L No 105-206, § 7002(c)(5)(A).

(n697)Footnote 393. Pub L No 105-206, § 7002(c)(5)(C).

(n698)Footnote 394. Pub L No 105-206, § 7002(c)(5)(B).

(n699)Footnote 395. See *Treas Reg § 1.701-2(d)*, Ex 4.

(n700)Footnote 396. *IRC § 721(b)* provides that gain will be realized on transfer of the existing partnership interests to an umbrella partnership if such partnership would be treated as an investment company under *IRC § 351* assuming the umbrella partnership was incorporated.

(n701)Footnote 397. See § 16.02[2][c][ii][D], *supra*.

(n702)Footnote 398. In Ltr Rul 9744003 and Ltr Rul 9428018 , the Service also ruled on several matters arising under an UPREIT structure. For an additional discussion of tax issues arising in UPREITs, see Bennett I. Deutsch, *UPREITs--How Much Gain Does a Partner Have if a Partner Does Have Gain?*, 9 *Tax Mgmt Real Est J* 183 (Oct 1993).

(n703)Footnote 398.1. *TAM 9943005, TAM 9943006, TAM 9943007.*

(n704)Footnote 399. See *IRC §§ 752, 731.*

(n705)Footnote 400. *Treas Reg § 1.752-3.*

(n706)Footnote 401. *Treas Reg § 1.704-2(b)(2).*

(n707)Footnote 402. *Treas Reg § 1.704-2(b).*

(n708)Footnote 403. *Treas Reg § 1.704-2(b)(2)(f).*

(n709)Footnote 404. *Treas Reg § 1.704-1(b)(2)(iv)(f), -2(d)(4).*

(n710)Footnote 405. *IRC § 707(c); Treas Reg §§ 1.707-0 to 1.707-9.*

(n711)Footnote 406. *Treas Reg § 1.707-5.*

(n712)Footnote 407. *Treas Reg § 1.707-5(a)(5).*

(n713)Footnote 408. *IRC § 704(c).*

(n714)Footnote 409. See *IRC § 269B(c)*; see also [6], above, for a discussion of umbrella partnership REITs (UPREITs).

(n715)Footnote 410. *IRC § 269B(a)(3).*

(n716)Footnote 411. Pub L No 98-369, § 136(c)(3).

(n717)Footnote 412. Pub L No 105-206, § 7002(a), (b)(1).

(n718)Footnote 413. Pub L No 105-206, § 7002(b)(3).

(n719)Footnote 414. Pub L No 105-206, § 7002(b)(4).

(n720)Footnote 415. Pub L No 105-206, § 7002(d).

(n721)Footnote 416. Pub L No 105-206, § 7002(c).

(n722)Footnote 416.1. See Ltr Ruls 200052021 , 199945055 , 199927021 , 8838016 . Note that although a private letter ruling may be relied upon only by the taxpayer to which the ruling is issued [*IRC § 6110(k)(3)*], private rulings do provide an indication of administrative practice.

(n723)Footnote 416.2. See *IRC § 856(c)(5)(I).*

(n724)Footnote 416.3. *IRC §§ 856(c)(2)(I), 856(c)(4)(B)(ii), 856(c)(5)(H)(iii), 856(c)(8), 857(b)(6)(D)(v), 857(b)(6)(G)*; Pub Law. 110-234, §§ 15312(c), 15313(c), 15314(b), 15315(e); also see Pub Law 110-289, § 3051(b).

(n725)Footnote 416.4. See *IRC § 856(c)(2)(D), (3)(C).*

(n726)Footnote 416.5. *IRC § 856(c)(5)(H)(i)(I).*

(n727)Footnote 416.6. *IRC § 856(c)(5)(H)(i)(II).*

(n728)Footnote 416.7. *IRC § 856(c)(5)(H)(i)(III).*

(n729)Footnote 416.8. See *IRC* § 856(c)(5)(H).

(n730)Footnote 416.9. See *IRC* §§ 856(c)(2)(D), 856(c)(3)(C).

(n731)Footnote 416.10. *IRC* § 856(c)(5)(H)(ii)(II).

(n732)Footnote 416.11. *IRC* § 856(c)(5)(H)(ii)(I).

(n733)Footnote 416.12. Pub Law 110-234, § 15312(c).

(n734)Footnote 416.13. *IRC* § 856(c)(5)(H)(iii), 856(c)(8).

(n735)Footnote 416.14. *IRC* § 857(b)(6)(A).

(n736)Footnote 416.15. *IRC* § 857(b)(6)(D); for sales occurring before 7/31/08, the minimum holding period was 4 years.

(n737)Footnote 416.16. *IRC* § 857(b)(6)(D)(ii), (iii). For sales occurring before 7/31/08, expenditures in the four years preceding the date of sale are restricted.

(n738)Footnote 416.17. *IRC* § 857(b)(6)(D)(iv)(I), (v).

(n739)Footnote 416.18. *IRC* § 857(b)(6)(G).

(n740)Footnote 416.19. Pub Law 110-234, § 15314(e).

(n741)Footnote 416.20. *IRC* §§ 857(b)(6)(H), 856(c)(8).

(n742)Footnote 416.21. *IRC* § 856(c)(5)(I).

(n743)Footnote 416.22. *IRC* § 856(c)(2)(I); see Pub Law 110-234, § 15313(c).

(n744)Footnote 416.23. *IRC* § 856(c)(4)(B)(ii). This provision applies to taxable years beginning after May 22, 2008 [Pub Law 110-234, § 15314(b)], and only in the case of a quarter that closes on or before the last day of the REIT's first taxable year that begins after May 22, 2008 and before May 22, 2009 [*IRC* § 856(c)(4)(B)(ii), *before amendment by* Pub Law No 110-289; *IRC* § 856(c)(8)].

(n745)Footnote 416.24. *IRC* § 856(c)(4)(B)(ii).

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Federal Taxes Affecting Real Estate

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CHAPTER 16 Special Forms of Holding Real Estate *

1-16 Federal Taxes Affecting Real Estate § 16.03

§ 16.03 Real Estate Mortgage Investment Conduits (REMICs)

[1] Introduction

Real estate mortgage loans, and in particular residential mortgage loans, are extensively traded on secondary markets. Frequently, the mortgage loans are packaged for "resale" by forming a "pool" of mortgage loans held by a trust, partnership or corporation. If a trust is used, certificates of beneficial interest are sold. If a partnership is used, limited partnership interests are sold. If a corporation is used, it generally issues corporate bonds backed by the mortgage loans and their proceeds. Before 1986, there was uncertainty about the income tax treatment of certain types of these mortgage-backed securities. n417

The *Tax Reform Act of 1986* authorized the creation of a new type of entity--real estate mortgage investment conduits (REMIC)--as the exclusive vehicle for holding fixed pools of mortgages and for issuing regular and residual classes of interests to investors. The REMIC vehicle is a very flexible and sophisticated one. The election to be treated as a REMIC n418 is solely for tax purposes. Consequently, for financial accounting purposes, a sponsor can obtain sale treatment or financing treatment for the assets included in the REMIC. For tax purposes, a sale by the sponsor of the REMIC of any interests in the REMIC is effectively treated as a sale of the assets represented by those interests. n419

A REMIC election may be made with respect to a corporation, association, partnership, trust or even a segregated pool of assets. n420 A REMIC must satisfy the following six statutory requirements.

[a] Election to be a REMIC

An election must be made to treat the entity as a REMIC for its first taxable year. n421 The election is made on the REMIC's first tax return filed on Form 1066. n422 The tax return must be filed timely, but the Service is authorized (but not required) to grant an extension of time to file if the return is late. Extensions for making a REMIC election are requested through private letter rulings. n423

[b] Only Regular Interests or Residual Interests

All of the interests in the REMIC must be "regular interests" or "residual interests." n424 A "regular interest" is any interest in a REMIC which is issued on the startup day (the REMIC's first day or any other day within its first ten days of existence designated by the REMIC) n425 with fixed terms and which is designated as a regular interest if--

(1) the interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount); and

(2) interest payments (or other similar amounts), if any, with respect to that interest at or before maturity--

(a) are payable based on a fixed rate (or, to the extent provided in Treasury regulations, at a variable rate), n426

(b) consist of a specified portion of the interest payments on qualified mortgages, and such portion does not vary during the period such interest is outstanding. n427

The interest does not fail to meet the requirements of subparagraph (1) merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent on the extent of prepayments on "qualified mortgages" and the amount of income from "permitted investments." n428 In addition, an interest in a REMIC does not fail to qualify as a regular interest solely because the specified principal amount of that interest or the amount of interest accrued on it could be reduced as a result of the nonoccurrence of one or more contingent payments with respect to one or more reverse mortgages loans that are held by the REMIC. This holds true, however, only if on the startup day for the REMIC, the REMIC sponsor reasonably believes that all principal and interest due under the interest will be paid at or prior to the liquidation of the REMIC. n428.1 For this purpose, a reasonable belief is presumed to exist if, as of the startup day, the REMIC interest receives an investment grade rating from at least one nationally recognized statistical rating agency.

The regular interests of a REMIC must be designated as such on the REMIC's first tax return. n429 Generally, variable interest rates may take the form of an index-based rate or a weighted average of the interest rates on some or all of the qualified mortgages held by the REMIC. n430 A variable rate may consist of a combination of rates, including fixed rates, in effect during different interest accrual periods n431 and may be subject to variable adjustments, maximum rates or minimum rates. n432

A residual interest is an interest in a REMIC which is issued on the REMIC's startup day, is not a regular interest and is designated as a residual interest. n433 A residual interest is not required to be entitled to any cash distributions from the REMIC.

[c] Single Class of Residual Interest

The REMIC must have one and only one class of residual interest, and distributions, if any, must be pro rata on residual interests. n434 An independently-formed partnership could be used to allocate distributions from a residual interest.

[d] Restrictions on Asset Types

As of the close of the third month beginning after the startup day and at all times thereafter, substantially all of the assets of the REMIC must be "qualified mortgages" and "permitted investments." n435 A "qualified mortgage" means--

(1) any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property n435.1 and which

(a) is transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC;

(b) is purchased by the REMIC within the 3-month period beginning on the startup day if, except as provided in the regulations, such purchase is pursuant to a fixed price contract in effect on the startup day; or

(c) represents an increase in the principal amount under the original terms of an obligation, provided that increase (i) is attributable to an advance made to the obligor pursuant to the original terms of a reverse mortgage loan or other obligation; (ii) occurs after the REMIC startup day; and (iii) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. n435.2

For purposes of the above obligations, any obligation originated by the United States or any State (or any of their political subdivisions, agencies, or instrumentalities) is treated as principally secured by an interest in real property if more than 50 percent of those obligations which are transferred to, or purchased by, the REMIC are principally secured by an interest in real property (determined without regard to this sentence). n435.3 Regulations provide that an obligation is "principally secured" by an interest in real property only if it satisfies either an 80-percent test or an alternative test. n435.3.1 Under the 80-percent test, an obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (or was significantly modified), or is at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC. n435.3.2 Under the alternative test, an obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at the origination date, is the only security for the obligation. n435.3.3

(2) Reverse mortgage loans and the periodic advances made to obligors on them; n435.4 For this purpose, a "reverse mortgage loan" is a loan that (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a "balance increase"), provided those advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan. n435.5

(3) any qualified replacement mortgage.

(4) any regular interest (but not a residual interest) in another REMIC transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC. n436

(5) Prior to 2005, a qualified mortgage also included any regular interest (but not an ownership interest) in a FASIT, if 95 percent or more of the value of the FASIT's assets consisted, at all times, of real estate mortgages that were transferred to, or purchased by, the REMIC. n436.1 The statutory provisions related to FASITs were repealed effective January 1, 2005. n436.2 A transition period for existing FASITs is provided, pursuant to which the repeal generally does not apply to any FASIT in existence on October 22, 2004 to the extent that regular interests issued by the FASIT prior to that date continue to remain outstanding in accordance with their original terms. n436.3

A "qualified replacement mortgage" means an obligation which would have been a qualified mortgage if transferred to the REMIC on the startup day and which is transferred to the REMIC within three months of the startup day or within two years if such obligation is replacing a defective mortgage loan. n437 Defective mortgage loans include defaulted or

nearly defaulted mortgage loans and mortgage loans that breach a representation or warranty of the transferor. n438

"Permitted Investments" are--

(1) cash flow investments (temporary investments of cash collected on mortgage loans until the next distribution date on the regular REMIC interests); n438.1

(2) qualified reserve assets (assets held in a reserve fund to pay expenses or to pay regular interests if there is a default on mortgage loans or lower than expected returns on cash-flow investments, or to provide a source of funds for the purchase of obligations that qualify as a "qualified mortgage") n438.2
or

(3) foreclosure property (property obtained through a foreclosure and held for up to two years (unless the Service grants an extension). n439

This asset requirement does not apply during a liquidation of up to 90 days. n440

[e] Calendar Year

The REMIC must use a calendar year as its taxable year. n441

[f] Restrictions on Ownership of Residual Interests by Disqualified Organizations

There must be reasonable arrangements designed to prevent "disqualified organizations" from acquiring a residual interest and for providing certain information necessary for computing a tax on transferors who transfer a residual interest to a disqualified organization. n442 A "disqualified organization" means a governmental entity, certain cooperatives and other organizations exempt from the tax on unrelated business taxable income. n443 Generally, the residual interest must be in registered form and must have a restrictive legend. The applicable organizational document must expressly include these two requirements. n444 There is a tax imposed on the transferor of any residual interest to a disqualified organization. The tax is equal to the highest corporate tax rate applied to the present value of all anticipated excess inclusions (as described below). n445

[g] Significant Modification of REMIC Assets

An entity that initially qualifies as a REMIC may cease to qualify, if a sufficiently large portion of its qualified mortgages are significantly modified and the modified obligations are not qualified mortgages. n445.1 For this purpose, a qualified mortgage is generally treated as having been significantly modified if the change in terms would be treated as an exchange of obligations under *IRC Section 1001* and the related regulations. n445.2 The following changes in the terms of an obligation, however, are not considered to be significant modifications for this purpose: n445.3

- changes in the terms of an obligation occasioned by default or a reasonably foreseeable default;
- assumption of the obligation;
- waiver of a due-on-sale clause or a due-on-encumbrance clause;
- conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage;
- a modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse

obligation, so long as the obligation continues to be principally secured by an interest in real property following the release, substitution, addition, or other alteration; n445.3.1 and

- a change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse), so long as the obligation continues to be principally secured by an interest in real property following the change. n445.3.2 substitution, addition, or other alteration; n445.3.3

The IRS has issued several revenue procedures describing circumstances under it will allow modifications to certain mortgage loans without challenging the tax status of securitization vehicles (in particular, REMICs and investment trusts) that hold the loans or asserting that those modifications give rise to prohibited transactions. *Revenue Procedure 2009-45*, n445.3.4 was issued in response to the crisis in the commercial lending market, largely due to the difficulty in refinancing existing loans. It also is acknowledgement of the ability of professionals to recognize when there may be a substantial risk of foreclosure on a loan—even though the loan may not currently be in default, and even though there may be a substantial time before the loan's maturity date. Under the revenue procedure, if a modification of a loan meets the requirements set forth below, the IRS: n445.3.5

- Will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications are not among the exceptions in the regulations as to what constitutes a significant modification; n445.3.6.
- Will not contend that a modification is a REMIC prohibited transaction by virtue of being an impermissible disposition of qualified mortgage, even though the modification is not listed as a statutory exception to a prohibited transaction; n445.3.7.
- Will not challenge a securitization vehicle's classification as an investment trust n445.3.8 on the ground that the modifications manifest a power to vary the investment of the certificate holders; and
- Will not challenge a securitization vehicle's qualification as a REMIC on the ground that the modifications result in a deemed reissuance of the REMIC regular interests.

The safe-harbor treatment described above applies to a modification (including an actual exchange) n445.3.9 of a mortgage loan (the "pre-modification loan") that is held by a REMIC, or by an investment trust, only if all of the following conditions are satisfied: n445.3.10

- The pre-modification loan is not secured by a residence that contains fewer than five dwelling units and that is the principal residence of the issuer of the loan.
- Either (1) If a REMIC holds the pre-modification loan, then as of the end of the 3-month period beginning on the startup day, no more than 10 percent of the stated principal of the total assets of the REMIC was represented by loans fitting the following description: At the time of contribution to the REMIC, the payments on the loan were then overdue by at least 30 days or a default on the loan was reasonably foreseeable; or (2) If an investment trust holds the pre-modification loan, then as of all dates when assets were contributed to the trust, no more than 10 percent of the stated principal of all the debt instruments then held by the trust was represented by instruments the payments on which were then overdue by 30 days or more or for which default was reasonably foreseeable.
- Based on all the facts and circumstances, the holder or servicer reasonably believes that there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date. The belief must be based on a diligent contemporaneous determination of that risk, which may take into

account credible written factual representations made by the issuer of the loan if the holder or servicer neither knows nor has reason to know that those representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is *per se* not foreseeable. For example, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

- Based on all the facts and circumstances, the holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modification loan.

Note:

Although it mentions a one-year benchmark, *Revenue Procedure 2009-45* does not set out a maximum period before a loan maturity date in which a holder or servicer may determine that a loan presents a substantial risk of forfeiture. It seems likely that a longer period would be permitted, provided there is concrete evidence to support a determination of substantial risk. n445.3.11

Previously, in response to the sub-prime mortgage crisis in 2007, the IRS issued a revenue procedure that describes the conditions under which changes to certain subprime mortgage loans will not cause the IRS to challenge the REMIC status of certain entities holding the loans. The purpose of the revenue procedure is to provide certainty in the current economic environment with respect to certain potential tax issues that may be implicated by various "fast track" loan modifications. n445.4 The revenue procedure was issued in response to a document entitled, "Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans" (the "Framework"), which was issued by the American Securitization Forum ("ASF") in December 2007. An executive summary of the Framework is attached as an Appendix in *Revenue Procedure 2007-72*.

Revenue Procedure 2007-72 applies to the following transactions occurring on or before July 31, 2010: n445.5

- a fast track modification of a loan pursuant to the Framework; and
- a second-lien holder's action of subordinating its lien to any new lien that may arise under a loan as the result of a fast track modification.

However, if the Framework is materially modified after December 6, 2007, the revenue procedure does not necessarily apply to fast track modifications under the revised Framework or to second-lien subordinations to accommodate those modifications. n445.6

If a transaction falls within the ambit of the revenue procedure, the following will apply: n445.7

- the IRS will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the transactions are not among the exceptions listed in the regulations; n445.8
- the IRS will not contend that the transactions are prohibited transactions n445.9 on the grounds that the transactions are not among the statutory exceptions under which qualified mortgages may be disposed of without being subject to the 100-percent penalty tax; n445.10

- the IRS will not challenge a securitization vehicle's classification as a trust on the grounds that the transactions manifest a power to vary the investment of the certificate holders; and
- the IRS will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the transactions resulted in a deemed reissuance of the REMIC regular interests.

In July 2008, the ASF released an updated Framework, which covers additional fast-track loan modifications. The IRS issued another revenue procedure-- *Revenue Procedure 2008-47*, n445.11 --which extends the above provisions of *Revenue Procedure 2007-72* to these additional loan modifications. *Revenue Procedure 2008-47* applies to the following transactions occurring on or before July 31, 2010: n445.12

- a fast track modification of a loan pursuant to the July 2008 Framework; and
- a second-lien holder's action of subordinating its lien to any new lien that may arise under a loan as the result of such a fast track modification.

If the July 2008 Framework is materially modified after July 8, 2008, however, *Revenue Procedure 2008-47* does not necessarily apply to fast track modifications under the modified Framework or to second-lien subordinations to accommodate those modifications. n445.13

The IRS has also issued two additional revenue procedures regarding the treatment of mortgage loans modified pursuant to certain foreclosure prevention programs. n445.14 One describes conditions under which modifications of certain mortgage loans will not cause the IRS either to challenge the tax status of the REMIC or other securitization vehicle that holds the loans or to assert that those modifications create a liability for tax on a prohibited transaction. n445.15

The procedure applies to a modification of a mortgage loan if the following conditions are satisfied: n445.16

- The real property securing the mortgage loan is a residence that contains fewer than five dwelling units.
- The real property securing the mortgage loan is owner-occupied.
- If a REMIC holds the mortgage loan, then as of either the startup day or the end of the 3-month period beginning on the startup day, no more than ten percent of the stated principal of the total assets of the REMIC was represented by loans the payments on which were then overdue by 30 days or more. If an investment trust holds the mortgage loan, then as of all dates when assets were contributed to the trust, no more than ten percent of the stated principal of all the debt instruments then held by the trust was represented by instruments the payments on which were then overdue by 30 days or more.
- The holder or servicer reasonably believes that there is a significant risk of foreclosure of the original loan. This reasonable belief may be based on guidelines developed as part of a foreclosure prevention program similar to that described in the revenue procedure or may be based on any other credible systematic determination.
- The terms of the modified loan are less favorable to the holder than were the unmodified terms of the original mortgage loan.
- The holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of foreclosure, as compared with the original loan.

A second revenue procedure addresses potential tax issues that may be implicated by loan modifications made pursuant to the Home Affordable Modification Program ("HAMP"). n445.16.01 The HAMP applies both to loans that investors hold directly and to those that are held through securitization vehicles such as REMICs. The revenue procedure describes the conditions under which modifications to certain mortgage loans made pursuant to the HAMP of a mortgage that is held by a REMIC or investment trust will not cause the IRS to challenge the tax status of certain securitization vehicles that hold the loans or to assert that those modifications give rise to prohibited transactions: n445.16.02

- The IRS will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications are not among the exceptions listed in *Treasury Regulation Section 1.860G-2(b)(3)*; the most critical aspect of the regulation for the HAMP purposes is that if a change in the terms of an obligation is "occasioned by default or a reasonably foreseeable default," the change is not a significant modification. Thus, under *Revenue Procedure 2009-23*, a modification may be treated as not significant even if there isn't a risk of default.

- The IRS will not contend that the modifications are prohibited transactions under *IRC Section 860F(a)(2)* for purposes of imposing the 100 percent tax n445.16.03 on the grounds that the modifications result in one or more dispositions of qualified mortgages and that the dispositions are not among the exceptions listed in *IRC Section 860F(a)(2)(A)(i)-(iv)*. This rule allows dispositions of a qualified mortgage to avoid the tax even if, among other things, the disposition is not incident to the foreclosure, default, or imminent default of the mortgage.

- The IRS will not challenge a securitization vehicle's classification as a trust on the grounds that the modifications manifest a power to vary the investment of the certificate holders. n445.16.04

- The IRS will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications result in a deemed reissuance of the REMIC regular interests.

[h] When an Obligation Continues to be Principally Secured by an Interest in Real Property Following a Loan Modification

Regulations clarify when an interest in real property continues to be principally secured by an interest in real property following certain loan modifications n445.16.1 or a REMIC release of its lien on an interest in real property that secures a qualified mortgage. n445.16.2 An obligation continues to be principally secured by an interest in real property following the modification only if, as of the date of the modification, the obligation satisfies one of the following alternatives: n445.16.3

- (1) The fair market value of the interest in real property securing the obligation, determined as of the date of the modification, is at least 80 percent of the adjusted issue price of the modified obligation, determined as of the date of the modification. This criterion is met if, as of the date of the modification, the servicer reasonably believes that the obligation satisfies it, and belief is based on at least one of the following: (a) a current appraisal performed by an independent appraiser; (b) an appraisal that was obtained in connection with the origination of the obligation and, if appropriate, that has been updated for the passage of time and for any other changes that might affect the value of the interest in real property; (c) the sales price of the interest in real property in the case of a substantially contemporary sale in which the buyer assumes the seller's obligations under the mortgage; or (d) some other commercially reasonable valuation method.

- (2) The fair market value of the interest in real property that secures the obligation immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the

obligation immediately before the modification. This criterion must be established by a current appraisal, an original (and updated) appraisal, or some other commercially reasonable valuation method; and the servicer must not actually know, or have reason to know, that the criterion in the preceding sentence is not satisfied.

[2] Taxation of REMICs

[a] Overview

Generally, a REMIC is not subject to taxation and is not treated as a corporation, partnership or trust for purposes of income taxation. n446 However, solely for purposes of the administrative and audit provisions under Subtitle F of the Code, a REMIC is treated as a partnership, and any holder of a residual interest is treated as a partner. n447 Generally, a REMIC must file an income tax return annually with the Service. The REMIC income is taxable to the interest holders of the REMIC. n448

[b] Prohibited Transactions

A REMIC is subject to a 100 percent tax on income derived from certain prohibited transactions. n449 Disposition of a qualified mortgage is prohibited unless it is done:

- (1) to substitute a qualified mortgage for a defective mortgage (or the defective mortgage is sold);
- (2) incident to foreclosure, default or imminent default;
- (3) upon the REMIC's bankruptcy; or
- (4) upon the REMIC's liquidation. n450

The following are also prohibited transactions upon which the tax is imposed: n451

- the receipt of any income attributable to assets other than qualified mortgages or permitted investments;
- the receipt by the REMIC of any amount that is a fee or other compensation for services; or
- gain from the disposition of any cash flow investment other than pursuant to a qualified liquidation.

[c] Liquidations

A REMIC may liquidate without recognizing any gain or loss on the sale of its qualified mortgages and permitted assets; however, to do so, the REMIC must adopt a plan, liquidate within 90 days and, within the same period, distribute the proceeds of its assets to holders of its regular or residual interests. n452

[3] Taxation of Investors in the REMIC

A REMIC may only issue regular interest securities and residual interest securities. Holders of each of these classes of securities are subject to special tax rules, as are transferors of the mortgage loans to the REMIC.

[a] Regular-Interest Holders

The holders of a regular interest have an unconditional right to receive a specified principal amount and payments of

interest at a fixed rate (although regulations may prescribe a variable rate). n453 A regular interest is treated as a debt instrument n454 with two exceptions. First, all holders must report their interest income amounts on the accrual basis. n455 Second, gain on the disposition of a regular interest is treated as ordinary income to the extent such gain does not exceed the excess of the amount that would have been includible in gross income if the yield was 110 percent of the "applicable Federal rate," n456 over the amount actually includible in the holder's gross income. n457 If the holders receive their regular interest in exchange for property, the issue price of the regular interest is equal to the fair market value of the property at the time of the exchange. n458

[b] Residual-Interest Holders Generally

A residual interest in a REMIC is, in effect, an equity interest in the residual assets of the REMIC. Residual holders include in income the daily portion of the taxable income or net loss of the REMIC. n459 Thus, a residual interest holder generally is taxable currently on the taxable income or net loss of the REMIC without regard to whether or when the REMIC makes distributions. n459.1 There is an exception to this rule for certain foreign investors. For purposes of the tax on nonresident alien individuals and foreign corporations and the withholding provisions that apply to those taxes, n459.2 if amounts are includible in the income of a holder of a REMIC residual interest that is a nonresident alien individual or a foreign corporation, the amounts are taken into account only when paid or distributed to the foreign holder, or when the interest is disposed of. n459.3

Under its statutory authority to do so, n459.4 Treasury has issued regulations regarding noneconomic REMIC residual interests, i.e. residual interests that entitle the holder to little or no distributions. The regulations accelerate when foreign partners of domestic partnerships are required to account for REMIC net income. They generally require a foreign partner in a partnership holding one or more REMIC residual interests to take into account REMIC net income inclusions at the end of its taxable year (or on the last date of the taxable year of a partnership that allocates REMIC net income to the foreign partner). n459.5 The regulations require a foreign shareholder in a REIT or regulated investment company, a foreign participant in a common trust fund, or a foreign patron of a subchapter T cooperative organization to take into account excess inclusion income at the same time as other income from the entity. n459.6 The above regulations are applicable to REMIC net income (including excess inclusions) of a foreign person with respect to a REMIC residual interest if the first net income allocation to the foreign person with respect to that interest occurs on or after August 1, 2006. n459.7

An excess inclusion is treated as income from sources within the United States. To the extent excess inclusions are taken into account with respect to a residual interest, net losses with respect to the residual interest are allocated and apportioned to the class and grouping(s) of gross income to which the excess inclusions were assigned. n459.7.1

With respect to REMIC residual interests, withholding is required on excess inclusions, n459.7.2 and on the portion of amounts allocated to foreign partners in partnerships holding REMIC residual interests n459.7.3 that is an excess inclusion. n459.7.4 The exemption available under certain circumstances to certain withholding agents that do not have custody or control of money or property from which to satisfy a withholding obligation n459.8 does not apply to partnership allocations for foreign partners of REMIC net income with respect to a REMIC residual interest. n459.8.1

Some or all of a residual holder's allocable share of a REMIC's taxable income may be an excess inclusion, and this amount is fully taxed--the taxable income of any holder of a residual interest in a REMIC for any tax year cannot be less than the excess inclusion (generally an amount equal to the REMIC's phantom income) for that year. n459.9 This prevents the application of NOLs to offset the excess inclusion income. NOL coordinating rules apply that govern excess inclusions with NOL provisions. n459.10 These rules have the effect of creating a separate basket for taxing excess inclusion income, so that the amount calculated as an NOL for a year is not reduced by excess inclusion income, and NOL carryovers are not absorbed by excess inclusion income. n459.11 The IRS has issued a ruling illustrating the interaction between the REMIC excess inclusion rules and the NOL rules. n459.12 The basis of a residual interest is increased by the amount of taxable income recognized by the interest holder. n460 Distributions to residual interest

holders are not taxable to the extent they do not exceed the adjusted basis of the interest. Distributions in excess of the adjusted basis of the interest are treated as gain from the sale of the interest. n461

Special rules apply to "excess inclusions." Excess inclusion is the income from a residual interest in excess of income, accrued at the rate of 120 percent of a specified Federal interest rate on the residual interest's adjusted issue price. The adjusted issue price is the original issue price increased by the residual interest's taxable income and reduced by distributions. n462 Excess inclusion income generally cannot be offset by net operating losses n463 and is treated as unrelated business taxable income by tax-exempt entities. n464

The Service has determined that the use of inventories would undermine the Congressional intent to tax currently a REMIC residual holder's excess inclusion. Therefore, it has ruled that taxpayers who hold residual interests in a REMIC may not use an inventory method under *IRC Section 471* to account for those interests, including any residual interest. Taxpayers using an inventory method to account for REMIC interests must change their method of accounting in accordance with the ruling. n465

Regulations clarify the treatment of transfers of noneconomic residual interests in REMICs. n465.1 In general, a transfer of a noneconomic residual interest in a REMIC is disregarded for all tax purposes if a significant purpose of the transfer is to enable the transferor to impede the assessment or collection of tax. A purpose to impede the assessment or collection of tax (a wrongful purpose) exists if the transferor, at the time of the transfer, either knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of the REMIC's taxable income. n465.2 Under a regulatory safe harbor, the transferor of a REMIC noneconomic residual interest is presumed not to have a wrongful purpose if four requirements are satisfied:

- (1) the transferor conducts a reasonable investigation of the transferee's financial condition (the investigation requirement); n465.3
- (2) the transferor secures a representation from the transferee to the effect that the transferee understands the tax obligations associated with holding a residual interest and intends to pay those taxes (the representation requirement); n465.4
- (3) the transferee must represent that it will not cause income from the noneconomic residual interest to be attributable to a foreign permanent establishment or fixed base of the transferee or another US taxpayer; n465.5 and
- (4) the transferor of a REMIC noneconomic residual interest must also satisfy either the "asset test" or the "formula test." n465.6

A transfer meets the "asset test" if the following requirements are met: n465.7

- At the time of the transfer and at the close of each of the transferee's two fiscal years preceding the fiscal year of the transfer, the transferee's gross assets for financial reporting purposes exceed \$100 million and its net assets for financial reporting purposes exceed \$10 million. The regulation clarifies that obligations of related persons and assets acquired solely to satisfy the asset test are not taken into account in determining gross or net assets. n465.8

- The transferee must be an "eligible corporation." An eligible corporation includes any domestic C corporation other than (1) a corporation exempt from, or not subject to federal income tax; (2) a regulated investment company or REIT; (3) a REMIC; or (4) a cooperative.

- The transferee must agree in writing that any subsequent transfer of the interest will be to another

eligible corporation in a transaction that satisfies the investigation and representation requirements and the asset test. A transfer to a foreign permanent establishment cannot meet this requirement, nor can a transfer if the transferor has reason to know the transferee will not honor the restrictions on subsequent transfers of the residual interest.

- A reasonable person would not conclude from facts known to the transferor on or before the time of the transfer that the taxes associated with the residual interest will not be paid. The regulation briefly details how various factors are considered in this regard. n465.9

A transfer satisfies the "formula test" if the present value of the anticipated tax liabilities associated with holding the residual interest must not exceed the sum of the following: n465.10

- the present value of any consideration given to the transferee to acquire the interest;
- the present value of the expected future distributions on the interest; and
- the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

In applying the "formula test," a transferee is generally presumed to pay tax at a rate equal to the highest corporate tax rate in *IRC Section 11(b)*. Transferees that have been subject to the alternative minimum tax for the preceding two years and will be subject to the AMT for the year of the transfer, however, may use the alternative minimum tax rate applicable to corporations. n465.11 A direct or indirect transfer of the residual interest to a foreign permanent establishment or fixed base of a domestic transferee is not eligible for the formula test. n465.12 In applying the formula test, present values are computed using a discount rate equal to the Federal short-term rate prescribed by *IRC Section 1274(d)* for the month of the transfer and the compounding period used by the taxpayer. n465.13

Prospective transferees are sometimes paid a fee to induce them to become holders of residual interests in a REMIC. Regulations govern the proper timing and source of income from that fee. n465.14 The fee must generally be included in income over a period that is reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the non-economic residual interest. n465.15 An inducement fee generally may not be taken into account in a single tax year. The general rule is that all taxpayers, regardless of their overall method of accounting, must recognize an inducement fee over the remaining expected life of the applicable REMIC in a manner that reasonably reflects the after-tax costs and benefits of holding that non-economic residual interest. n465.16

Regulations provide two safe harbor methods of accounting for inducement fees that will be deemed to meet the general rule—a book method and a modified REMIC regulatory method. n465.17 Under the book method, an inducement fee is recognized in accordance with the method of accounting, and over the same period, used by the taxpayer for financial reporting purposes (including consolidated financial statements to shareholders, partners, beneficiaries, and other proprietors and for credit purposes), provided that the inducement fee is included in income for financial reporting purposes over a period that is not shorter than the period during which the applicable REMIC is expected to generate taxable income. n465.18 Under the modified REMIC regulatory method, the inducement fee is recognized ratably over the remaining anticipated weighted average life of the applicable REMIC as if the inducement fee were unrecognized gain being included in gross income under applicable regulations. n465.19

A special rule that applies when a taxpayer disposes of a residual interest in a REMIC before recognizing the inducement fee in gross income. If any portion of the inducement fee has not been recognized in full by the holder as of the time the holder transfers, or otherwise ceases to be the holder of that residual interest, then the holder must include the unrecognized portion of the inducement fee in income at that time. This rule does not apply to with respect to

carryovers in certain corporate acquisitions under *IRC Section 381*. n465.20

The treatment of inducement fees is a method of accounting to which the statutory method of accounting rules apply. n465.21 A taxpayer is generally permitted to adopt a method of accounting for inducement fees that satisfies the general rule. Once adopted, that method must be applied consistently to all inducement fees received, and may be changed only with the consent of the Commissioner. n465.22 For purposes of applying the sourcing rules, n465.23 inducement fees are treated as income from sources within the United States. n465.24

[c] Residual Interests Held By REITs, RICs, and Other Pass-Thru Entities

The REMIC provisions seek to ensure that excess inclusion income does not escape current taxation. Some of these provisions are designed to prevent certain tax-exempt entities (disqualified organizations) from being holders of a REMIC residual interest through a REIT or similar pass-thru entity. A tax is imposed on certain pass-thru entities that have excess inclusion income allocable to a record owner that is a disqualified organization. n465.25 For this purpose, pass-thru entities include REITs, RICs, and nominees n465.26 and disqualified organizations include tax exempt entities that are not subject to unrelated business income tax under *IRC Section 511*. n465.27 For example, a REIT that owns REMIC residual interests must pay the tax imposed with respect to excess inclusion income allocable to a shareholder that is a disqualified organization. n465.28

IRC Section 860E(d) addresses the tax consequences to a REIT's shareholders when the REIT holds a REMIC residual interest. If a REIT holds one or more REMIC residual interests, then, under regulations prescribed by the Secretary, the excess of the aggregate excess inclusions determined with respect to those interests over the REIT's taxable income must be allocated among the shareholders of the REIT in proportion to the dividends received from the REIT. n465.29 Any such amounts allocated to a shareholder must be treated as an excess inclusion with respect to a residual interest held by the shareholder. n465.30 Similar rules apply to RICs, common trust funds, and certain cooperative organizations. Regulations have not yet been issued under this provision.

In response to growing numbers of REITs generating excess inclusion income by engaging in mortgage securitization transactions that cause the REIT to be a taxable mortgage pool (TMP) n465.31 or have a qualified REIT subsidiary that is a TMP, the IRS has issued interim guidance that applies to excess inclusion income both from REMIC residual interests and from REIT TMPs, whether received directly or allocated from another pass-thru entity. n465.32 Pending the issuance of further guidance, the IRS follows the following principles in administering the statutory rules that apply to excess inclusion income, whether from TMPs or from REMIC residual interests: n465.33 A REIT must do the following:

- Determine whether it or its qualified REIT subsidiary (or a portion of either) is a TMP, and if so, calculate the excess inclusion income of the TMP under a reasonable method.
- Allocate its excess inclusion income to its shareholders in proportion to dividends paid (determined without regard to any special allocation of the expense for any tax paid under *IRC Section 860E(e)(6)*) and inform the shareholders that are not disqualified organizations of the amount and character of the excess inclusion income allocated to them.
- Pay the tax imposed on the excess inclusion income n465.34 that is allocable to its shareholders that are disqualified organizations.
- Apply the withholding tax provisions with respect to the excess inclusion portion of dividends paid to foreign persons without regard to any treaty exception or reduction in tax rate. n465.35

With respect to its excess inclusion income, a pass-through entity, other than a REIT, RIC, or nominee, must do the

following: n465.36

- Allocate its excess inclusion income to its partners, participants, beneficiaries, or patrons (collectively, "owners") in accordance with applicable statutory provisions; n465.37 and inform any owners that are not disqualified organizations of the amount and character of the excess inclusion income that has been allocated to them.
- Pay the tax imposed on excess inclusion income n465.38 that is allocable to disqualified organizations.
- Apply the withholding tax provisions with respect to the excess inclusion portion of the payments made to foreign persons without regard to any treaty exception or reduction in tax rate. n465.39

With respect to excess inclusion income, a nominee must do the following: n465.40

- Inform the beneficial owners that are not disqualified organizations of the amount and character of their excess inclusion income.
- Pay the tax on the excess inclusion income of beneficial owners that are disqualified organizations. n465.41
- Apply the withholding tax provisions to the excess inclusion portion of the payments made to foreign persons without regard to any treaty exemption or reduction in tax rate. n465.42

With respect to its excess inclusion income, a RIC must do the following: n465.43

- Allocate its excess inclusion income to its shareholders in proportion to dividends paid (determined without regard to any special allocation of the expense for any tax paid). n465.44
- Inform shareholders who are nominees of the amount and character of the excess inclusion income that has been allocated to them.
- Pay the tax on excess inclusion income that is allocable to record shareholders that are disqualified organizations. n465.45
- Apply the withholding tax provisions to the excess inclusion portion of dividends paid to foreign shareholders without regard to any exemption or reduction in tax rate. n465.46

Pending the issuance of further guidance, except as provided in this paragraph, a RIC is not required to report the amount and character of the excess inclusion income allocated to its shareholders who are not nominees. For RIC taxable years beginning on or after January 1, 2007, the following requirements apply: n465.47

- A RIC must inform all of its shareholders that are not nominees regarding the amount and character of the excess inclusion income allocated to them if the excess inclusion income received by the RIC from all sources (including investments in REMIC residual interests) exceeds one percent of the gross income of the RIC.
- A RIC that is not subject to the reporting requirement in the preceding bullet must inform all of its shareholders that are not nominees regarding the amount and character of excess inclusion income allocated to them, taking into account only excess inclusion income allocated to the RIC from REITs

described in the following sentence. A REIT is described in this sentence if it reported to its shareholders for the most recent REIT taxable year ending not later than nine months before the first day of the RIC's taxable year that (1) a portion of the REIT's dividends for the year was excess inclusion income, and (2) this excess inclusion income exceeded three percent of the REIT's total dividends for the year. As an example, the reporting obligation described in this bullet applies to a fiscal year RIC for its taxable year beginning February 1, 2007, with respect to excess inclusion income allocated to the RIC by that REIT for the REIT's taxable year ending December 31, 2007, if the REIT had reported for its taxable year ending December 31, 2005, that its excess inclusion income exceeded three percent of its total dividends for that year.

[d] Transferors of Qualified Mortgages to a REMIC

If mortgages are transferred to a REMIC in exchange for a regular or residual interest, no gain or loss is recognized. n466 The adjusted basis of a regular or residual interest received by the transferor is equal to the adjusted basis of the mortgages transferred. n467

[4] Other features of REMICs

Other features characteristic of REMICs include:

- A REIT owning regular or residual interests in a REMIC is generally treated as holding real estate assets. n468
- A savings and loan institution owning regular or residual REMIC interests is generally treated as having made a qualifying real property loan. n469
- The original interest discount (OID) rules apply to interests in REMICs.
- The same withholding rules that apply for mortgage pass-through securities apply to interest paid to foreign holders of regular interests in a REMIC. For foreign holders of a residual REMIC interest, withholding is imposed at the statutory rate or lower treaty rate if the distributions are includable in gross income. n470

[5] Reporting Requirements for REMICs

A REMIC is generally required to file an income tax return with the Service annually. The Service has developed Form 1066, "U. S. Real Estate Mortgage Investment Conduit Income Tax Return," for this purpose. REMIC returns are due on the 15th day of the 4th month following the end of the REMIC's taxable year, n471 but an automatic 3-month filing extension is available if the REMIC timely files a proper application for an extension on Form 8736. n472

At the close of each calendar quarter, a REMIC is required to provide certain information outlined on Schedule Q (Form 1066) and in *Regulations Section 1.860F-4(e)(1)(i)(A)-(D)* to each person who held a residual interest in the REMIC during that quarter. Schedule Q generally must be mailed or otherwise delivered to each holder of a residual interest during a calendar quarter no later than the last day of the month following the close of the calendar quarter.

In addition, a REMIC and every issuer of a collateralized debt obligation must file Form 8811, "Information Return for Real Estate Mortgage Investment Conduits (REMICs) and Issuers of Collateralized Debt Obligations," unless all of the then-regular interests in the REMIC are owned by another REMIC. Form 8811 must be filed within 30 days after the start-up day (as defined by *IRC Section 860G(a)(9)*). Further, a REMIC must file a new Form 8811 within 30 days after a change of any information previously reported on Form 8811.

Other reporting requirements include those concerning the 95-percent asset test (outlined by *Regulations Section 1.860F-4(e)(1)(ii)*), and requirements for issuing Forms 1099 (described by *Regulations Section 1.6049-7(b)(2)*).

[6] Taxable Mortgage Pool (TMP)

Congress intended REMICS to be the only arrangement capable of issuing multiple-class real estate mortgage-backed securities without the *issuer* incurring a double layer of tax. Any arrangement that functions like a REMIC but fails to qualify as one is classified as a taxable mortgage pool (TMP). A TMP is generally any entity (other than a REMIC) that meets the following requirements: n473

- (1) substantially all of its assets consist of debt obligations (or interests in them), more than 50 percent of which consist of real estate mortgages or interests in them;
- (2) the entity has issued its own debt obligations with two or more maturities; and
- (3) under the terms of the debt obligations (or underlying arrangement), payments on the debt obligations bear a relationship to payments on the debt obligations or interests in them.

Any portion of an entity that meets the above definition is treated as a TMP. n474

The asset composition test (see item (1) in the above definition) is applied using the entity's tax bases in its assets. n475 Seriously impaired real estate mortgages are not treated as debt obligations for purposes of the asset composition test. Whether a real estate mortgage is seriously impaired generally depends on all facts and circumstances, n476 but two safe harbors are available. Under the safe harbors, whether a mortgage is seriously impaired depends only on the number of days that payments on the mortgage are delinquent (more than 89 days for single-family residential real estate mortgages, and more than 59 days for multi-family residential and commercial real estate mortgages). n477 The safe harbors are not available, however, if an entity is receiving or anticipates receiving certain payments on the mortgage. n478 If an entity makes reasonable efforts to resolve a mortgage and fails to do so within 180 days after the designated testing day, then the entity is treated as not having anticipated receiving payments on the mortgage. n479

Certain entities that liquidate within three years of acquiring their first asset n479.1 and certain governmental entities n479.2 are not treated as TMPs. If specified conditions are met, certain entities and funds, or portions of them, that are created in connection with the Public-Private Investment Program will also not be treated as being TMPs. n479.3

Real estate mortgages and interests in them include all obligations that are principally secured by an interest in real property, as well as regular and residual interests in a REMIC, and certain stripped bonds and coupons. n480 An obligation is "principally secured" by an interest in real property only if it meets one of the following tests: n481

- (1) the fair market value of the interest in real property securing the obligation was at least equal to 80 percent of the adjusted issue price of the obligation on the issue date; or
- (2) substantially all the proceeds of obligation were used to acquire, improve or protect an interest in real property that, at the origination date, was the only security for the obligation.

An obligation secured by a real estate mortgage is treated as an obligation secured by an interest in real property. That obligation, therefore, may itself qualify as a real estate mortgage. n482 An obligation secured both by real estate mortgages (or interests in them) and other assets is treated as secured by real property, but only to the extent of the combined value of the real estate mortgages and any real property that secures the obligation. n483-485

A TMP will be treated as a corporation. n486 Accordingly, the packaging of mortgages for resale in the secondary market through a TMP results in two tiers of taxation, once at the entity level and again at the "stockholder" level. However, a REIT may issue a TMP and be subject to only one level of tax. n487

In private letter rulings predating the issuance of final regulations, the Service ruled that certain corporate entities created to dispose of poorly-performing mortgages were not TMPs, but were partnerships. The Service's apparent rationale was that the entities intended to dispose of loans and distribute the proceeds of sale. Because a REMIC is created to *hold* a fixed pool of mortgages (and not quickly dispose of them), the entities were not functioning as REMICs, and therefore would not have to be classified as TMPs. n488

FOOTNOTES:

(n1)Footnote 417. The *Tax Reform Act of 1986* did not affect the taxation of fixed investment trusts which are classified as trusts under *Treas Reg § 301.7701-4(c)*. The Service treats these trusts as "grantor" trusts subject to the rules found in *IRC §§ 671-79*. See, eg, *Rev Rul 70-544, 1970-2 CB 6* ; *Rev Rul 70-545, 1970-2 CB 7* ; *Rev Rul 71-399, 1971-2 CB 433* ; *Rev Rul 75-192, 1975-1 CB 384* ; *Rev Rul 77-59, 1977-1 CB 196* ; *Rev Rul 77-349, 1977-2 CB 20* ; *Rev Rul 84-10, 1984-1 CB 155* .

(n2)Footnote 418. See *IRC § 860D(a)(1), (b)(1)*.

(n3)Footnote 419. *Treas Reg § 1.860F-2(b)(2)*.

(n4)Footnote 420. *Treas Reg § 1.860D-1(c)*.

(n5)Footnote 421. See *IRC § 1.860D(a)(1)*.

(n6)Footnote 422. *Treas Reg § 1.860D-1(d)*.

(n7)Footnote 423. *Treas Reg § 301.9100-1, 301.9100-3*; see, eg, *Ltr Ruls 200533018, 200413003, 200323007, 200219007, 200124015, 200117032, 200117030, 200101017, 200040015, 9931031, 9808041, 9802035, 9309043*.

(n8)Footnote 424. *IRC § 860D(a)(2)*.

(n9)Footnote 425. *Treas Reg § 1.860G-2(k)*.

(n10)Footnote 426. See *Treas Reg § 1.860G-1(a)(3)*; variable rate regulations set forth a qualified floating rate and an objective rate (*Reg § 1.1275-5(b), (c)*), but regular interests in REMICs are not permitted to use objective rates.

(n11)Footnote 427. *IRC § 860G(a)(1)*.

(n12)Footnote 428. *IRC § 860G(a)(1)*.

(n13)Footnote 428.1. *IRC § 860G(a)(1)*.

(n14)Footnote 429. *Treas Reg § 1.860G-1(a)*.

(n15)Footnote 430. *Treas Reg § 1.860G-1(a)(3)(i), (ii)*.

(n16)Footnote 431. *Treas Reg § 1.860G-1(a)(3)(iv)*.

(n17)Footnote 432. *Treas Reg § 1.860G-1(a)(3)(i)-(v)*.

(n18)Footnote 433. *IRC § 860G(a)(2)*.

(n19)Footnote 434. *IRC § 860D(a)(3)*.

(n20)Footnote 435. *IRC § 860D(a)(4)*.

(n21)Footnote 435.1. For this purpose, an obligation secured by stock held by a person as a tenant-stockholder in a cooperative housing corporation under *IRC § 216* is treated as secured by an interest in real property (*IRC § 860G(a)(3)*).

(n22)Footnote 435.2. *IRC § 860G(a)(3)(A)(iii)*; this item is effective Jan 1, 2005.

(n23)Footnote 435.3. *IRC § 860G(a)(3)*.

(n24)Footnote 435.3.1. *Treas Reg § 1.860G-2(a)(1)*. See Ltr Rul 200518033 (in applying the 80-percent test with respect to a hospital, the IRS allowed taxpayer to use value of land as determined by a HUD loan appraisal, and the value of improvements as determined by their actual replacement costs, as audited and certified after construction of the hospital).

(n25)Footnote 435.3.2. *Treas Reg § 1.860G-2(a)(1)(i)*.

(n26)Footnote 435.3.3. *Treas Reg § 1.860G-2(a)(1)(ii)*.

(n27)Footnote 435.4. *IRC § 860G(a)(3)*, effective Jan 1, 2005.

(n28)Footnote 435.5. Conference Report to Pub L No 108-357.

(n29)Footnote 436. *IRC § 860G(a)(3)*.

(n30)Footnote 436.1. *IRC § 860G(a)(3)(D)*, before repeal by Pub L No 108-357.

(n31)Footnote 436.2. Former *IRC §§ 860H through 860L*, repealed by Pub L No 108-357, § 835(a).

(n32)Footnote 436.3. Pub L No 108-357, § 835(c)(2).

(n33)Footnote 437. *IRC § 860G(a)(4)*.

(n34)Footnote 438. *Treas Reg § 1.860G-2(f)(iv)*.

(n35)Footnote 438.1. *IRC § 860G(5)(A)*, (6).

(n36)Footnote 438.2. *IRC § 860G(a)(5)(B),(7)(B)*; see *IRC § 860G(a)(3)(a)(3)(A)(ii), (iii)*.

(n37)Footnote 439. *IRC § 860G(a)(5)(C), (8)*. REMICs may request private letter rulings that property acquired in connection with the foreclosure of loans will qualify as foreclosure property (see Ltr Ruls 9721005, 9720014, 9630004).

(n38)Footnote 440. *IRC § 860D(a)*.

(n39)Footnote 441. *IRC § 860D(a)(5)*.

(n40)Footnote 442. *IRC § 860D(a)(6)*.

(n41)Footnote 443. *IRC § 860E(e)(5)*.

(n42)Footnote 444. *Treas Reg § 1.860D-1(b)(5)*.

(n43)Footnote 445. *IRC § 860E(e)(2)*.

(n44)Footnote 445.1. *Treas Reg § 1.860G-2(b)(1)*.

(n45)Footnote 445.2. *Treas Reg § 1.860G-2(b)(2)*.

(n46)Footnote 445.3. *Treas Reg § 1.860G-2(b)(3)*.

(n47)Footnote 445.3.1. See *Treas Reg § 1.860G-2(b)(7)*. See § 16.03[1][h], below, for a discussion.

(n48)Footnote 445.3.2. See *Treas Reg § 1.860G-2(b)(7)*.

(n49)Footnote 445.3.3. See *Treas Reg § 1.860G-2(b)(7)*. See § 16.03[1][h], below, for a discussion.

(n50)Footnote 445.3.4. *Rev Proc 2009-45, 2009-40 IRB 471* , effective for loan modifications to loan modifications effected on or after Jan 1, 2008.

(n51)Footnote 445.3.5. *Rev Proc 2009-45* , § 6, *2009-40 IRB 471* .

(n52)Footnote 445.3.6. See *Treas Reg § 1.860G-2(b)(3)*.

(n53)Footnote 445.3.7. See *IRC § 860F(a)(2)(A)(i)-(iv)*.

(n54)Footnote 445.3.8. See *Treas Reg § 301.7701-4(c)*.

(n55)Footnote 445.3.9. See *Treas Reg § 1.1001-3*.

(n56)Footnote 445.3.10. *Rev Proc 2009-45* , § 5, *2009-40 IRB 471* .

(n57)Footnote 445.3.11. *Rev Proc 2009-45* , §§ 5, 7, *2009-40 IRB 471* .

(n58)Footnote 445.4. *Rev Proc 2007-72, 2007-52 IRB 1257* . The procedure is effective Dec 6, 2007.

(n59)Footnote 445.5. *Rev Proc 2007-72* , § 5, *2007-52 IRB 1257* .

(n60)Footnote 445.6. *Rev Proc 2007-72* , § 5, *2007-52 IRB 1257* .

(n61)Footnote 445.7. *Rev Proc 2007-72* , § 6, *2007-52 IRB 1257* .

(n62)Footnote 445.8. See *Treas Reg § 1.860G-2(b)(3)*.

(n63)Footnote 445.9. See *IRC § 860F(a)(2)*.

(n64)Footnote 445.10. See *IRC § 860F(a)(2)(A)(i)-(iv)*.

(n65)Footnote 445.11. *Rev Proc 2008-47, 2008-31 IRB 272* . The updated Framework is attached as an Appendix to the revenue procedure.

(n66)Footnote 445.12. *Rev Proc 2008-47* , § 5.01, *2008-31 IRB 272* .

(n67)Footnote 445.13. *Rev Proc 2008-47* , § 5.02, *2008-31 IRB 272* .

(n68)Footnote 445.14. *Rev Proc 2008-28, 2008-23 IRB 1054* .

(n69)Footnote 445.15. *Rev Proc 2008-28* , §§ 6, 8, *2008-23, IRB 1054*. The procedure applies only to determinations made by the IRS on or after May 16, 2008, with respect to loan modifications that are effected on or before Dec 31, 2008.

(n70)Footnote 445.16. *Rev Proc 2008-28* , § 6, *2008-23 IRB 1054* .

(n71)Footnote 445.16.01. *Rev Proc 2009-23, 2009-40 IRB 884* , effective for loan modifications on or after March 4, 2009. Details of the HAMP program are available at <http://www.makinghomeaffordable.gov>.

(n72)Footnote 445.16.02. *Rev Proc 2009-23, 2009-40 IRB 884* , § 6.

(n73)Footnote 445.16.03. See *IRC § 860F(a)(1)*.

(n74)Footnote 445.16.04. See *Treas Reg § 301.7701-4(c)*.

(n75)Footnote 445.16.1. See *Treas Reg § 1.860G-2(b)(3)(v), (vi)*, discussed in § 16.03[1][g], above.

(n76)Footnote 445.16.2. See *Treas Reg § 1.860G-2(a)(8)*.

(n77)Footnote 445.16.3. *Treas Reg § 1.860G-2(b)(7)*.

(n78)Footnote 446. *IRC § 860A(a)*.

(n79)Footnote 447. *IRC § 860F(e)*.

(n80)Footnote 448. *IRC § 860A(b)*.

(n81)Footnote 449. *IRC § 860F(a)*.

(n82)Footnote 450. *IRC § 860F(a)(2)(A)*.

(n83)Footnote 451. *IRC § 860F(a)(2)(B)-(D)*.

(n84)Footnote 452. *IRC § 860F(a)(4)*.

(n85)Footnote 453. *IRC § 860G(a)(1)*.

(n86)Footnote 454. *IRC § 860B(a)*.

(n87)Footnote 455. *IRC § 860B(b)*.

(n88)Footnote 456. *IRC § 1274(d)*.

(n89)Footnote 457. *IRC § 860B(c)*.

(n90)Footnote 458. *IRC § 860G(a)(10)*.

(n91)Footnote 459. *IRC § 860C(a)(1)*.

(n92)Footnote 459.1. See *IRC § 860C(a)(1)*.

(n93)Footnote 459.2. See *IRC §§ 871(a), 881, 1441, 1442*.

(n94)Footnote 459.3. *IRC § 860G(b)*.

(n95)Footnote 459.4. *IRC § 860G(b)(1)*.

(n96)Footnote 459.5. *Treas Reg § 1.860G-3(b)(1)*.

(n97)Footnote 459.6. *Treas Reg* § 1.860G-3(b)(2).

(n98)Footnote 459.7. *Treas Reg* § 1.860A-1(b)(5). See *IRC* § 860C(a)(1)

(n99)Footnote 459.7.1. *Treas Reg* § 1.863-1(e)(2).

(n100)Footnote 459.7.2. See *Treas Reg* § 1.860G-3(b)(2).

(n101)Footnote 459.7.3. See *Treas Reg* § 1.860G-3(b)(1).

(n102)Footnote 459.7.4. *Treas Reg* § 1.1441-2(b)(5).

(n103)Footnote 459.8. See *Treas Reg* § 1.1441-2(d).

(n104)Footnote 459.8.1. *Treas Reg* § 1.1441-2(d)(4); see *Treas Reg* § 1.860G-3(b)(1). This rule is effective for payments made after Aug 10, 2006 [*Treas Reg* § 1.1441-2(f)].

(n105)Footnote 459.9. *IRC* § 860E(a)(1).

(n106)Footnote 459.10. *IRC* § 860E(a)(3). See *IRC* § 172.

(n107)Footnote 459.11. See *IRC* § 860E(a)(3).

(n108)Footnote 459.12. *Rev Rul* 2005-68, 2005-2 CB 853 .

(n109)Footnote 460. *IRC* § 860C(d).

(n110)Footnote 461. *IRC* § 860C(c).

(n111)Footnote 462. *IRC* § 860E(c).

(n112)Footnote 463. *IRC* § 860E(a).

(n113)Footnote 464. *IRC* § 860E(b).

(n114)Footnote 465. *Rev Rul* 95-81, 1995-2 CB 70 .

(n115)Footnote 465.1. *Treas Reg* § 1.860E-1(c); the regulations are generally effective to transfers occurring on or after February 4, 2000. Taxpayers may, however, choose to apply a prior interest rate formula set forth in the proposed regulations and *Revenue Procedure* 2001-12 for transfers occurring before August 19, 2002. *Revenue Procedure* 2001-12 is obsolete for transfers of noneconomic residual interests in REMICs occurring on or after August 19, 2002.

(n116)Footnote 465.2. *Treas Reg* § 1.860E-1(c)(1).

(n117)Footnote 465.3. *Treas Reg* § 1.860E-1(c)(4)(i).

(n118)Footnote 465.4. *Treas Reg* § 1.860E-1(c)(4)(ii).

(n119)Footnote 465.5. *Treas Reg* § 1.860E-1(c)(4)(iii).

(n120)Footnote 465.6. *Treas Reg* § 1.860E-1(c)(4)(iv).

(n121)Footnote 465.7. *Treas Reg* § 1.860E-1(c)(5).

(n122)Footnote 465.8. *Treas Reg* § 1.860E-1(c)(5)(i).

(n123)Footnote 465.9. *Treas Reg § 1.860E-1(c)(5)(iii)*.

(n124)Footnote 465.10. *Treas Reg § 1.860E-1(c)(7)*.

(n125)Footnote 465.11. *Treas Reg § 1.860E-1(c)(8)(i)*.

(n126)Footnote 465.12. *Treas Reg § 1.860E-1(c)(8)(ii)*.

(n127)Footnote 465.13. *Treas Reg § 1.860E-1(c)(8)(iii)*.

(n128)Footnote 465.14. *Treas Reg § 1.446-6*, effective for taxable years ending on or after May 11, 2004 (*Reg § 1.446-6(g)*).

(n129)Footnote 465.15. *Treas Reg § 1.446-6(a)*.

(n130)Footnote 465.16. *Treas Reg § 1.446-6(c)*.

(n131)Footnote 465.17. *Treas Reg § 1.446-6(e)*.

(n132)Footnote 465.18. *Treas Reg § 1.446-6(e)(1)*.

(n133)Footnote 465.19. *Treas Reg § 1.446-6(e)(2)*; see *Treas Reg § 1.860F-2(b)(4)(iii)*; the Commissioner is authorized to provide additional safe harbors (*Reg § 1.446-6(e)(3)*).

(n134)Footnote 465.20. *Treas Reg § 1.446-6(d)*; see *IRC § 381(c)(4)*.

(n135)Footnote 465.21. See *IRC §§ 446, 481*.

(n136)Footnote 465.22. *Treas Reg § 1.446-6(f)*; see *IRC § 446(e)*.

(n137)Footnote 465.23. See *IRC § 863*.

(n138)Footnote 465.24. *Treas Reg § 1.863-1(e)*.

(n139)Footnote 465.25. *IRC § 860E(e)(6)(A)*.

(n140)Footnote 465.26. *IRC § 860E(e)(6)(B)*.

(n141)Footnote 465.27. *IRC § 860E(e)(5)(B)*.

(n142)Footnote 465.28. *IRC § 860E(e)(6)*; see *Rev Rul 2006-58, 2006-2 CB 876* (application of the tax to a REIT [or a partnership] with excess inclusion income that has a charitable remainder trust as a shareholder [or a partner]).

(n143)Footnote 465.29. *IRC § 860E(d)(1)*.

(n144)Footnote 465.30. *IRC § 860E(d)(2)*.

(n145)Footnote 465.31. See *IRC § 7701(i)* for a definition.

(n146)Footnote 465.32. *Notice 2006-97, 2006-2 CB 904*.

(n147)Footnote 465.33. *Notice 2006-97, 2006-2 CB 904*; see *IRC §§ 860E(d), 860E(e)(6), 7701(i)*.

(n148)Footnote 465.34. See *IRC § 860E(e)(6)*.

- (n149)Footnote 465.35. See *IRC § 860G(b)(2)*.
- (n150)Footnote 465.36. *Notice 2006-97, 2006-2 CB 904*
- (n151)Footnote 465.37. See *IRC §§ 584, 641-692, 702, 1381-1383*.
- (n152)Footnote 465.38. See *IRC § 860E(e)(6)*.
- (n153)Footnote 465.39. See *IRC § 860G(b)(2)*.
- (n154)Footnote 465.40. *Notice 2006-97, 2006-2 CB 904*
- (n155)Footnote 465.41. See *IRC § 860E(e)(6)*.
- (n156)Footnote 465.42. *IRC § 860G(b)(2)*.
- (n157)Footnote 465.43. *Notice 2006-97, 2006-2 CB 904* .
- (n158)Footnote 465.44. See *IRC § 860E(e)(6)*.
- (n159)Footnote 465.45. See *IRC § 860E(e)(6)*.
- (n160)Footnote 465.46. *IRC § 860G(b)(2)*.
- (n161)Footnote 465.47. *Notice 2006-97, 2006-2 CB 904* .
- (n162)Footnote 466. *IRC § 860F(b)(1)(A)*.
- (n163)Footnote 467. *IRC § 860F(b)(1)(B)*.
- (n164)Footnote 468. *IRC § 856(c)(5)(E)*.
- (n165)Footnote 469. *IRC § 593(d)(4)*.
- (n166)Footnote 470. *IRC § 860G(b)*.
- (N167)Footnote 471. *IRC § 6072(a)*.
- (n168)Footnote 472. *Treas Reg § 1.6081-7*.
- (n169)Footnote 473. *IRC § 7701(i)(2)(A)*.
- (n170)Footnote 474. *IRC § 7701(i)(2)(B)*.
- (n171)Footnote 475. *Treas Reg § 301.7701(i)-(c)(1)*.
- (n172)Footnote 476. *Treas Reg § 301.7701(i)-1(c)(5)(i)*.
- (n173)Footnote 477. *Treas Reg § 301.7701(i)-1(c)(5)(ii)(A)*.
- (n174)Footnote 478. *Treas Reg § 301.7701(i)-1(c)(5)(ii)(A)*.
- (n175)Footnote 479. *Treas Reg § 301.7701(i)-1(c)(5)(ii)(C)*.
- (n176)Footnote 479.1. *Treas Reg § 301.7701(i)-(1)(f)(3)(iv)*.

(n177)Footnote 479.2. *Treas Reg § 301.7701(i)-4.*

(n178)Footnote 479.3. *Rev Proc 2009-38, 2009-37 IRB 362 .*

(n179)Footnote 480. *Treas Reg § 301.7701(i)-1(d)(1).*

(n180)Footnote 481. *Treas Reg § 301.7701(i)-1(d)(3)(i).*

(n181)Footnote 482. *Treas Reg § 301.7701(i)-1(d)(3)(ii)(A).*

(n182)Footnote 483-485. *Treas Reg § 301.7701(i)-1(d)(3)(ii)(A).*

(n183)Footnote 486. *IRC § 7701(i)(1).*

(n184)Footnote 487. *IRC § 7701(i)(3).*

(n185)Footnote 488. *Ltr Ruls 9511006; 9507002; 9442016.*

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CHAPTER 16 Special Forms of Holding Real Estate *

1-16 Federal Taxes Affecting Real Estate § 16.04

§ 16.04 Condominiums

[1] Overview

Condominiums are building complexes with common facilities, such as, stairways, hallways, ground-floor facilities and recreational areas. Each unit within the complex is owned individually, and common areas are owned either by a common owners' management association or by all the individual unit owners as tenants in common.

The Service has ruled that a condominium unit will be treated as any other real property for federal income tax purposes. n489 All the tax advantages of a homeowner also belong to the condominium owner. Interest on mortgages, real estate taxes, casualty losses and profit from the sale of a unit are all reportable items of the taxpayer. The deductibility of real estate taxes is subject to one restriction. In cases where condominiums are built on land leased by the unit owner, the real estate tax deduction may be lost to those unit owners, because the lessor is entitled to the deduction.

Unlike the cooperative residence (discussed in *Section 16.05*, below), each condominium owner takes title to his or her own unit and obtains a separate mortgage. If any individual owner cannot meet mortgage and tax payments on a unit, the other owners do not become responsible for the payments.

It should be noted that costs incurred by a homeowner in litigation against a homeowners' association are not probably not deductible under *IRC Section 212*. Although the production or collection of income might be a consequence of a successful claim, the origin of the claim--at least with respect to a homeowner's personal residence--is personal in nature. Therefore, the Tax Court and the Fifth Circuit have held that legal and other expenses connected with the claim are not deductible because they are not related to a trade or business or an income-producing activity. n489.1

[2] Tax-Exempt Homeowners' Association Status

Condominiums are usually managed by condominium management associations owned by the unit owners or developers of the condominium. Condominium management associations are considered homeowners' associations and are given favorable tax treatment if they satisfy the criteria set forth in the Code. n490

Five tests must be satisfied by the condominium management association before it will qualify as a tax-exempt homeowners' association. First, substantially all of the units of the condominium must be used by individuals for

residential purposes. n491 Second, the association must be organized and operated for the "acquisition, construction, management, maintenance, and care of association property." n492 Third, 60 percent or more of the gross income of the association must be derived from membership dues, fees or assessments from owners of the residential property. n493 Fourth, 90 percent or more of the association's expenditures must constitute expenditures for the "acquisition, construction, management, maintenance and care of 'association property' ." n494 Finally, no part of the association's net earnings may inure to the benefit of any private shareholder or individual. n495

A condominium management association must elect tax-exempt status. n496 The effect of such an election is to tax the association only on its net income from investments and business with nonmembers. n497 Note that the election prohibits the association from deriving benefits from any excess allowable deductions connected with its membership income and any operating losses carried over from other years. As a result, if the association's allowable deductions related to membership income, plus any operating losses carried over from other years, exceed the association's membership income, the association could possibly pay more tax with the election than without it. Qualified associations of holders of timeshare interests may also elect to be taxed like other homeowners associations. n498 An election to be treated as a homeowners association is made by filing a Form 1120-H for each tax year. n499 The election generally must be made no later than the time, including extensions, for filing an income tax return for the year in which the election is to apply, n500 but the IRS can grant extensions of time for making the election. n501 The IRS has also allowed taxpayers to revoke an election to be treated as a homeowners' association. n501.1

FOOTNOTES:

(n1)Footnote 489. *Rev Rul 64-31, 1964-1 CB 300* .

(n2)Footnote 489.1. *Colvin v Commr, TC Memo 2004-67, affd in unpubl opinion 122 Fed Appx 788 (5th Cir 2005)* , citing *US v Gilmore, 372 US 39 (1963)* . The *Colvin* case has been the subject of critical commentary [see Daley, "More Attorney Fee Puzzles," *110 Tax Notes* 291 (Jan 16, 2006), and Wood, "Wood Responds to Daley on Attorney Fee Puzzles," *110 Tax Notes* 413 (Jan 23, 2006)].

(n3)Footnote 490. See *IRC § 528*.

(n4)Footnote 491. *IRC § 528(c)(2)*.

(n5)Footnote 492. *IRC § 528(c)(1)(A)*.

(n6)Footnote 493. *IRC § 528(c)(1)(B)*.

(n7)Footnote 494. *IRC § 528(c)(1)(C)*.

(n8)Footnote 495. *IRC § 528(c)(1)(D)*.

(n9)Footnote 496. *IRC § 528(c)(2)(E)*.

(n10)Footnote 497. See *IRC § 528(d)*.

(n11)Footnote 498. *IRC § 528(c)(1)*, effective for tax years beginning after Dec 31, 1996.

(n12)Footnote 499. *Treas Reg § 1.528-8(a)*.

(n13)Footnote 500. *Treas Reg § 1.528-8(b)*.

(n14)Footnote 501. *Ltr Ruls 9931045, 200203027, 201016008*.

(n15)Footnote 501.1. *Ltr Rul 200344017* .

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CHAPTER 16 Special Forms of Holding Real Estate *

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§ 16.05 Cooperative Housing Corporations

Another form of ownership that combines some of the nontax advantages of renting with the tax benefits of ownership is the housing cooperative. Unlike condominiums, the land and buildings of a housing cooperative are owned by a cooperative corporation which is responsible for the taxes and mortgage on the property. Each resident buys shares in the corporation, which, in turn, gives the resident the right to lease a particular unit. Because this arrangement confers more elements of ownership on the resident than a conventional lease, the term "proprietary lease" is usually used to describe the lease. Although each owner is not individually liable on the mortgage, each owner must pay a pro rata share of the mortgage and attendant interest.

If the corporation meets certain requirements, the tenant-stockholder is entitled to a deduction of a proportionate share of both the taxes on the property and the interest on the indebtedness incurred by the corporation in acquiring the buildings and land. n502 A tenant-stockholder who uses a housing unit in a trade or business or for the production of income is also entitled to a deduction for depreciation. n503 Corporations, trusts, estates, partnerships, or other entities may qualify as tenant-stockholders of cooperative housing corporations. n504

NOTE:

Although tenant-stockholders may deduct their proportionate share of the co-op's real estate taxes for regular tax purposes, n504.1 the Tax Court, affirmed by the Second Circuit, has ruled that those taxes cannot be taken into account in computing alternative minimum taxable income for purposes of the AMT. n504.2

A corporation must meet the following requirements before the tenant-stockholder will qualify for the above deductions:

- (1) With very minor exceptions, only one class of stock may be outstanding. n505
- (2) Each stockholder must be entitled, solely by reason of his stock ownership, to occupy a housing unit owned or leased by the corporation. n506
- (3) No stockholder may be entitled to receive distributions other than from earnings and profits, except upon partial or complete liquidation of the corporation. n507

(4) At least one of the following three alternative tests: (a) At least 80 percent of the corporation's gross income during the taxable year must be derived from the tenant-stockholders; (b) At all times during the taxable year, at least 80 percent of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to that residential use; or (c) At least 90 percent of the expenditures of the corporation paid or incurred during the taxable year are paid or incurred for the acquisition, construction, management, maintenance, or care of the corporation's property for the benefit of the tenant-stockholders. n507.1 For tax years ending before December 21, 2007, at least 80 percent of the corporation's gross income during the year had to be derived from the tenant-stockholders. The other two alternatives were not available. n507.2

NOTE:

The reason for the addition of two non-income-based alternatives to the 80-percent gross income test was Congress' concern that some cooperative housing corporations were forced into renting space to commercial tenants at below-market rates in order to satisfy the 80-percent rule. It is hoped that the availability of the new alternatives will discourage any incentive to charge below-market-rate rents. n508 Rulings occasionally address whether particular items qualify as income derived from tenant-stockholders for purposes of the 80-percent test. n508.1

Failure of the corporation to meet these requirements in a given tax year may result in the tenant-stockholder being denied all homeowner tax benefits for that year. The determination of cooperative housing corporation status must be made each year and independently of other years. A taxpayer's status can therefore change from year to year. A taxpayer's failure to qualify for cooperative housing corporation status in one year does not affect its qualification for other years. n508.2

The IRS occasionally issues letter rulings with respect to whether the issuance of stock to *non-residential* units in a cooperative housing corporation satisfies the requirements of *IRC Section 216(b)(1)*. Almost always, the ruling is favorable, because the nonresidential unit qualifies as an "apartment in a building" which the taxpayer is entitled to occupy by reason of stock ownership in the cooperative corporation. n509 A unit qualifies as an apartment if: (1) the stockholder is entitled to convert the unit to an apartment; (2) the conversion of the unit would be reasonable under all facts and circumstances, including structural feasibility and costs; and (3) applicable local zoning, building, and fire codes permit both the conversion and the residential use of the unit as a matter of right. n510 The IRS has also ruled that a person who purchases stock attributable to a nonresidential unit for the commercial use of that space qualifies as "tenant-stockholder" for purposes of *IRC Section 216(b)(2)*, provided that stock is fully paid up in an amount that bears a reasonable relationship to the portion of the value of the taxpayer's equity in the building and land that was attributable to the unit. n510.1

The IRS also made a ruling involving a cooperative which, in connection with below-market private financing and subsidized governmental financing, was required to include low income and moderate income units and impose income eligibility requirements, limitations on purchase prices, and restrictions on resale with respect to certain residential units in the building. The IRS ruled that these requirements would not cause any person to fail to qualify as a tenant-stockholder or prevent the cooperative from qualifying as a "cooperative housing corporation." The ruling was conditioned on the stock being fully paid up in an amount that bore a reasonable relationship to the portion of the value of cooperative's equity in the building and land that was attributable to the unit that the purchaser was entitled to occupy. It also was conditioned on the cooperative's representation that it could issue only one class of stock and that all outstanding shares conferred identical rights to distribution and liquidation proceeds to the tenant-stockholders. n510.1.1

The fact that the tenant-stockholders are entitled to these deductions for regular tax purposes does not change the tax

status of the corporation. The corporation must report its rental income and may deduct taxes, interest, depreciation, and other operating expenses in the same manner as it would if it was not a cooperative. n510.2

Several rulings have dealt with whether a cooperative housing corporation is entitled to deduct real estate taxes paid with respect to a building or land it leases from a landlord. Ordinarily, taxes paid by a tenant to or for a landlord for business property constitute additional rents deductible by the tenant as an ordinary and necessary business expense only in connection with the carrying on of a trade or business. n510.3 The additional rent is taxable income to the landlord, and the only the landlord is entitled to deduct real estate taxes. n510.4 This general rule has been applied to prevent a lessee cooperative housing corporation from deducting real estate taxes it was required to pay on a building it leased from a landlord. Although the useful life of the building was less than the term of the lease, the lessor was treated as the owner of the building for purposes of *IRC Section 164* because the lessor received rental income attributable to the building. The building was pre-existing and was not constructed by the lessee. Accordingly, the lessee was not treated as the owner of the building for purposes of *IRC Section 164*, and the tenant-stockholders of the lessee were not allowed a *IRC Section 216(a)* deduction for amounts paid to the lessee representing their proportionate shares of the taxes paid. n510.5 A lessee cooperative housing corporation can be entitled to a deduction for real estate taxes, however, if it is treated as owner of the building for purposes of *IRC Section 164*. This can happen when the lessee constructs the building with its own funds on leased land, and the building has a substantially shorter useful life than the term of the ground lease. In that case, no portion of the rent received by the landlord is attributable to the building, so the lessee is allowed a deduction for real estate taxes paid on the building (but not the underlying land). This deduction passes through to the tenant-stockholders of the lessee, who are allowed an *IRC Section 216(a)* deduction for their proportionate shares of the real estate taxes paid with respect to the building. n510.6 A deduction is allowed only to the extent the taxes are attributable to the portion of the building containing the tenant-stockholders' dwelling units, and are not attributable to the remainder of the building or the land.

FOOTNOTES:

(n1)Footnote 502. *IRC § 216*.

(n2)Footnote 503. *IRC § 216(c)*.

(n3)Footnote 504. *IRC § 216*.

(n4)Footnote 504.1. *IRC § 216*.

(n5)Footnote 504.2. *Ostrow v Commr*, 122 TC 378 (2004) , *affd* 430 F3d 581 (2nd Cir 2005) , citing *IRC § 56(b)(1)(A)(ii)*.

(n6)Footnote 505. *IRC § 216(b)(1)(A)*.

(n7)Footnote 506. *IRC § 216(b)(1)(B)*. In Rev Rul 85-147, 1985-2 CB 86 , the Service held that shareholders could not deduct their proportionate share of the real estate taxes and interest paid by the corporation that owned the land on which house trailers were parked, since the shareholders derived their right to occupy the house trailers by reason of outright ownership rather than by reason of stock ownership. The outright ownership of the trailer park by the shareholders disqualified the corporation as a cooperative housing corporation. In Rev Rul 80-299, 1980-2 CB 82 , the Service held that the inability of a purchaser of stock to obtain occupancy of the apartment for which he obtains a proprietary lease, because the apartment is occupied by a tenant protected by rent control laws, will not prevent the purchaser from having the requisite occupancy rights.

(n8)Footnote 507. *IRC § 216(b)(1)(C)*.

(n9)Footnote 507.1. *IRC § 216(b)(1)(D)*, effective for taxable years ending after December 20, 2007 [Pub Law No 110-142, § 4(b)].

(n10)Footnote 507.2. *IRC § 216(b)(1)(D), before amendment by Pub Law No 110-142, § 4.*

(n11)Footnote 508. See *IRC § 216(b)(1)(D)*.

(n12)Footnote 508.1. *Ltr Rul 200329032* (amounts paid by tenant-stockholders to the cooperative housing corporation for use of an off-site garage rented by the corporation qualify as income from tenant stockholders); *Rev Rul 68-387, 1968-2 CB 112* (amounts received by a cooperative housing corporation from its tenant-stockholders to defray expenses associated with their occupancy of a garage or parking space qualify as income derived from tenant-stockholders, provided that the amounts were not received from commercial leases or from the operation of a non-housing trade or business); *Rev Rul 79-137, 1979-1 CB 118* (revenue generated by a cooperative housing corporation from real estate brokerage services provided to its tenant-stockholders in connection with the transfer of their apartment units and which was applied against recurring expenses for repair and maintenance of the corporation's property was income derived from tenant-stockholders). In *Ltr Rul 200324024* the taxpayer proposed to distribute to its current tenant-stockholders shares of stock that would be allocated to the nonresidential spaces. The tenant-stockholders then planned, but would not be required, to contribute the shares of stock allocated to the nonresidential spaces to an LLC in exchange for a stated percentage of the membership interests in the LLC. The LLC would perform certain activities in connection with its ownership of the shares of stock allocated to the nonresidential spaces. IRS ruled that income the taxpayer received from the LLC, or from any tenant-stockholders who chose not to transfer their shares to the LLC, would be income derived from tenant-stockholders, provided that the stock of all the tenant-stockholders (including the LLC) was fully-paid up, as required by *IRC § 216(b)(2)*.

(n13)Footnote 508.2. See *IRC § 216(b); FSA 200011002* .

(n14)Footnote 509. See *Ltr Ruls 200602030, 200533005* (cooperative housing corporation formed an LLC to receive shares allocated to commercial units, and distributed the membership interests in the LLC to the tenant-stockholders), *200406021, 200339050, 200327058, 200324024, 200232029, 200232031, 200217042, 200135014, 200125013, 9851038; 9829003; 9649017; 9637031; 9743030; 9802047* (various rulings regarding effect of distribution of nonresidential co-op shares to current tenant-stockholders, who planned to distribute them to an LLC in exchange for shares in the LLC).

(n15)Footnote 510. *Rev Rul 74-241, 1974-1 CB 68 ; Rev Rul 90-35, 1990-1 CB 48* .

(n16)Footnote 510.1. *Ltr Ruls 200602030, 200339050* .

(n17)Footnote 510.1.1. *Ltr Rul 201029018* .

(n18)Footnote 510.2. See *FSA 200011002* (housing cooperative may take advantage of NOLs).

(n19)Footnote 510.3. *Treas Reg § 1.162-11(a)*.

(n20)Footnote 510.4. *IRC § 164*.

(n21)Footnote 510.5. *Rev Rul 62-177, 1962-2 CB 89* .

(n22)Footnote 510.6. *Rev Rul 62-178, 1962-2 CB 91 ; Ltr Rul 200612010 ; Ltr Rul 200921023* .

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§ 16.06 Employee Benefit Trusts

[1] Real Estate Investments in General

In 1969, legislation was enacted which severely limited the ability of a retirement or employees' trust to leverage investments through the use of debt. n511 This legislation provided that income received by a tax-exempt organization from debt-financed property would be subject to tax in the proportion of the average debt to average adjusted tax basis. n511.1 Because real estate is typically acquired through debt financing, the effect of this provision was to render real estate a largely taxable means of investment to otherwise tax-exempt employees' trusts. As a result, real estate became economically undesirable to such organizations.

The intent of the 1969 legislation was to prevent tax-exempt organizations from abusing their status; however, an unintended consequence was that of preventing tax-exempt organizations from making wise and prudent investments in real property. As a result, several exemptions have been added over the years that specifically exclude income from real property from the debt-financing UBIT rules for specified qualified organizations. n512 Qualified organizations include the following:

- qualified pension and retirement plans qualified under *IRC Section 401*;
- certain educational organizations; n512.1
- certain title-holding corporations and trusts organized for the exclusive purpose of acquiring, holding title to, and collecting income from real property, and turning over the entire amount less expenses to certain exempt member organizations; n512.2 and
- retirement income accounts of a churches (or certain other organizations). n513

To eliminate the most egregious abuses addressed in the 1969 legislation, specific limitations are included in the statute. In general these limitations are as follows:

- (1) The acquisition price must be fixed at the date of acquisition.

- (2) The amount of indebtedness cannot be dependent upon future revenues or profits.
- (3) The property cannot be leased by the trust to the seller or a related party thereof.
- (4) The property cannot be acquired from a party related to the trust or educational entity or leased to such a party.
- (5) The seller, a person related to the seller or a person related to the trust or educational entity cannot provide financing.
- (6) The property cannot be held by a partnership, unless the partnership meets specified requirements, discussed in § 16.06[2], below. n514

Thus, subject to the above limitations, real property has become a viable investment for employees' trusts; however, special rules apply if the investment is made through a partnership as described in the following *Section 16.06[2]*, below.

[2] Investments in Partnership With Tax-Exempt Entities

The rule that allows tax-exempt organizations to escape the unrelated business income tax on income from debt-financed real property is limited (by the *Revenue Act of 1987*) with respect to its use by tax-exempt entities that are in a partnership with taxable entities. For property acquired after October 13, 1987, or for partnership interests acquired after that date, tax-exempt organizations in a partnership with taxable entities have to treat income from debt-financed real property as unrelated business taxable income, unless the partnership allocations are *qualified allocations* or permissible *disproportionate allocations*. n515

An allocation to a tax-exempt entity is considered a *qualified allocation* if such entity is allocated the same distributive share of income, gain, loss, deduction, credit and basis during the entire period the entity is a partner, and the allocation has substantial economic effect. n516

A *disproportionate allocation* is permissible if:

- (1) a tax-exempt partner is not allocated net taxable income or gain in excess of its lowest share of losses or deductions for any taxable year; and
- (2) each partnership allocation has substantial economic effect. n517

For further discussion of this topic, see Chapter 14.

FOOTNOTES:

(n1)Footnote 511. See generally *IRC* § 514.

(n2)Footnote 511.1. *IRC* § 514(a).

(n3)Footnote 512. *IRC* § 514(c)(9)(C).

(n4)Footnote 512.1. See *IRC* §§ 170(b)(1)(A)(ii), 509(a)(3).

(n5)Footnote 512.2. See *IRC* § 501(c)(25).

(n6)Footnote 513. *IRC* § 403(b)(9); this exception is effective for tax years beginning on or after Aug 17, 2006.

(n7)Footnote 514. *IRC § 514(c)(9)(B)*.

(n8)Footnote 515. *IRC § 514(c)(9)(B)(vi)*.

(n9)Footnote 516. *IRC §§ 514(c)(9)(B)(vi)(II), 168(h)(6)*.

(n10)Footnote 517. *IRC §§ 514(c)(9)(E); Treas Reg § 1.514(c)-2; see Ltr Rul 200224014* (IRS ruled that "fractions rule" of the regulations [see *Treas Reg § 1.514(c)-2(b)(1)(i)*] was met, so the taxpayer could exclude certain mortgage indebtedness from "acquisition indebtedness" under *IRC § 514*).

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Federal Taxes Affecting Real Estate

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CHAPTER 16 Special Forms of Holding Real Estate *

1-16 Federal Taxes Affecting Real Estate § 16.07

§ 16.07 Financial Asset Securitization Investment Trusts (FASITs) (PRIOR LAW)

NOTE:

Public Law 108-357, enacted on October 22, 2004, repealed the special rules for FASITs, effective January 1, 2005. n517.1 A transition period for existing FASITs is provided, pursuant to which the repeal generally does not apply to any FASIT in existence on October 22, 2004 to the extent that regular interests issued by the FASIT prior to that date continue to remain outstanding in accordance with their original terms. n517.2

As noted in § 16.03[1][d], *above*, the definitions of REMIC regular interests, qualified mortgages, and permitted investments have been modified so that certain types of real estate loans and loan pools held by FASITs can be transferred to, or purchase.

The discussion that follows in this section is retained for historic purposes.

[1] In General

Effective September 1, 1997, a new statutory entity called a "financial asset securitization investment trust" (FASIT) is authorized. n518 FASITs are intended to facilitate the securitization of home equity loans and a variety of other debt obligations. A FASIT generally is not taxable, but is a pass-through entity. n519 A FASIT's taxable income or net loss flows through to the owner of the FASIT. n520 A FASIT may hold only specified assets and is subject to restrictions on its activities. n521 A FASIT may issue instruments that qualify as debt for federal income tax purposes. n522 Instruments issued by a FASIT bearing yields to maturity greater than 5 percentage points above the yield to maturity on specified US government obligations must be held, directly or indirectly, only by qualified holders. n523 Qualified holders generally include only domestic C corporations that are not exempt from income tax, and other FASITs. n524 The FASIT provisions are repealed, effective January 1, 2005. n524.1

[2] Qualification and Election as a FASIT

Any entity, including a corporation, partnership, trust or segregated pool of assets may qualify as a FASIT. n525 To qualify as a FASIT, an entity must: n526

- (1) make an election to be treated as a FASIT for the year of election and all subsequent years;
- (2) have assets substantially all of which are "permitted assets"; n527
- (3) have non-ownership interests which are certain specified types of debt instruments called "regular interests"; n528
- (4) have a single ownership interest which is held by an "eligible corporation"; n529 and
- (5) not qualify as a regulated investment company (RIC).

The election to be a FASIT applies from the date specified in the election and for all later years until the entity ceases to be a FASIT. The election may be revoked only with the consent of the Commissioner. n530

The manner of making the election is to be determined by the Secretary of the Treasury. If an election to be a FASIT is made after the initial year of an entity's existence, all of the assets in the entity at the time of the FASIT election generally are deemed contributed to the FASIT at that time, and, accordingly, any gain (but not loss) on the assets will be recognized. n531 A non-statutory transition rule, however, applies for entities that were in existence on September 1, 1997 (pre-effective date FASITs). Under the transition rule, certain gain is not recognized on property transferred to a FASIT until the property ceases to be properly allocable to a pre-FASIT interest. n532

[3] Permitted Assets of a FASIT

Substantially all of the assets of a FASIT must be permitted assets, as of the close of the third month beginning after the day of its formation. n533

Permitted assets include only the following: n534

- (1) cash or cash equivalents;
- (2) certain debt instruments under which interest payments, if any, at or before maturity are either payable based on a fixed rate (or, to the extent permitted by regulations, at a variable rate), or consist of a specified portion of the interest payments on qualified mortgages and that portion does not vary during the period the interest is outstanding; n535
- (3) certain foreclosure property; n536
- (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT;
- (5) contract rights to acquire permitted debt instruments or hedges; and
- (6) a regular interest in another FASIT.

Except for cash equivalents, permitted debt obligations cannot be obligations issued, directly or indirectly, by the owner of the FASIT or a related person. n537

Except as provided in regulations, an asset that was a permitted asset at the time it was acquired by a FASIT is not treated as an interest in the FASIT. n538

Foreclosure property generally includes the following: n539 (1) property that would be foreclosure property under the REIT provisions (without regard to the REIT election requirement or events that can terminate a REIT grace period for REIT foreclosure property); n540 and (2) property that is acquired in connection with the default or imminent default of a debt instrument held by the FASIT, unless the security interest in that property was created for the principal purpose of permitting the FASIT to invest in that property.

[4] "Regular Interests" of a FASIT

Regular interests of a FASIT are treated as debt for federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity. n541 To be treated as a "regular interest," an instrument must be issued by the FASIT on or after its startup date, must have fixed terms, and must: n542

- (1) unconditionally entitle the holder to receive a specified principal amount;
- (2) pay interest that is based on:
 - (a) one or more rates that are fixed,
 - (b) rates that measure contemporaneous variations in the cost of newly-borrowed funds (such as variable interest rates described in *Treas Reg Section 1.860G-1(a)(3)*), or
 - (c) to the extent permitted by regulations, variable rates allowed to regular interests of a REMIC if the FASIT would otherwise qualify as a REMIC;
- (3) have a term to maturity of no more than 30 years (including options to renew), except as permitted by regulations;
- (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and
- (5) have a yield to maturity determined on the date of issue of no more than five percentage points above the applicable Federal rate for the calendar month in which the instrument is issued.

The term "regular interest" also includes any high-yield interest. n543 A high-yield interest includes any debt instrument issued by a FASIT that meets the second and third conditions described above, so long as the interest is not held by a disqualified holder. n544 It also includes "interest-only instruments" (IOs) if the instrument makes payments that consist of a specified portion of the interest payments in permitted assets, and that portion does not vary throughout the life of that instrument. n545

A "disqualified holder" generally is any holder other than an eligible corporation or a FASIT. n546 An "eligible corporation" is a domestic C corporation other than a tax-exempt corporation, a RIC, REIT, REMIC, or cooperative. n547

[5] Ownership Interests in a FASIT

A FASIT may have only one ownership interest, and that interest must be held directly by an eligible corporation. n548 As noted above, an eligible corporation is a domestic C corporation other than a tax-exempt corporation, a RIC, REIT, REMIC or cooperative. n549

[6] Taxation of FASITs

A FASIT is a pass-through entity and is not subject to tax. n550 Instead, all of the FASIT's assets and liabilities and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. n551 Accordingly, income tax rules applicable to a FASIT are to be applied in the same manner as they apply to the FASIT's owner. Any securities held by the FASIT that are treated as held by its owner are treated as held for investment. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining OID accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments. n552 For this purpose, a FASIT's income does not include any income subject to the 100-percent penalty excise tax on prohibited transactions. n553

[7] Taxation of Interests in a FASIT

[a] Taxation of Holders of Regular Interests

A holder of a regular interest in a FASIT, including a high-yield interest, is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder. n554 Several restrictions should be noted, however. Holders of high-yield interests are not allowed to use net operating losses to offset any income derived from the high-yield debt. n555 Any NOL carryover is computed by disregarding any income arising by reason of the disallowed loss. n556 In addition, the transfer of a high-yield interest to a disqualified holder is ineffective. Therefore, the transferor continues to be taxed on the income from the high-yield interest unless the transferee provides the transferor with an affidavit that the transferee is not a disqualified person, or the Secretary determines that the high-yield interest is no longer held by a disqualified person and a corporate tax has been paid on the income from the high-yield interest while it was held by a disqualified person. n557

High-yield interests may be held without a corporate tax being imposed on the income from the high-yield interest where the interest is held by a dealer in securities who acquired the high-yield interest for sale in the ordinary course of business (and not for investment). n558 A corporate tax is imposed on the dealer if the reason for holding the high-yield interest changes to investment, or if the dealer ceases to be a dealer. n559 A 31-day grace period is granted before ownership of an interest held by dealer generally is treated as held by the FASIT owner for investment purposes. n560

When a pass-through entity other than a FASIT issues either debt or equity instruments that are secured by regular interests in a FASIT and those instruments bear a yield to maturity greater than the yield on the regular interests or the applicable Federal rate plus five percentage points (determined on the date the pass-through entity acquires the regular interests in the FASIT), and the pass-through entity issued the debt or equity with a principal purpose of avoiding the rule that the high-yield interests be held by qualified holders, then an excise tax is imposed on the pass-through entity at a rate equal to the highest corporate rate on the income of any holder of the instrument attributable to the regular interests. n561

[b] Taxation of Holder of Ownership Interest

All of the FASIT's assets and liabilities are treated as the assets and liabilities of the holder of a FASIT ownership interest, and that owner takes into account all of the FASIT's income, gain, deduction or loss in computing its taxable income or net loss for the taxable year. n562 The character of the income to the owner is the same as its character to the FASIT, except tax-exempt interest is treated as ordinary income to the owner. n563

Losses on assets contributed to a FASIT are not allowed upon their contribution, n564 but may be allowed to the FASIT owner upon their disposition by the FASIT. n565 The holder of a FASIT ownership interest cannot offset income or gain from the FASIT ownership interest (including gains or losses from the sales and exchanges of those interests) with any other losses. n566 In addition, a FASIT owner cannot offset REMIC excess inclusion income against NOLs under

the FASIT provisions. n567 Any net operating loss carryover of the FASIT owner is computed by disregarding any income arising by reason of a disallowed loss. n568

For purposes of the alternative minimum tax, the owner's taxable income is determined without regard to the minimum FASIT income. n569 The alternative minimum taxable income of the FASIT owner cannot be less than the FASIT income for that year, n570 and the alternative minimum tax net operating loss deduction is computed without regard to the minimum FASIT income. n571

For purposes of the loss offset restrictions, n572 and their coordination with NOL provisions n573 and minimum tax provisions, n574 all members of an affiliated group filing a consolidated return are treated as one taxpayer. n575

[8] Tax on Income From Prohibited Transactions

The owner of a FASIT must pay a penalty excise tax equal to 100 percent of net income derived from prohibited transactions. n576 Subject to certain exceptions, prohibited transactions include the following: n577

- (1) the receipt of any income derived from an asset that is not a permitted asset; n578
- (2) any disposition (other than a permitted disposition) of a permitted asset other than foreclosure property;
- (3) the receipt of any income derived from any loan originated by the FASIT; and
- (4) the receipt of any compensation for services (other than fees for a waiver, amendment or consent under permitted assets not acquired through foreclosure).

A permitted disposition is any of the following dispositions of any permitted asset:

- (1) one arising from complete liquidation of a class of regular interests (i.e., a qualified liquidation); n579
- (2) one incident to the foreclosure, default or imminent default of the asset; n580
- (3) one incident to the bankruptcy or insolvency of the FASIT; n581
- (4) one necessary to avoid a default on any indebtedness of the FASIT attributable to a default (or imminent default) on an asset of the FASIT, if the FASIT were treated as a REMIC and permitted assets (other than cash or cash equivalents) were treated as qualified mortgages; n582
- (5) one necessary to facilitate a clean-up call, if the FASIT were treated as a REMIC and permitted assets (other than cash or cash equivalents) were treated as qualified mortgages; n583
- (6) one to substitute a permitted debt instrument for another such instrument; n584
- (7) one made in order to reduce over-collateralization where a principal purpose of the disposition was not to avoid recognition of gain arising from an increase in its market value after its acquisition by the FASIT; n585 or
- (8) one that disposes of an asset or a contract right to acquire an asset that was initially a hedge asset when acquired, but at the time of disposition was no longer a hedge asset. n586

Planning Tip:

Notwithstanding the above tax on income from prohibited transactions, the owner of a FASIT may currently deduct its losses incurred in prohibited transactions in computing its taxable income for the year of the loss. n587

[9] Transfers to FASITs

Gain generally is recognized immediately by the owner of a FASIT on the transfer of assets to a FASIT. n588 Assets that are acquired by the FASIT from someone other than its owner are treated as if they were acquired by the owner and then sold by the owner to the FASIT at their statutory valuation. n589 If any assets held by the holder of the ownership interest in a FASIT or a related person are used to support FASIT regular interests, the holder or related person must recognize gain on those assets in the same manner as if the assets had been sold to the FASIT at their statutory valuation n590 at the earliest date that the assets support any of the FASIT's regular interests. n591 The assets are then treated as held by the FASIT. n592 To the extent provided by regulations, gain recognition on contributed assets may be deferred until the assets support regular interests issued by the FASIT or any indebtedness of the owner or related persons. The regulations may also adjust other statutory FASIT provisions to the extent appropriate in the context of the above deferral. n593

[10] Valuation Rules of FASIT Assets

Except for debt instruments, the value of FASIT assets is their fair market value. n594 For debt instruments that are traded on an established securities market, their market price is used to determine gain realized upon their contribution to a FASIT. n595 For other debt instruments, their value is the sum of the present values of the reasonably-expected cash flows from the obligations discounted over the weighted average life of the assets. The discount rate is 120 percent of the applicable Federal rate, or such other discount rate specified in the regulations, compounded semiannually. n596 For purposes of determining the value of a pool of revolving loan accounts having substantially the same terms, each extension of credit (other than the accrual of interest) is treated as a separate debt instrument, and the maturity of the instruments is determined using the reasonably anticipated periodic payment rate at which principal payments will be made as a proportion of their aggregate outstanding principal balances assuming that payments are applied to the earliest credit extensions. n597

[11] Termination of FASIT

If an entity ceases to be a FASIT at any time during the taxable year, the entity is not treated as a FASIT after the date of the cessation. n598 If an entity inadvertently fails to qualify or remain qualified as a FASIT, however, it may nevertheless continue to qualify as a FASIT. To do so, it must, within a reasonable time after discovering that it fails to qualify as a FASIT, take whatever steps are necessary to qualify as a FASIT, and make whatever adjustments may be required by the Secretary. n599

Caution:

Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt. n600 This may result in the creation of cancellation of indebtedness income under *IRC Section 108* where the new instruments deemed to be issued are treated as stock. n601

FOOTNOTES:

(n1)Footnote 517.1. Former *IRC §§ 860H through 860L, repealed by Pub L No 108-357, § 835(a)*.

(n2)Footnote 517.2. Pub L No 108-357, § 835(c)(2).

(n3)Footnote 518. *IRC §§ 860H through 860L, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n4)Footnote 519. *IRC § 860H(a); see [6], below.*

(n5)Footnote 520. *IRC § 860H(b), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005; see [7][b], below.*

(n6)Footnote 521. *IRC § 860L, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see [3], below.*

(n7)Footnote 522. *IRC § 860H(c)(1), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005; see [4], below.*

(n8)Footnote 523. *IRC § 860K(a), (c), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see [4], below.*

(n9)Footnote 524. *IRC §§ 860K(c), 860L(a)(2), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n10)Footnote 524.1. *Former IRC §§ 860H through 860L, repealed by Pub L No 108-357, § 835(a).*

(n11)Footnote 525. *IRC § 860L(a), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n12)Footnote 526. *IRC § 860L(a)(1), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n13)Footnote 527. *IRC § 860L(c), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see [3], below.*

(n14)Footnote 528. *See IRC § 860L(b)(1), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see [4], below.*

(n15)Footnote 529. *See [5], below.*

(n16)Footnote 530. *IRC 860L(a)(3), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n17)Footnote 531. *Sen Rprt No 3448.*

(n18)Footnote 532. *Pub L No 104-188, § 1621(e).*

(n19)Footnote 533. *IRC § 860L(a)(1)(D), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n20)Footnote 534. *IRC § 860L(c)(1), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n21)Footnote 535. *See IRC § 860G(a)(1)(B).*

(n22)Footnote 536. *IRC § 860L(c)(3), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n23)Footnote 537. *IRC § 860L(c)(2), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see IRC § 860L(g), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005. for definition of "related person".*

(n24)Footnote 538. *IRC § 860L(a)(6), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

(n25)Footnote 539. *IRC § 860L(3), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.*

- (n26)Footnote 540. See *IRC § 856(e)*.
- (n27)Footnote 541. *IRC § 860H(c)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n28)Footnote 542. *IRC § 860L(b)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n29)Footnote 543. *IRC § 860L(b)(1)(B)(i)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n30)Footnote 544. *IRC §§ 860L(b)(1)(B)(ii)*, *860K*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n31)Footnote 545. *IRC § 860L(b)(1)(B)(ii)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n32)Footnote 546. *IRC § 860K(c)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n33)Footnote 547. *IRC § 860L(a)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n34)Footnote 548. *IRC § 860L(a)(1)(C)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n35)Footnote 549. *IRC § 860L(a)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n36)Footnote 550. *IRC § 860H(a)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n37)Footnote 551. *IRC § 860H(b)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n38)Footnote 552. *IRC § 860H(b)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n39)Footnote 553. *IRC § 860H(b)(3)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see [8], below, for a discussion.
- (n40)Footnote 554. *IRC § 860H(c)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n41)Footnote 555. *IRC § 860J(b)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n42)Footnote 556. *IRC § 860J(b)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n43)Footnote 557. *IRC § 860K(a)(2)*, (b), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860E(e)(4)*, (7).
- (n44)Footnote 558. *IRC § 860K(d)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n45)Footnote 559. *IRC § 860K(d)(2)(A)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 11(b)(1)*.
- (n46)Footnote 560. *IRC § 860K(d)(2)(B)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n47)Footnote 561. *Treas Reg §§ 1.897*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 11(b)(1)*.
- (n48)Footnote 562. *IRC § 860H(b)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n49)Footnote 563. *IRC § 860H(b)(4)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n50)Footnote 564. *IRC § 860I(a)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

- (n51)Footnote 565. See *IRC § 860H(b)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n52)Footnote 566. *IRC § 860J(a)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n53)Footnote 567. *IRC § 860J(a)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n54)Footnote 568. *IRC § 860J(b)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n55)Footnote 569. *IRC § 860J(c)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n56)Footnote 570. *IRC § 860J(c)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n57)Footnote 571. *IRC § 860J(c)(3)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n58)Footnote 572. See *IRC § 860J(a)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n59)Footnote 573. See *IRC § 860J(b)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n60)Footnote 574. See *IRC § 860J(c)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n61)Footnote 575. *IRC § 860J(d)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n62)Footnote 576. *IRC § 860L(e)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n63)Footnote 577. *IRC § 860L(e)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n64)Footnote 578. See [3], above, for what constitutes a permitted asset.
- (n65)Footnote 579. *IRC § 860L(e)(3)(A)(i)*, (C), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860F(a)(2)(A)(iv)*.
- (n66)Footnote 580. *IRC § 860L(e)(3)(A)(i)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860F(a)(2)(A)(ii)*.
- (n67)Footnote 581. *IRC § 860L(e)(3)(A)(i)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860F(a)(2)(A)(iii)*.
- (n68)Footnote 582. *IRC § 860L(e)(3)(A)(ii)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860F(a)(5)(A)*.
- (n69)Footnote 583. *IRC § 860L(e)(3)(A)(ii)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860F(a)(5)(B)*.
- (n70)Footnote 584. *IRC § 860L(e)(3)(B)(i)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n71)Footnote 585. *IRC § 860L(e)(3)(B)(ii)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n72)Footnote 586. *IRC § 860L(e)(3)(D)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860L(c)(1)(D)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n73)Footnote 587. Sen Rprt No 3448.
- (n74)Footnote 588. *IRC § 860L(a)(1)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.
- (n75)Footnote 589. *IRC § 860I(a)(2)*, before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC*

§ 860I(d), before repeal by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see [10], below, for the statutory valuation rules.

(n76)Footnote 590. See *IRC § 860I(d), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see [10], below, for the statutory valuation rules.

(n77)Footnote 591. *IRC § 860I(b)(1), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860L(g), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005. for definition of "related person".

(n78)Footnote 592. *IRC § 860I(b)(2), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

(n79)Footnote 593. *IRC § 860I(c), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

(n80)Footnote 594. *IRC § 860I(d)(1)(B), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

(n81)Footnote 595. See *IRC § 860I(d)(1)(B), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

(n82)Footnote 596. *IRC § 860I(d)(1)(A), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

(n83)Footnote 597. *IRC § 860I(e)(2), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

(n84)Footnote 598. *IRC § 860L(a)(4), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

(n85)Footnote 599. *IRC § 860L(a)(5), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.; see *IRC § 860D(b)(2)(B)*.

(n86)Footnote 600. See *IRC § 860H(c)(1), before repeal* by Pub L No 108-357, § 835(a), effective Jan 1, 2005.

(n87)Footnote 601. Sen Com Rprt No 3448.

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§ 17.00 Introduction

Foreign interest in investing in U.S. real estate is at least as volatile as interest in most other investments. It is affected by the perceived attractiveness of U.S. real estate as a pure investment, which is, in turn, affected by supply and demand factors and by the state of the U.S. economy; by the value of the U.S. dollar *vis-a-vis* alternative foreign currency investments; by the attractiveness of real estate and other investments in other foreign jurisdictions; by political instability abroad (wherein an investment in U.S. real estate is seen as a "safe" investment and, possibly, an emergency entree to the U.S.); and by the relationship between the inflation rate in the U.S. and the inflation rates affecting alternative investments.

This chapter reviews the federal income tax provisions affecting real estate owned by individuals who are neither citizens nor residents of the U.S. and by business entities organized under the laws of jurisdictions other than the U.S., the 50 states and the District of Columbia. Planning for an investment in U.S. real estate requires careful scrutiny, on a property-by-property basis, of the residence of the foreign investor, the possible sources of capital for the investment, an analysis of U.S. federal and state and local income tax laws and U.S. federal estate and gift tax laws, and an analysis of local laws relating to property ownership by aliens. In addition, of course, it requires a review of relevant U.S. tax treaties and an analysis of applicable foreign tax and capital export laws.

During the remainder of this chapter, unless the context requires otherwise, the term "alien" will generally be used to refer to an individual who is neither a citizen nor a resident of the U.S. and to entities organized under the laws of jurisdictions other than the U.S., the 50 states and the District of Columbia. n1

FOOTNOTES:

(n1)Footnote 1. *IRC § 7701(a)(30)* defines the term "U.S. person" to mean a citizen or resident of the U.S., a domestic partnership, a domestic corporation, an estate other than a foreign estate, and a trust, if a court within the U.S. is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

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*1-17 Federal Taxes Affecting Real Estate § 17.01***§ 17.01 State Restrictions on Alien Property Ownership**

As land law is basically state law, legislation and legal precedents of the various states must be reviewed to identify any restriction or prohibition on alien ownership of real property.

It is beyond the scope of this chapter to discuss the legal issues relating to restrictions on alien property ownership. The status of each proposed investment must be reviewed on a state-by-state, property-by-property and investor-by-investor basis. Most states have restrictions on alien ownership, but the restrictions vary from state to state and changes occur frequently. Table I, below, is a broad outline of state legislation regulating the ownership of U.S. real estate by alien individuals and foreign corporations and other business entities:

TABLE I Summary of State Restrictions and Reporting Requirements

State _____ _____	Ali- ens _____	Reporting Requirements	Corporations and Other Business Entit- ies _____	Reporting Requirements
	Restrictions		Restrictions	
Alabama				
Alaska				
Arizona			x	
Arkansas		x		
California	x			
Colorado				
Connecticut				
Delaware				
Florida				x
Georgia	x	x		
Hawaii				

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Idaho	x			
Illinois	x	x	x	x
Indiana	x			
Iowa	x	x	x	x
Kansas	x		x	x
Kentucky	x			
Louisiana			x	x
Maine				x
Maryland	x			
Massachusetts				
Michigan				
Minnesota	x	x	x	x
Mississippi	x			
Missouri	x	x	x	x
Montana	x			
Nebraska	x			
Nevada	x			
New Hampshire	x			
New Jersey	x			
New Mexico				
New York				
North Carolina	x			
North Dakota	x	x	x	x
Ohio		x		
Oklahoma	x		x	x
Oregon	x			
Pennsylvania	x			
Rhode Island				
South Carolina	x			
South Dakota	x		x	x
Tennessee				
Texas				
Utah				
Vermont				
Virginia	x	x		
Washington				
West Virginia				

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Wisconsin	x	x
Wyoming	x	

The most common form of state restriction is a general prohibition on alien ownership of land. In most instances, however, there are some exceptions. For example, many states that prohibit alien ownership permit resident aliens to own land. ⁿ² Other states permit land ownership by aliens who have declared their intention to become citizens. Certain states limit the amount of acreage an alien may own, and some states limit the time that an alien may own property. ⁿ³ These limitations were probably selected to allow an alien who had acquired land by inheritance a reasonable time for disposition.

Limitations on inheritance rights may be a substantial barrier to individual foreign investment. Forfeiture or forced sale upon the death of an investor can deter investment. In some instances, a foreign heir may inherit land only if a reciprocal right exists under the laws of the foreign jurisdiction. This requirement is sometimes set forth in the state's probate law.

Fewer states have specific statutory prohibitions on alien ownership of property through corporations, although some states have substantial restrictions on corporate ownership of farmland. These normally include prohibitions or restrictions on corporate farming. Some states restrict ownership by corporations incorporated in jurisdictions outside the United States. Other states prohibit ownership by a corporation that has more than a specified percentage of alien ownership or has alien directors.

FOOTNOTES:

(n1)Footnote 2. J David Aiken, "State Laws Relating to the Ownership of US Land by Aliens and Business Entities December 31, 1989," ERS Staff Rep No AGES9111 (issued by the Resources and Technology Div, Economic Research Service, US Dept of Agriculture, Mar, 1991). For a current survey of federal and state laws addressing foreign ownership of United States real property, see James R. Mason, " 'Pssst, Hey Buddy, Wanna Buy a Country?' [sic] An Economic and Political Policy Analysis of Federal and State Laws Governing Foreign Ownership of United States Real Estate", 27 *Vand J Transnat'l L* 453 (1994).

(n2)Footnote 3. *Id* at 19.

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§ 17.02 U.S. Taxation of Nonresident Aliens

The most significant tax levied on nonresident alien individuals and corporations investing in U.S. real estate is the federal income tax. Individual investors also may be subject to federal transfer taxes (estate, gift and generation-skipping transfer tax), and state inheritance and gift taxes.

Individual and corporate investors are also subject to real estate taxes and state and local income taxes. Although tax treaties may reduce or eliminate U.S. federal income and transfer taxes, state and local taxes will remain.

United States taxation of nonresident aliens generally is limited to income from U.S. activities or sources. n4 Federal taxation of nonresident aliens is based on the nature of the alien's ownership interest and the determination whether the alien is conducting a U.S. business. It is also affected by any tax treaty between the country in which the foreign investor (individual or corporation) is resident and the United States. These "conventions" for the avoidance of double taxation, or tax treaties as they are commonly referred to, generally extend more favorable tax treatment to those entitled to take advantage of the treaty provisions than does the Internal Revenue Code. The purpose of these treaties is to alleviate double taxation of income from transactions that cross national boundaries. An updated listing of current tax treaties in effect can be found in IRS Publication 901.

The general rules establishing the relationship between provisions of the Internal Revenue Code and provisions in tax treaties are found in *IRC Section 894* (which states that the provisions of the Internal Revenue Code shall be applied "with due regard" to any treaty obligation of the U.S.) and *IRC Section 7852(d)(1)* (which provides that, for purposes of determining the relationship between a provision of a treaty and any tax code provision, neither the treaty nor the tax code provision shall have preferential status by reason of its being a treaty or a tax code provision). Thus, in general, unless the treaty provision or the Internal Revenue Code provision provides specifically to the contrary, whichever provision is enacted later in time will prevail. n5

Generally, a nonresident alien not engaged in a U.S. business is taxed only on fixed or determinable annual or periodic (passive) income from U.S. sources. n6 Tax is imposed at a rate of 30 percent on gross income of these types unless a tax treaty provides for a lower rate. n7 The tax is imposed on a gross basis, and losses or other deductions cannot be offset against profits. The tax is generally imposed at its source through withholding. n8 Types of income normally subject to taxation and withholding pursuant to these provisions include dividends, interest, annuities, rental, or other fixed, determinable annual or periodic income. n9 No deduction or withholding is required for a number of specified

items, including interest on portfolio debt investments. n10 The term *portfolio interest* means any interest (including original issue discount) that is (1) paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person, or (2) for obligations issued before March 19, 2012, paid on an obligation that is not in registered form and that meets the foreign targeting requirements of *IRC Section 163(f)(2)(B)*. n10.01 The foreign targeting exception allowing the treatment of that interest as portfolio interest is repealed effective for debt obligations issued after March 18, 2012. n10.02 Portfolio interest, however, does not include interest received by a 10-percent shareholder, n10.03 certain contingent interest, n10.04 interest received by a controlled foreign corporation from a related person, n10.05 or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. n10.06

In most instances, capital gains that are not effectively connected with the conduct of a trade or business within the U.S. are exempt from taxation under the withholding provisions (unless the alien is present in the United States for 183 days during the year). n10.1

A nonresident alien engaged in a U.S. business is subject to income tax at ordinary corporate or individual tax rates on the taxable income that is effectively connected with the conduct of a trade or business within the United States. n10.2 Profits from the disposition of U.S. real estate are generally treated as income that is effectively connected with the conduct of a trade or business within the U.S. n10.3

FOOTNOTES:

(n1)Footnote 4. *IRC §§ 871 and 881*. This rule is expanded in the case of former U.S. citizens or former long-term permanent residents of the U.S. See *IRC §§ 877 and 877A*, dealing with expatriation to avoid tax.

(n2)Footnote 5. Report of the Committee on Ways and Means on the Miscellaneous Revenue Act of 1988, 100th Cong, 2nd Sess, HR Rep No 100-795, 300-309 (July 26, 1988).

(n3)Footnote 6. *IRC §§ 871(a), 881(a)*.

(n4)Footnote 7. *IRC §§ 894(a), 7852(d); Treas Reg § 1.871-12*.

(n5)Footnote 8. *IRC §§ 1441, 1442*.

(n6)Footnote 9. *IRC §§ 871(a), 881(a), 1441(b)*.

(n7)Footnote 10. *IRC §§ 871(h), 881(c), 1441(c)(9)*.

(n8)Footnote 10.01. *IRC § 871(h)(2)*.

(n9)Footnote 10.02. Pub Law No 111-147, § 502(f).

(n10)Footnote 10.03. *IRC §§ 871(h)(3), 881(c)(3)(B)*.

(n11)Footnote 10.04. *IRC §§ 871(h)(4), 881(c)(4)*.

(n12)Footnote 10.05. *IRC § 881(c)(3)(C)*.

(n13)Footnote 10.06. *IRC § 881(c)(3)(A)*.

(n14)Footnote 10.1. *IRC § 871(a)(2)*.

(n15)Footnote 10.2. *IRC § 871(b)*.

(n16)Footnote 10.3. *IRC § 897*; also see *IRC § 871(d)* (election to treat real property income as income connected with U.S. business).

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§ 17.03 Conduct of Business in the United States

In any real estate investment, it is necessary to determine if the alien is engaged in business in the United States. Neither the Internal Revenue Code nor the Regulations contains a comprehensive definition of the term "trade or business." n11 Surrounding circumstances, such as the nature of the business and physical facilities used to pursue the activity, must be considered in making the determination of whether business activities rise to the level of the conduct of a trade or business. n12

When analyzing the tax consequences of alien ownership of real property, each real estate investment must be separately analyzed to determine whether the activities are sufficient to cause the alien to be engaged in business in the United States. The result of this analysis will determine whether income from the property is subject to withholding tax on a gross basis or must be reported on a federal income tax return and taxed on a net basis.

If property is subject to a lease under which the owner or its U.S. agent merely collects rents from the property and the tenant pays all operating expenses, the owner may be considered to be engaged in a U.S. business, if the owner or his agent does not perform any substantial services relating to the property. In this regard, the separate ownership of each parcel of real estate by separate entities could strengthen the position that the owner is not engaged in business in the United States.

On the other hand, if the real estate is actually an operating property and the owner's or agent's activities extend beyond the mere collection of rents and include the negotiation of leases, making of repairs, paying of expenses and taxes, and the performance of other operating activities, the owner will probably be deemed to be engaged in business in the United States. n13 In many cases, it is desirable for the alien owner to be considered to be engaged in a U.S. business since its U.S. taxes may be lower if computed on a net basis rather than on a gross basis.

In *Lewenhaupt v Commissioner*, n14 the court held that the taxpayer's activities with respect to certain parcels of improved real estate constituted a U.S. business. It was demonstrated that the taxpayer employed an agent to manage the properties and empowered the agent to buy, sell, lease, and mortgage real estate for and in the name of the taxpayer. During the taxable year, the agent's activities included executing leases, renting properties, maintaining books, collecting rents, supervising property repairs, insuring properties, paying taxes and mortgage interest, and executing the sale of one of the properties, as well as notifying the taxpayer of available realty.

On the other hand, a strong argument could be made that the taxpayer is not engaged in U.S. business if the alien owner attends to these various activities from outside the United States, while a U.S. agent is entrusted only with the basic necessities and does not work exclusively for the owner. Sporadic decisions by the alien owner in the United States will not taint this conclusion. n15

Given the uncertainties of the definition of a U.S. business, the Foreign Investors Tax Act introduced a special tax election for nonresident aliens to pay taxes on income from real property on a net basis, as if the alien were engaged in a trade or business. n16 The election will result in the income from the property being subject to the normal individual or corporate tax rates on the basis of net taxable income rather than being subject to a withholding tax on gross income. n17 If the electing alien has other income or deductions that are effectively connected with the conduct of a U.S. trade or business, they must be combined with the income under the real property election in determining the alien's total taxable income. n18 If the deductions for the real property exceed the property's current income, such excess loss may be used to offset income from other U.S. trades or businesses, as well as income from other property subject to the election. n19 Any gain or loss on the disposition of U.S. real property will be treated as a gain or loss that is effectively connected with the conduct of a trade or business. n20 The election, once made, applies to all U.S. real estate owned and property that may be acquired in the future by a nonresident alien, and to rents or royalties from natural resources. It cannot be revoked without the prior consent of the Commissioner of the Internal Revenue Service. If revocation is approved, a new election cannot be made for five years. The election may be made at any time before the expiration of the statute of limitations for filing refund claims (including extensions thereof) and is made by filing a statement to the effect that the election is being made with the income tax return required for the year. The Regulation does not reconcile the timing conflicts inherent in these two statements. n21 Where property is held by a partnership, the election is made at the partner level. n22 An alien who is deciding whether to make the election must project the income and gain to be received with respect to the properties to which the election will apply, and compare the amount of tax payable under the FIRPTA n23 rules, pursuant to which dispositions of U.S. real property interests are subject to a withholding tax on gross receipts, and the withholding tax on rental income with the tax resulting from applying regular U.S. rates to net income after allowable deductions.

Various tax treaties permit a similar election to be made on an annual basis. n24 Aliens from countries that have no tax treaty or an unfavorable tax treaty with the United States will face difficulties in attempting to take advantage of treaty elections by acquiring U.S. real property through a corporation resident in treaty countries with favorable treaties because Congress has taken action to limit so-called "treaty shopping." For example, the Code provides that the branch profits tax, which was enacted by TRA 1986, is not to be overridden by a tax treaty in which treaty shopping is possible. n25 The Service has also issued regulations implementing *IRC Section 7701(l)*, authorizing the Secretary of the Treasury to prescribe regulations recharacterizing multiple-party financing transactions as conduit arrangements. n26

Under these regulations, the Service could attack back-to-back dividends or royalties, as well as certain "mixed" back-to-back payments (i.e., interest is paid from the United States to the treaty country corporation, which, in turn, pays a dividend or royalty of the same amount). Subject to certain "grandparent" rules, the regulations are effective for payments made on or after September 11, 1995.

The use of a treaty may be beneficial as it may permit an alien to elect annually whether to be taxed on rental income from real estate on a net taxable income basis or on a gross income basis.

FOOTNOTES:

(n1)Footnote 11. *IRC § 864(b)*.

(n2)Footnote 12. See Saunders, "Trade or Business, Its Meaning Under the Internal Revenue Code," 1960 *So Cal Tax Inst* 693, for further discussion of cases in this area. Also, Gorelick, "What Constitutes Doing Business Within the United States by a Non-Resident Alien Individual or Foreign Corporation," 18 *Tax L Rev* 423 (1962). This is an area on which the Service will not ordinarily rule. *Rev Proc* 99-7, 1999-1 *IRB* 226, § 4.01(3).

(n3)Footnote 13. *Herbert v Commr*, 30 TC 26 (1958) , acq 1958-2 CB 6 .

(n4)Footnote 14. 20 TC 151 (1953) , *affd per curiam on another issue* 221 F2d 227 , 55-1 USTC P 9239 , 47 AFTR 420 (9th Cir 1955) .

(n5)Footnote 15. In Rev Rul 73-522, 1973-2 CB 226 , the Service held that a non-resident alien whose only activity in the U.S. during the tax year was a short visit for the purpose of supervising the negotiation of leases on rental property he owned during that year is not considered to be engaged in a trade or business in the United States.

(n6)Footnote 16. Pub L No 89-809, 89th Cong, 2d Sess (1966) created *IRC §§ 871(d), 882(d)*.

(n7)Footnote 17. As enacted, the election would also apply to income from the disposition of the property, although the treatment of that income as effectively connected is now mandatory, not elective, as a result of the enactment of *IRC § 897* (FIRPTA).

(n8)Footnote 18. *Treas Reg § 1.871-10(c)*.

(n9)Footnote 19. *Rev Rul 92-74*, 1992-2 CB 156 .

(n10)Footnote 20. *Id*; *Treas Reg § 1.871-10(c)*.

(n11)Footnote 21. *Treas Reg § 1.871-10(d)*.

(n12)Footnote 22. *Treas Reg § 1.871-10(d)(3)*

(n13)Footnote 23. The Foreign Investment in U.S. Real Property Tax Act of 1980, PL No 96-499.

(n14)Footnote 24. See, eg, Article IX of the treaty with Austria. This flexibility tends to be found in older treaties and may be changed to conform to the requirements of the Code as, and when, those treaties are renegotiated.

(n15)Footnote 25. *IRC § 884(e)*.

(n16)Footnote 26. *Treas Reg § 1.881-3*. *IRC § 7701(l)* was enacted as part of PL No 103-66, effective Aug 10, 1993.

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§ 17.04 Income "Effectively Connected" with a U.S. Business

An alien that is not engaged in a U.S. business pursuant to the criteria discussed in § 17.03, above, will be subject to tax only on U.S.-source income, in the manner described in § 17.02.

An alien individual, partnership, or foreign corporation that is engaged in U.S. business will be taxed on the U.S. business on the same basis as any other U.S. taxpayer.

The alien engaged in a U.S. business must segregate its income into the following three categories:

- (1) U.S.-source and foreign-source income effectively connected with the conduct of the U.S. business;
- (2) U.S.-source income not effectively connected with the conduct of the U.S. business; and
- (3) foreign-source income not effectively connected with the conduct of the U.S. business.

United States and foreign-source income effectively connected with the U.S. business will be subject to U.S. tax at ordinary rates. n27 As a result, losses from such a business can be offset against profits, subject to the passive activity and various other limitations. See Chapter 13. To determine whether U.S.-source income that is either "fixed or determinable annual or periodic" or that arises from the sale or exchange of capital assets is "effectively connected" income, the following factors are taken into account:

- (1) whether the income, gain, or loss is derived from assets used or held for use in the conduct of such trade or business; or
- (2) whether the activities of such trade or business were a material factor in the realization of the income, gain, or loss. n28

Treasury regulations state that, generally, stock of a corporation, whether domestic or foreign, is not treated as an asset used, or held for use, in a U.S. trade or business. n29 However, an investment in the stock of a U.S. real property holding (USRPH) corporation is treated as an asset used in a trade or business within the United States and any gain or loss from the disposition of such stock will be treated as if such gain or loss were effectively connected with such trade

or business. n30 USRPH corporations are discussed in § 17.11[2], below.

All other types of U.S. source income are deemed to be effectively connected, regardless of how derived. n31

While an alien is subject to tax at normal rates on U.S.-source income effectively connected with the conduct of a U.S. business, he is not subject to U.S. tax at normal rates on U.S.-source income that is not effectively connected with his U.S. business. If the above tests relating to the derivation of income from assets used in a U.S. business, or closely related activities resulting from the U.S. business, are not met, the income is not considered to be effectively connected. In such a case, a withholding tax is assessed on that portion of gross income, while the remaining net taxable income from the U.S. business is taxed at ordinary rates. n32

Foreign-source income and economic equivalents of it generally can be subject to U.S. tax only if it is effectively connected with the conduct of a U.S. business. In this case, the U.S. office must be a material factor in producing the income and must regularly carry on activities of the type from which the income is derived. Only the amount that is properly allocable to the U.S. business will be treated as effectively connected foreign source income. n33

FOOTNOTES:

(n1)Footnote 27. *IRC §§ 871(b), 882(a).*

(n2)Footnote 28. *IRC § 864(c)(2).*

(n3)Footnote 29. *Treas Reg § 1.864-4(c)(2)(iii).*

(n4)Footnote 30. *IRC §§ 897(a); 897(c)(1)(A)(ii).*

(n5)Footnote 31. *IRC § 864(c)(3).*

(n6)Footnote 32. *IRC §§ 871(a), 881(a); Treas Reg § 1.871-8(b).*

(n7)Footnote 33. *IRC § 864(c)(4), (5).*

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1-17 Federal Taxes Affecting Real Estate § 17.05

§ 17.05 Forms of Alien Ownership

[1] In General

Foreign investors may generally invest in U.S. real estate in the same manner as domestic investors. Alternative methods of ownership for foreign investors include:

- (1) Direct ownership by foreign individual investors.
- (2) Ownership by foreign individuals through a limited or general partnership or a limited liability company (LLC).
- (3) Ownership by a business trust, generally a real estate investment trust (REIT).
- (4) Ownership by a U.S. corporation.
- (5) Ownership by a foreign corporation.

The most direct form of investment is outright ownership by the alien individual. However, this form of ownership is generally undesirable from a U.S. gift and estate tax perspective. (See § 17.06.) The manner in which the alien acquires the property, such as by purchase, gift, inheritance, etc., may be relevant for purposes of state rules relating to alien ownership of real property.

Somewhat less direct ownership may be acquired through a trust or other arrangement for equitable ownership. Under a trust arrangement, an alien could designate a citizen or U.S. corporation to hold the property as trustee. The trustee would hold title and maintain control over the property with the alien reserving a beneficial interest. The trustee would be required to account to the alien for the financial results of the property. An alien that owns real property pursuant to such an arrangement would be subject to federal income tax in the same manner as if it owned the property directly.

Another ownership structure is for an alien to own real estate through a partnership organized under the Uniform Partnership Act or Uniform Limited Partnership Act in effect in most states, as an informal joint venture, or through a limited liability company that will be taxed as a partnership. While the partnership acts and their interpretations vary

from state to state, the laws tend to follow a general pattern. Similarly, a partnership could be created under foreign law to own U.S. real estate. (See Chapter 14.)

A REIT can also be used by aliens to own U.S. real estate. REITs are discussed below at § 17.11[3](6) and in greater detail in Chapter 16.

A more common form of ownership for an alien interested in investing in U.S. real estate is through a corporation that owns several parcels of property, or a corporation organized by an alien or group of aliens to own one parcel of property. The corporate organization, and particularly the limited liability inherent in the corporate form, make corporate ownership attractive. If the corporation is organized in the United States, the stock of the corporation will potentially be subject to U.S. gift and estate taxes in the hands of an individual alien. If the corporation is organized outside the United States, it will generally be subject to the branch profits tax. Accordingly, a common form of ownership for an individual alien is to organize a foreign corporation with a U.S. subsidiary corporation that invests in U.S. real estate, thus avoiding both U.S. estate and gift tax implications and the branch profits tax. For further analysis, see § 17.10.

The form of ownership that will be selected by an alien will be determined by the foreign investor's objectives. These may include limited liability, right of control, management participation, and transferability of ownership interest, as well as the U.S., local, state, and foreign tax treatment of income and losses from the real estate operations.

[2] Limited Liability Company

A new form of business entity that is rapidly gaining popularity is known as the "limited liability company," or LLC. An LLC combines favorable partnership and corporate characteristics more effectively than any other form of business organization.

The limited liability company is a "hybrid" entity that has both corporate business attributes and partnership tax attributes. It has the corporate attribute of limited liability and is a legal entity separate and distinct from its owners, but has the partnership federal income tax attribute of having its income taxed directly to its owners for federal income tax purposes. As a result, the limited liability company combines the most significant legal benefit of a corporation (i.e., limited liability) with the tax attributes of a partnership. A limited liability company can have an unlimited number of members, and the members can be virtually any type of entity (e.g., individual, corporation, trust, estate, partnership, foreign investor, etc.). There is no federal income tax prohibition against alien ownership of an LLC.

If the venture is structured as a partnership, the investor must choose between obtaining limited liability as a limited partner or participating in management as a general partner. If the venture is structured as a C corporation, the investor can obtain both limited liability and participation in management but must incur the cost of a double tax on the venture's income. A limited liability company allows limited liability, participation in management, *and* a single level of taxation, although the single level of tax may be compromised by the branch-profits tax provisions where the foreign owner is a corporation. (See § 17.10[1].)

Although almost all states recognize the existence of limited liability companies and almost all states will follow the federal tax treatment of LLCs, the few exceptions require that a specific statutory analysis be done with respect to each state in which an LLC may be doing business. See Chapter 14. The analysis must also include laws concerning the requirements for qualification of entities to do business.

If a state law requires that an entity meet specific legal formalities to be a corporation or a limited partnership, the foreign investor faces the risk that a limited liability company may be considered to do business as a general partnership in that state because the definition of a general partnership is generally so broad as to cover an unincorporated venture between two or more persons other than one that is organized as a limited partnership or other recognized form of

business under state law. n34

FOOTNOTES:

(n1)Footnote 34. For further discussion of limited liability companies, see 1 Z. Cavitch, Business Organizations with Tax Planning §§ 1.05 and 9.04 (Matthew Bender).

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CHAPTER 17 Foreign Investment in U.S. Real Estate *

1-17 Federal Taxes Affecting Real Estate § 17.06

§ 17.06 Taxation of Investment by an Individual Alien

A nonresident alien individual may purchase property personally and appoint an agent in the United States to manage the property. As discussed above, the relative responsibilities of that agent will be a material factor in determining whether the owner is engaged in a U.S. business. If the alien is engaged in a U.S. business, his net income will be subject to U.S. tax at graduated rates. n35 Once taxed, the income can be repatriated by the owner without imposition of any U.S. withholding tax at the source, n36 and without the imposition of any branch-profits tax. Any capital gain resulting from sale of the property also may be treated as effectively connected with the conduct of a U.S. business and taxed as such. n37

If an owner is not engaged in a U.S. business, the gross rentals from the property will be subject to withholding tax at a flat 30 percent rate. n38 One significant disadvantage of direct ownership of U.S. real estate by an alien individual is that U.S. real estate is included in the gross estate of every nonresident alien decedent n39 and may be subject to estate tax as well as the generation-skipping transfer tax. n40 Furthermore, state inheritance and related probate and administrative costs may be incurred. United States transfer tax also is imposed on nonresident aliens upon transfer of U.S. real estate by gift. n41 Accordingly, it is generally undesirable for an individual alien to own real estate in the U.S. in his or her own name, or through a partnership or limited liability company in which he or she is a direct partner or member.

FOOTNOTES:

(n1)Footnote 35. *IRC § 871(b)(1)*.

(n2)Footnote 36. *IRC § 871(a)(1)*.

(n3)Footnote 37. *IRC §§ 864(c)(1), (2); 897(a)(1)*. See § 17.11, *infra*.

(n4)Footnote 38. *IRC § 871(a)(1)*.

(n5)Footnote 39. *IRC § 2103*.

(n6)Footnote 40. *IRC § 2663(2)*.

(n7)Footnote 41. *IRC § 2511*.

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CHAPTER 17 Foreign Investment in U.S. Real Estate *

1-17 Federal Taxes Affecting Real Estate § 17.07

§ 17.07 Taxation of Investment Through a U.S. or Foreign Partnership or Limited Liability Company

The rules that apply to individual ownership also apply to individual ownership of an interest in a partnership. Just as in the case of a U.S. partnership having only U.S. partners, it is the partners that are taxed and not the partnership. n42 The foreign partners, whether corporate or individual, are subject to U.S. tax on their shares of partnership income from U.S. sources. If the partnership is engaged in a U.S. business, the partners will be considered to be engaged in a U.S. business and will be subject to tax accordingly. n43

A US person who contributes cash or real or personal property to a foreign partnership may be required to furnish information about the transfer to the IRS. n43.1 Penalties of up to \$100,000 may be imposed if the information is not reported. n43.2 In addition, the person will be required to recognize gain as if the contributed property had been sold for its fair market value at the time of the contribution. n43.3 Information must be furnished if either of the following requirements is met: n43.4

- immediately after the transfer, the US person owns at least a 10-percent interest in the partnership; or
- the value of the property transferred, when added to the value of any other property transferred in a Section 721 contribution by that person (or a related person) to the partnership within the 12-month period ending on the date of the transfer, exceeds \$100,000.

The information is reported on Form 8865, "Information Return of US Persons With Respect to Certain Foreign Partnerships." n43.5 The Form 8865 generally must be filed with the transferor's timely filed (including extensions) income tax return (including a partnership return of income) for the tax year that includes the date of the transfer. n43.6

Three potentially overlapping sets of withholding rules apply to U.S. partnerships having foreign partners. First, when a domestic partnership generates fixed or determinable annual or periodical income that is not effectively connected with the conduct of the trade or business within the United States, and is, therefore, subject to withholding, a 30 percent withholding is required at the time the income is included in the partner's distributive share of partnership income whether or not it is actually distributed. n44 The Treasury Regulations provide that the partnership should withhold from all distributions to the foreign partner, to the extent that the distribution includes items of fixed or determinable annual or periodical income, except that if the partnership withholds on a foreign partner's share of distributable income before the income is actually distributed to the partner, then withholding is not required when the income is

subsequently distributed. Second, a domestic partnership is also required to withhold 35 percent of each foreign partner's pro rata share of the partnership's gain from the disposition of a U.S. real property interest, n45 and 10 percent of the fair market value of any U.S. real property interest distributed to a foreign partner. n46 Finally, both foreign and domestic partnerships are required to withhold a specific percentage of the effectively connected taxable income allocable to foreign partners. For corporate partners, the withholding rate is 35 percent, and noncorporate. n47 Forms 8804, 8805, and 8813 are to be used by U.S. or foreign partnerships to pay and report the *IRC Section 1446* withholding tax.

The legal characteristics of a foreign entity must be reviewed to determine if it will be treated as a partnership for U.S. tax purposes. Treasury Regulations, commonly known as the "check-the-box" regulations, greatly simplify this analysis. n48

FOOTNOTES:

(n1)Footnote 42. *IRC § 701.*

(n2)Footnote 43. *IRC § 875(1).*

(n3)Footnote 43.1. *IRC § 6038B(a).*

(n4)Footnote 43.2. *IRC § 6038B(c)(1), (3).*

(n5)Footnote 43.3. *IRC § 6038B(c)(1).*

(n6)Footnote 43.4. *IRC § 6038B(b)(1); Treas Reg § 1.6038B-2(a)(1).*

(n7)Footnote 43.5. *Treas Reg § 1.6038B-2(a)(1).*

(n8)Footnote 43.6. *Treas Reg § 1.6038B-2(a)(5)(i)*; different timing requirements apply if information about the partnership must also be reported under *IRC § 6038 (Reg § 1.6038B-2(a)(5)(ii))*.

(n9)Footnote 44. See *Treas Reg § 1.1441-1,-3(f)*; *Rev Rul 89-33, 1989-1 CB 269* .

(n10)Footnote 45. *IRC § 1445(e)(1); Treas Reg § 1.1445-5(c).*

(n11)Footnote 46. *IRC § 1445(e)(4).*

(n12)Footnote 47. *IRC § 1446*. See *IRC §§ 1, 11(b)*.

(n13)Footnote 48. *Treas Reg § 301.7701-3(b)(2)*

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CHAPTER 17 Foreign Investment in U.S. Real Estate *

1-17 Federal Taxes Affecting Real Estate § 17.08

§ 17.08 Taxation of Investment by a Business Trust or Regulated Investment Company

[1] In General

A business trust, whether organized under the laws of the United States or a foreign jurisdiction, generally is subject to U.S. tax in the same manner as a corporation. Consequently, there is no federal income tax advantage in holding realty through a trust rather than a corporation. However, a U.S. business trust that qualifies as a Real Estate Investment Trust (REIT) is not subject to tax on ordinary income or capital gains that are distributed to its shareholders. ⁿ⁴⁹ Alien stockholders of a REIT are subject to U.S. dividend withholding tax on distributions from the REIT ^{n49.1} and are subject to tax under the FIRPTA rules on their shares of gain from sales or exchanges by the REIT of U.S. real property interests, ^{n49.2}

A special look-through rule applies to distributions from a qualified investment entity. ^{n49.3} A "qualified investment entity" is either a REIT or--before 2010 only--a regulated investment company (RIC) that is a US real property holding corporation. ^{n49.4} Under the look-through rule, any distribution by a qualified investment entity to a nonresident alien individual, foreign corporation, or other qualified investment entity is, to the extent attributable to gains from sales or exchanges of the qualified investment entity of US real property interests, treated as gain recognized by that nonresident alien individual, foreign corporation, or other qualified investment entity from the sale or exchange of a US real property interest. ^{n49.5}

There is an exception, however--any distribution by a qualified investment entity to a nonresident alien individual or a foreign corporation with respect to any class of stock that is regularly traded on an established securities market located in the US is not treated as gain recognized from the sale or exchange of US real property interest if that individual or corporation did not own more than 5 percent of that class of stock at any time during the 1-year period ending of the date of the distribution. These distributions instead are treated as dividend distributions and are subject to 30 percent (or lower treaty rate) dividend withholding. ^{n49.6}

Caution:

Although this exception applies when the distribution is made to a foreign shareholder of a RIC or REIT, it does not apply when the distribution is made to another RIC or a REIT. ^{n49.7} For those distributions, a look-through rule applies, and the character of the distribution as FIRPTA gain is retained and must be tracked by the recipient RIC or REIT; the distribution itself, however, does not become dividend income

in the hands of the recipient RIC or REIT. Therefore, the recipient RIC or REIT can in turn distribute amounts attributable to that distribution (attributable to the sale of USRPIs) to its US shareholders as capital gain. However, if any recipient RIC or REIT in turn distributes to a foreign shareholder amounts that are attributable to a sale by a lower tier RIC or REIT of USRPIs, any amounts distributed to a foreign shareholder are treated as FIRPTA gain or as dividend income, according to whether or not the distribution to that foreign shareholder qualifies for dividend treatment. n49.8

The gain from a sale of stock in a domestically controlled qualified investment entity is not subject to the above look-through rule and is not taxed under FIRPTA. n49.9 A domestically controlled qualified investment entity is one in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons. n49.10 The testing period is the 5-year period ending on the date of the distribution or disposition, or, if shorter, the period during which the qualified investment entity was in existence. n49.11

[2] FIRPTA Wash Sale Rule

A FIRPTA wash sale rule prevents foreign persons from avoiding FIRPTA tax on a RIC or REIT distribution by disposing of the RIC or REIT stock shortly before the distribution and buying it back shortly thereafter. n50 The period within which the wash sale rule applies is 61 days. This period includes the 30 days before and the 30 days after the ex-dividend date, in addition to the ex-dividend date itself. n50.1

The wash sale rule comes into play only if the following events occur: n50.2

- A foreign person disposes of RIC or REIT stock during the 30-day period preceding a distribution on that stock;
- The distribution would have been treated as a disposition of a US real property interest
- The foreign person acquires a substantially identical interest, or enters into a contract or option to acquire one, during the 61-day wash sale period; and
- The foreign person does not in fact receive the distribution in a manner that subjects the person to tax under FIRPTA.

If the above events occur, the foreign person must pay FIRPTA tax on an amount equal to the amount of the distribution that avoided FIRPTA tax as a result of the disposition. n50.3

Attribution rules apply in determining if a foreign person has acquired an interest that falls within the wash sale provision. A foreign person is treated as having acquired any interest acquired (or which will be acquired under a contract or option entered into within the wash-sale period) by any person treated as related within the meaning of *IRC Sections 267(b) or 707(b)(1)*. n50.4 These rules generally apply a 50-percent relationship test. n50.5

The wash sale rule also applies to substitute dividend payments. n50.6 A substitute dividend payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction. n50.7 The wash sale rule applies if the substitute dividend payment would be properly treated by the foreign taxpayer as receipt of a distribution of FIRPTA gain if the distribution from the RIC or REIT had itself been received by the taxpayer, but was not treated in that manner because of the transaction giving rise to the substitute dividend payment. n50.8 The wash sale rule also applies to other similar arrangements to which Treasury may extend it. n50.9

The wash sale rule does not apply if the foreign person actually receives the distribution, either with respect to the disposed of or acquired stock. n50.10 It also does not apply to any transaction involving the disposition of any class of stock that is regularly traded on an established securities market located in the United States, provided the foreign person did not hold more than 5 percent of that class of stock within the one year period ending on the date of the distribution. n50.11

[3] Withholding on REIT or RIC Distributions Attributable to the Sale of a US Real Property Interest

Withholding is required on REIT or RIC distributions to foreign persons that are attributable to the sale of USRPIs. The required withholding rate is 35 percent or, to the extent provided by regulations, 15 percent (or 20 percent in tax years beginning after December 31, 2010). n50.12 No withholding is required, however, with respect to a disposition that is treated as a disposition of a US real property interest solely because of the wash sale rule. n50.13

FOOTNOTES:

(n1)Footnote 49. *IRC § 857(b).*

(n2)Footnote 49.1. *IRC §§ 1441, 1445.*

(n3)Footnote 49.2. *IRC § 897(a).*

(n4)Footnote 49.3. *IRC § 897(h)(1), (2), (3).*

(n5)Footnote 49.4. *IRC § 897(h)(4)(A).* A RIC that would be a US real property holding corporation but for statutory exceptions relating to stock traded on an established securities market and to sales of stock in domestically controlled entities [see *IRC § 897(c)(3), (h)(2)*] is also a qualified investment entity [*IRC § 897(h)(4)(A)(i)(II)*]. A RIC that receives a distribution from a REIT continues to be subject to FIRPTA after 2007 for purposes of the distribution rules (including withholding on distributions to foreign shareholders) and for purposes of the wash sale provision discussed in [2], below [*IRC § 897(h)(4)(A)(ii)*; see *IRC §§ 897(h)(1), (5), 1445*].

(n6)Footnote 49.5. *IRC § 897(h)(1).*

(n7)Footnote 49.6. *IRC §§ 897(h)(1), 1441(a).*

(n8)Footnote 49.7. *IRC § 897(h)(1)*

(n9)Footnote 49.8. See *IRC § 897(h)(1).*

(n10)Footnote 49.9. *IRC § 897(h)(2).*

(n11)Footnote 49.10. *IRC § 897(h)(4)(B).*

(n12)Footnote 49.11. *IRC § 897(h)(4)(D).*

(n13)Footnote 50. *IRC § 897(h)(5)*, effective generally for tax years beginning after 12/31/05 [Pub Law 109-222, § 506(c)].

(n14)Footnote 50.1. *IRC § 897(h)(5)(B)(i)(II).*

(n15)Footnote 50.2. *IRC § 897(h)(5)(B).*

(n16)Footnote 50.3. *IRC § 897(h)(5)(A).*

(n17)Footnote 50.4. *IRC § 897(h)(5)(B)(i).*

(n18)Footnote 50.5. See *IRC* §§ 267(b), 707(b)(1).

(n19)Footnote 50.6. *IRC* § 897(h)(5)(B)(ii)(I)

(n20)Footnote 50.7. *Treas Reg* § 1.861-3(a)(6).

(n21)Footnote 50.8. See *IRC* § 897(h)(5).

(n22)Footnote 50.9. *IRC* § 897(h)(5)(B)(ii)(II)

(n23)Footnote 50.10. [*IRC* § 897(h)(5)(B)(iii).

(n24)Footnote 50.11. *IRC* § 897(h)(5)(B)(iv).

(n25)Footnote 50.12. *IRC* § 1445(e)(6), effective generally for tax years of qualified investment entities beginning after 12/31/05.

(n26)Footnote 50.13. *IRC* § 1445(b)(8); see [2], above, for a discussion of the wash sale rule.

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CHAPTER 17 Foreign Investment in U.S. Real Estate *

1-17 Federal Taxes Affecting Real Estate § 17.09

§ 17.09 Taxation of Investment by a U.S. Corporation

[1] General Rules

In general, the tax consequences of a nonresident alien's using a U.S. corporation to acquire U.S. real estate are:

- (1) The corporation would be subject to U.S. income taxes at regular corporate rates on its worldwide income. State corporate income and franchise tax will generally apply.
- (2) Dividends paid to nonresident alien shareholders generally would be subject to the 30 percent withholding tax, unless otherwise modified by treaty. n51
- (3) Any tax loss arising from the operation of corporate-owned real estate cannot be passed on to the corporation's shareholders. (Aliens cannot be shareholders in an S corporation, which permits flow-through of tax losses to shareholders for federal tax purposes.) n51.1
- (4) Individual nonresident alien shareholders generally would be subject to U.S. estate, gift and generation-skipping transfer taxes and state inheritance taxes on the value of their shares in the U.S. corporation. n51.2
- (5) Gain or loss on disposition of the shares would be subject to U.S. tax if the corporation is a "U.S. real property holding corporation" n51.3 (see § 17.11, below).
- (6) The deductibility of interest paid or accrued by the corporation to a related party would be subject to various limitations. n52
- (7) The corporation may be subject to a personal holding company tax, in addition to regular income tax. n52.1 The characteristics of a "Personal Holding Company" are described in Chapter 15, above.

[2] Earnings Stripping: IRC Section 163(j)

IRC §§ 2422 limits the extent to which a U.S. corporation or a foreign corporation can reduce its U.S. tax liability by making interest payments to a related party that is not subject to U.S. tax with respect to those payments.

Before the enactment of *IRC Section 163(j)*, financing a U.S. trade or business with as much debt as possible was advantageous for the following reasons:

- the 30 percent statutory withholding rate could be reduced under many treaties and interest could be paid out to a related party with little or no U.S. withholding tax. Dividends, on the other hand, were subject to a 5 to 15 percent tax rate under most treaties; and
- the U.S. trade or business could get a deduction at the 34 percent tax rate for interest paid to a related party, whereas no deduction was allowed for dividends.

Therefore, when earnings were repatriated by a U.S. corporation to a foreign parent in the form of interest, there was a double benefit: little or no U.S. withholding tax and a reduction of U.S. taxable income.

IRC Section 163(j) disallows a portion of the interest expense paid to related parties when all of the following conditions are present:

- the corporation's debt to equity ratio exceeds 1.5 to 1;
- the total net interest expense of the corporation exceeds the sum of 50 percent of the company's adjusted taxable income ("ATI") plus any "excess limitation carry forward." ATI is taxable income computed without regard to any deduction for net interest expense, net operating loss carryovers, depreciation, amortization or depletion; excess limitation carry forward means the excess (if any) of 50 percent of the corporation's adjusted taxable income, over the corporation's net interest expense, which excess limitation carry forward may be carried to the first, second and third succeeding taxable years; and
- the corporation pays or accrues disqualified interest during the taxable year. "Disqualified interest" includes any of the following items:
 - any interest paid or accrued by the taxpayer (directly or indirectly) to a related person n53.1 if no federal income tax is imposed on the recipient.
 - any interest paid or accrued with respect to any indebtedness to unrelated parties if there is a disqualified guarantee of that indebtedness and no gross basis tax is imposed with respect to that interest; and
 - any interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary n53.2 of a REIT to that REIT.

In applying the earnings stripping provision, a special rule applies to certain partnerships that receive interest payments. Interest that is paid to an otherwise related partnership is not treated as paid to a related person (and is therefore not "disqualified interest") if less than 10 percent of the profits and capital interests in the partnership are held by persons not subject to federal income tax on that interest. This rule, however, does not apply to interest allocable to any partner of the partnership who is related to the taxpayer. n54 If a treaty between the US and a foreign country reduces the tax on a partner's share of interest paid to the partnership, that partner's interest in the partnership is treated as held in part by a tax-exempt person and in part by a taxable person for purposes of applying the 10-percent rule. The amount of interest treated as tax-exempt is the same proportion as the rate of tax imposed without regard to the treaty, and reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. n54.1

The interest disallowed under 163(j) is the lesser of the excess described in the second item above or the tax exempt interest paid to the related party. n55 Interest expense disallowed under 163(j) can be carried forward indefinitely and used in any year in which the taxpayer's ATI exceeds net interest expense. n56

In order to circumvent 163(j), many U.S. borrowers repaid their related party debt and subsequently borrowed funds from third-party lenders with the foreign parent guaranteeing the repayment of the debt. However, third-party loans *guaranteed* by tax exempt or foreign related parties are treated as related party loans for purposes of applying 163(j) if the interest paid on those loans is not subject to gross basis taxation. n56.1 A "gross basis" tax is a U.S. income tax imposed without regard to deductions, n56.2 such as the 30 percent gross withholding tax imposed on interest paid to a foreign person. n56.3 To the extent that a treaty reduces the 30 percent gross withholding tax, a ratable portion of the interest paid is treated as though it was not subject to a gross basis tax. n57

The term "guarantee" is defined broadly to include any arrangement in which a person directly or indirectly through an entity or otherwise assures payment of another's obligation under any indebtedness. n57.1 The U.S. Treasury has reserved comment on the treatment for purposes of the earnings stripping rules of back-to-back loans and guarantees of third-party debt by related parties. n58 To the extent provided in Regulations, the rules will not apply to guaranteed debt if the interest on the indebtedness would be subject to a net basis taxation if it was paid to the guarantor. n59

The earnings stripping rules apply to corporate partners. n59.1 Except to the extent provided by regulations, in the case of a corporation that owns, directly or indirectly, an interest in a partnership, the corporation's share of partnership liabilities must be treated as liabilities of the corporation for purposes of applying the earnings stripping rules to the corporation. n59.2 In addition, the corporation's distributive share of interest income or expense of the partnership is treated as interest income or interest expense of the corporation. n59.3 Treasury is authorized to reallocate shares of partnership debt, or distributive shares of the partnership's interest income or interest expense, as may be appropriate. n59.4 For example, it is not intended that the application of the earnings stripping rules to corporations with direct or indirect interests in partnerships be circumvented through the use of allocations of partnership interest income or expense (or partnership liabilities) to or away from partners. n59.5

The application of 163(j) has significantly increased the taxable income of affected companies and lowered the overall rate of return that foreign owners achieve on their U.S investments.

The provisions of *IRC Section 163(j)* are complemented by restrictions on the ability of foreign parties to receive tax exempt portfolio interest from related debtors. n60

[3] Informational Reporting Requirements

Certain domestic corporations and foreign corporations engaged in business within the United States must comply with certain informational reporting and record-keeping requirements. n61 A corporation subject to this requirement, referred to as a "reporting corporation," must file with the Service an annual information return containing information about its transactions with related parties, including identifying information about those parties. The return is submitted on Form 5472. Generally, the required statement includes:

- (1) the amounts paid or received on the purchase or sale of inventory or other property;
- (2) rent or royalties paid and received;
- (3) amounts paid or received for technical services;
- (4) commissions paid and received;

(5) amounts lent and borrowed, and interest paid or received with respect to loans; and

(6) premiums paid and received for insurance. n62

A "reporting corporation" is defined as a corporation in which a foreign person owns 25 percent or more of the combined voting power of all classes of stock of that corporation or 25 percent or more of the value of all classes of stock of the corporation. Broad stock attribution rules apply in determining whether the control requirement is met, and the term "related party" is also very broadly defined. n63 In general, transactions of a reporting corporation with a parent corporation, a major shareholder, a related trust or partnership, or a subsidiary corporation must be reported under the provisions of *IRC Section 6038A*. In addition to the reporting requirements, *IRC Section 6038A* imposes burdensome record-keeping requirements.

The penalty for noncompliance under either the reporting or record-keeping requirements is severe. The IRS may impose an initial penalty of \$10,000 per year for a failure to report related-party transactions, maintain adequate records, or comply with an IRS request for records. Additional penalties of \$10,000 per month per violation may be imposed for continued failure to comply after notification. n64 Lastly, if a reporting corporation fails to comply with a valid summons for information, the IRS may, in its sole discretion, adjust the cost of goods sold deduction and other allowable deductions for amounts paid to foreign related parties claimed on the U.S. tax return. The IRS will presumably not adjust such items upwards.

FOOTNOTES:

(n1)Footnote 51. 2510, 1441(a) and 1442(a).

(n2)Footnote 51.1. *IRC § 1361(b)(1)(C)*.

(n3)Footnote 51.2. See *IRC §§ 2101 through 2107, 2501, 2601*.

(n4)Footnote 51.3. See *IRC § 897(a)*.

(n5)Footnote 52. *IRC §§ 163(j), 267, 263A, and 469*.

(n6)Footnote 52.1. *IRC § 541*.

(n7)Footnote 53. *IRC § 163(j)(3)*.

(n8)Footnote 53.1. See *IRC §§ 267(b), 707(b)(1)*.

(n9)Footnote 53.2. See *IRC § 856(l)*.

(n10)Footnote 54. *IRC § 163(j)(4)(B)(i)*.

(n11)Footnote 54.1. *IRC § 163(j)(4)(B)(ii), (5)(B)*.

(n12)Footnote 55. *IRC § 163(j)(1)(A)*.

(n13)Footnote 56. *IRC § 163(j)(1)(B)*.

(n14)Footnote 56.1. *IRC § 163(j)(3)(B)*.

(n15)Footnote 56.2. *IRC § 163(j)(6)(E)(i)*.

(n16)Footnote 56.3. See *IRC § 871(a)*.

(n17)Footnote 57. *IRC § 163(j)(5)(B)*.

(n18)Footnote 57.1. *IRC § 163(j)(6)(D)(iii)*.

(n19)Footnote 58. *Prop Treas Reg § 1.163(j)-9* (Reserved).

(n20)Footnote 59. *IRC § 163(j)(6)(D)(ii)(I)*.

(n21)Footnote 59.1. *IRC § 163(j)(8)*, effective for taxable years beginning on or after 5/17/06 [Pub Law 109-222, § 501(c).

(n22)Footnote 59.2. *IRC § 163(j)(8)(C)*.

(n23)Footnote 59.3. *IRC § 163(j)(8)(A), (B)*.

(n24)Footnote 59.4. *IRC § 163(j)(9)(D)*.

(n25)Footnote 59.5. See Conference Report 109-455, accompanying H.R.4297.

(n26)Footnote 60. *IRC § 871(h)(3)*.

(n27)Footnote 61. *IRC § 6038A*.

(n28)Footnote 62. *Treas Reg § 1.6038A-2*.

(n29)Footnote 63. *IRC §§ 6038A(c)(2), (5)*.

(n30)Footnote 64. *IRC § 6038A(d)*.

* Revised by Thomas V. Glynn, a partner with the law firm of Wolf Block Schorr and Solis-Cohen LLP, New York, NY.



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Federal Taxes Affecting Real Estate

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CHAPTER 17 Foreign Investment in U.S. Real Estate *

1-17 Federal Taxes Affecting Real Estate § 17.10

§ 17.10 Taxation of Investment by a Foreign Corporation

A foreign corporation that acquires real property in the United States will be subject to U.S. tax at 30 percent on its gross rental income, unless it is engaged in a U.S. business or makes the net taxable income election as discussed above. n65 Dividends paid by the corporation directly or indirectly to nonresident alien shareholders *may* be subject to a U.S. withholding tax of 30 percent (unless reduced by a tax treaty). United States withholding tax is applied to dividends of a foreign corporation only if 25 percent or more of the income of the corporation was derived from U.S. sources for the prior three years. n66 If the 25 percent threshold is passed, the 30 percent withholding is applied to the portion of the dividend that bears the same ratio to the dividend as the corporation's effectively connected income bears to its total income from all sources.

[1] Branch-Profits Tax

In addition to the normal corporate tax, foreign corporations that engage in a U.S. trade or business, or that elect to be treated as so engaged, are generally subject to a U.S. branch-profits tax. n67 Foreign corporations having only passive investments in the United States, which are not engaged in a U.S. trade or business, are not affected by this tax. Foreign corporations subject to the tax pay a tax of 30 percent on their "dividend equivalent amount," unless a treaty exempts the foreign corporation from the tax or reduces the tax. n67.1 Even then, however, the tax is imposed, notwithstanding a treaty provision to the contrary, unless the foreign corporation is a qualified resident of the treaty country. n67.2 For this purpose, a "qualified resident" is defined in a way that is intended to prevent foreign corporations from being organized in treaty jurisdictions and beneficially owned by nonresident aliens who are not residents of the treaty jurisdiction. n67.3

The "dividend equivalent amount" is the foreign corporation's effectively connected earnings and profits for the year, reduced for increases in the net U.S. equity of the foreign corporation and increased for decreases in the net U.S. equity of the foreign corporation. n67.4 The term "U.S. net equity" means, in general, the excess of the adjusted basis of assets used in a U.S. trade or business over the U.S. liabilities connected with the conduct of a trade or business in the United States. n67.5 An active real estate business owned by a foreign corporation that is not reinvesting its earnings in the United States will likely be affected by the branch-profits tax rules.

[a] Mechanics

The branch-profits tax is imposed on the foreign corporation's effectively connected earnings and profits for the tax

year, which are referred to as the "dividend equivalent amount" (DEA). n67.6 A corporation's DEA is determined according to the following steps: n67.7

(1) The corporation must first determine the amount of its earnings and profits effectively connected with its U.S. trade or business for the tax year; this amount is known as "effectively connected earnings and profits" (ECE&P). ECE&P does *not* include: certain specific categories of income, including earnings derived from the sale of any interest in a U.S. real property holding corporation, and the assets and liabilities of the foreign corporation that are treated as connected with such income are not taken into account in determining the U.S. assets or U.S. liabilities of the foreign corporation. n67.8 In computing ECE&P, current-year profits are reduced by the current-year U.S. corporate tax, but not by current-year distributions to shareholders. Prior-year deficits will not carry forward to reduce current-year ECE&P for purposes of determining the branch-profits tax. n67.9

(2) ECE&P is then *reduced* (but not below zero) by any "increase in U.S. net equity" over the prior year or *increased* by any "decrease in U.S. net equity" over the prior year (but only to the extent of the accumulated effectively connected earnings and profits as of the close of the preceding taxable year.) n67.10 United States net equity is defined to mean U.S. assets reduced (including below zero) by U.S. liabilities. n67.11 United States assets include the amount of any money and the aggregate adjusted basis (as used for computing earnings and profits) of any property of a foreign corporation treated as connected with a U.S. trade or business. n68 United States liabilities include any liabilities of a company treated as effectively connected with a U.S. trade or business as computed under *Regulations Section 1.882-5*. n69

The operation of the branch-profits tax can be illustrated by the following examples.

Example 1:

Assume a foreign corporation, X, organized in the Netherlands, is engaged in the active conduct of a real estate business in the United States. For Year 1, X has rental income of \$2 million, interest expense to unrelated parties of \$900,000, and other deductions of \$600,000. As a result, its ECE&P from its real estate operations is \$500,000 before U.S. tax. X *does not* reinvest these earnings in its real estate business. For Year 1, X's DEA would be \$330,000 (i.e., \$500,000 - \$170,000 (U.S. tax at 34 percent)). Assuming X is not entitled to treaty benefits (because of treaty shopping), X's total U.S. tax liability is \$269,000, computed as follows:

X's U.S. corporate tax (\$500,000 x 34%)	\$170,000
X's branch-profits tax ((\$500,000 - \$170,000) x 30%)	99,000
	\$269,000*

*Note that the tax burden is equal to the federal tax burden that would be imposed if the foreign corporation conducted the U.S. activities through a wholly-owned U.S. subsidiary, which paid a dividend of its entire after-tax earnings, with the dividend being subject to 30% withholding.

Example 2:

1-17 Federal Taxes Affecting Real Estate § 17.10

If *X* *does* reinvest its after-tax profits (\$330,000) in additional U.S. real property in Year 1, its DEA is zero (i.e., \$500,000 - (\$170,000 + \$330,000)), and it pays no branch-profits tax. *X*'s total tax liability is \$170,000.

Example 3:

Assume *X* reinvests all of its after-tax earnings in Year 1, but that in Year 2, *X* sells all its assets for a gain of \$2 million. This amount represents all of *X*'s ECE&P for the year. Assume also that *X*'s decrease in U.S. net equity as a result of the sale is \$500,000. *X*'s U.S. tax liability is \$1.75 million, determined as follows:

U.S. corporate tax (\$2,000,000 x 34%)	\$680,000
Branch-profits tax (((\$2,000,000 - \$680,000 + \$330,000*) x 30%)	495,000
	\$1,175,000

* Note that the decrease in net equity is added to the DEA, but only to the extent of the \$330,000 that was reinvested in additional assets and that reduced the DEA amount in Year 1.

If *X* disposes of all of its U.S. assets and withdraws from conducting a business in the United States, then, subject to an anti-abuse rule, the branch-profits tax will not apply. n71

Example 4:

Assume foreign corporation *Y* is organized in a country that does not have a tax treaty with the United States. *Y* operates a meat packing plant in the United States. *Y* had a net operating loss of \$200,000 attributable to its U.S. business operations in Year 1, its first taxable year. *Y* also had a deficit in earnings and profits for Year 1 of \$150,000. In Year 2, *Y* had a profit attributable to its U.S. operations of \$100,000. Assume *Y* does not reinvest its Year 2 profits in U.S. assets. *Y*'s total U.S. tax liability in Year 2 is \$30,000. Thus, even though *Y* had an accumulated deficit in earnings and profits and a net operating loss carryforward for corporate tax purposes, it is still subject to a branch-profits tax on its current year's effectively connected earnings and profits. The U.S. tax liability is computed as follows:

Y's U.S. corporate tax (\$100,000-\$100,000 NOL carryforward x 34%)	\$ --
Y's branch-profits tax (\$100,000 x 30%)	30,000
	\$30,000

Since the branch-profits tax is intended to equalize the tax on operations through U.S. subsidiaries and foreign branches, if a foreign corporation is subject to the branch-profits tax, there is no U.S. secondary withholding tax when dividends

are paid by the corporation to its shareholders. n72 A foreign country's taxes cannot be credited against the branch-profits tax.

[b] Interaction with Treaties

Some U.S. income tax treaties specifically provide that the U.S. may impose a branch-profits tax. The rate of tax that can be imposed is usually limited to the rate that may be imposed on dividends paid to a foreign parent. Most U.S. treaties, however, obligate the United States not to discriminate against corporations organized in the treaty partner. This means they cannot be subject to greater U.S. tax than similarly situated U.S. companies. Arguably, these nondiscrimination provisions preclude the United States from imposing a branch-profits tax, although the United States could override any treaty provision merely by enacting conflicting statutory language after the treaty is approved. Congress generally chose not to do so in this case. Therefore, *IRC Section 884(e)* provides that the branch-profits tax generally does not apply to a foreign corporation that is a qualified resident of a treaty country if precluded by a treaty. However, this provision has been modified several times, and future legislation could add additional restrictions to this rule.

Consequently, when a treaty allows the United States to impose a branch-profits tax, and assuming that the other requirements of *IRC Section 884(e)* are satisfied, that tax is imposed on the foreign corporation at the rate specified in the treaty. If no rate is specified in the treaty, the branch-profits tax is applied at the rate for dividends paid to a foreign company by its wholly-owned U.S. subsidiary. Under many treaties this calls for a reduced rate of 5 percent. If the treaty allows a branch-profits tax, but limits it to profits attributable to a permanent establishment or provides a different formula for determining the tax, the treaty prevails. If the treaty prohibits a branch-profits tax (i.e., because of a nondiscrimination provision), and assuming that the other requirements of *IRC Section 884(e)* are satisfied, then no branch-profits tax is imposed. However, a secondary withholding tax, if applicable and if allowed under the treaty, is imposed when dividends are paid to shareholders.

[c] Treaty-Shopping Exception

Treaty prohibitions of branch-profits tax and secondary withholding taxes will be overridden if the shareholders are deemed to be treaty shopping. "Treaty shopping" is deemed to occur in any case in which (1) more than 50 percent of the *value* of the stock of the foreign corporation is owned directly or indirectly by third parties, that is, by individuals who are not residents of the treaty country or who are not U.S. citizens or resident aliens, or (2) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the treaty country or who are not U.S. citizens or resident aliens. However, treaty shopping is *not* deemed to be involved when the stock of the foreign corporation is primarily and regularly traded on an established securities market in the country of its residence, or when the foreign corporation is wholly owned by a foreign corporation that is resident in the same country and with stock that is publicly traded on a stock exchange in that country. n73 Thus, a Dutch corporation with stock that is substantially owned by non-Dutch persons is exempt from the branch-profits tax if its stock is primarily and regularly traded on an international stock exchange located in The Netherlands or the Dutch corporation is owned by a publicly traded Dutch corporation. The Treasury has authority to carve out other exceptions to the treaty shopping rules.

[d] Impact

The imposition of a branch-profits tax increases the U.S. tax liability of foreign corporations that are engaged in a U.S. trade or business and do not have treaty protection. Although the U.S. branches of most foreign companies were always subject to U.S. tax on current earnings from a U.S. trade or business, under prior law, dividends paid by the company were frequently considered foreign-source income, so there was no U.S. withholding tax. The branch tax is a surrogate for that withholding tax. The new branch tax can also increase the U.S. tax on foreign corporations that were treaty protected under prior law but are now subject to the branch-profits tax under the treaty-shopping rules. Thus, for example, much foreign investment into the U.S. through Netherlands and Swiss corporations is adversely affected.

Foreign corporations organized in treaty countries that allow a U.S. branch-profits tax (for instance, Canada and France) are also adversely affected but do have the benefit of a lower tax rate under the treaty.

[2] Secondary Withholding Tax

The secondary withholding tax is a tax imposed on the payment of interest or dividends to a foreign lender/shareholder by a foreign

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corporation engaged in U.S. trade or business. *IRC Sections 1441(a) and 1442(a)* impose withholding taxes on gross income from sources within the United States. *IRC Section 861(a)* sets forth the circumstances in which dividends from a foreign corporation can be U.S. source income, and *IRC Section 884(f)* provides the circumstances in which interest paid by a foreign corporation can be considered U.S. source income.

In general, dividends are treated as U.S.-source income unless less than 25 percent of the foreign corporation's gross income for the three preceding years was effectively connected with a U.S. trade or business. n73.1

Under the rule for interest, interest expense deductions allocable to the U.S. branch under the existing allocation rules (*Regulations Section 1.882-5*) in excess of the interest actually paid by it, is subject to withholding tax at the rate applicable to the home office, irrespective of where the home office borrowed the funds. n73.2 In effect, the U.S. branch is treated as a U.S. subsidiary with a "notional loan" from its home office. The "excess interest" is treated as paid on the last day of the corporation's taxable year and any U.S. tax due is payable when the U.S. tax return is required to be filed (not including extensions). n74 When the U.S. branch borrows directly from a third party, the rate of withholding applicable to the third party applies. The branch would be the U.S. withholding agent and is required to withhold tax on the date of payment. This rule can be illustrated by the following examples.

Example 1:

Assume a foreign company, organized in country X, has a U.S. branch and borrows \$10 million from a country X resident. Country X does not have an income tax treaty with the United States. Under the allocation rules (*Regulations Section 1.882-5*), \$500,000 of the interest expense of the foreign company is allocated to its U.S. branch. The U.S. branch pays no interest directly to third parties. Under the secondary withholding tax provision, a withholding tax of \$150,000 (i.e., 30 percent of \$500,000) is imposed. n74.1

Example 2:

The facts are the same as in Example 1, except that the foreign company is organized in a U.S. treaty partner. The rate of U.S. withholding tax on interest under the treaty is 10 percent. The home office borrows \$5 million from a resident of a second U.S. treaty partner, in which the treaty provides a zero rate of withholding on interest, and \$5 million from a resident of a country with no U.S. treaty. The U.S. branch pays no interest directly to third parties. Withholding tax of \$50,000 (i.e., \$500,000 x 10 percent) is imposed on the \$500,000 of interest that is allocable to the U.S. branch under *Regulations Section 1.882-5*. The issue is whether the home-office rate, the second-treaty-partner rate or the nontreaty rate applies. Under this example, the rate applicable under the treaty between the United States and the home office applies. If the interest were paid by the U.S. branch directly to the resident of the nontreaty country, the 30 percent statutory rate applies. If the interest were paid by the U.S. branch directly to the resident of the treaty country with zero rate, the zero rate applies. n74.2

[a] Election to Reduce U.S. Liabilities

The regulations under Section 884 permit a foreign corporation to make an annual election to reduce its U.S. liabilities (computed in accordance with *Regulations Section 1.882-5*) down to the amount of liabilities actually shown on the books and records of the U.S. branch at the end of its tax year. ⁿ⁷⁵ This annual election enables taxpayers to increase their net equity and therefore reduce their branch-profits tax.

By making the election, the foreign corporation must permanently forego the interest deduction calculated under *Regulations Section 1.882-5* attributable to the reduction in liabilities. ⁿ⁷⁶

This election is especially useful to foreign corporations whose U.S. trades or businesses produce effectively connected losses. Although a foreign corporation with effectively connected losses would generally not have a branch tax liability in that year, the corporation may have branch level interest tax to the extent the interest computed under *Regulations Section 1.882-5* exceeds actual interest paid by the branch. In this situation, the corporation may prefer to forego the interest deduction rather than pay the branch level interest tax.

[b] Interaction with Treaties

Many U.S. treaties contain articles that prohibit the United States from imposing a secondary withholding tax. Other treaties contain provisions reducing the rate of tax than can be imposed. The regulations, however, specifically limit the benefits of a treaty article prohibiting or reducing U.S. tax on interest paid by a foreign corporation. The foreign corporation will generally be entitled to a reduced treaty rate for the tax on excess interest under the interest article of the tax treaty. ⁿ⁷⁷

[c] Impact

The use of a branch to make investments into the U.S. through treaty shopping needs to be restructured due to the imposition of two taxes: (1) branch-profits tax on dividend-equivalent amounts, ^{n77.1} and (2) secondary withholding tax on interest paid to the investor. ^{n77.2} These provisions have a substantial impact on real estate operations through U.S. branches. In many cases, this causes foreign investors to incorporate their real estate investments in a U.S. company.

[3] Interaction of Branch-Profits and Secondary Withholding Taxes

The Service announced that the branch-profits tax is not imposed on foreign corporations that are qualified residents of certain countries (listed under Section 1, below) with which the United States has an income tax treaty. ⁿ⁷⁸ The income tax treaties in effect between the United States and the countries listed under Section 2, below, permit imposition of the branch-profits tax, subject to any limitations and rate reductions contained in the treaty with that country. ⁿ⁷⁹

Section 1--Countries whose qualified residents are not subject to the branch-profits tax:

Austria	Greece	Luxembourg
Belgium	Hungary	Morocco
People's Rep. of China	Iceland	Netherlands
Cyprus	Ireland	Norway
Denmark	Italy	Pakistan
Egypt	Jamaica	Philippines
Finland	Japan	Sweden
Germany	Korea	Switzerland

United Kingdom

Section 2--Treaties that permit imposition of the branch-profits tax:

Australia	Israel	Romania
Barbados	Kazakhstan	South Africa
Canada	New Zealand	Trinidad & Tobago
France	Poland	U.S.S.R.

[4] Earnings Stripping: *IRC Section 163(j)*

The rules under *IRC Section 163(j)* (detailed in § 17.09[2] above) that limit related party interest expense deductions apply to foreign corporations engaged in a U.S. trade or business as well as to U.S. corporations. n80 These rules apply only to foreign corporations whose debt to equity ratios exceed 1.5 to 1. n81

In determining the debt/equity ratio of a foreign corporation, the debt of the corporation equals the worldwide liabilities of the foreign corporation as calculated under *Regulations Section 1.882-5*. The equity of the foreign corporation is the amount of its worldwide assets (determined under *Regulations Section 1.882-5*) less worldwide liabilities. n82 It appears that the debt/equity ratio of a foreign corporation is determined by reference to the *value* of its assets, rather than the *adjusted basis* of its assets. n83

The foreign corporation determines the amount of related party interest by first applying the branch level interest rules under *IRC Section 884(f)*. Interest treated as actually paid by the U.S. branch under Section 884(f)(1)(A) is treated as paid to the recipient by a wholly owned U.S. subsidiary of the foreign corporation. n84 In addition, to the extent that the interest allocable to the branch (under the rules of *IRC Section 882*) exceeds the interest paid by the branch, the foreign corporation is subject to tax under *IRC Section 881(a)* in the same manner as if such excess were paid to it by a wholly-owned domestic subsidiary on the last day of its taxable year. n85 This interest deduction may be limited under *IRC 163(j)* if the recipient is a related tax-exempt party. For example, if the rate of tax on interest paid by the branch to a foreign party is reduced by treaty from 30 percent to 10 percent, two-thirds of the interest paid is treated as tax exempt related party interest.

Excess interest (the excess of the amount allowed as a deduction under *Regulations Section 1.882-5* over the amount paid by the branch) is treated as paid to the foreign corporation by its wholly owned domestic subsidiary. n86 Therefore, this amount is treated as paid to a related party for purposes of *IRC Section 163(j)*. If the tax on excess interest is reduced by treaty, interest will be treated as paid to a tax exempt related person to the extent of the reduction. Note that the above holds true even when the foreign corporation has borrowed only from unrelated third parties.

Foreign corporations calculate their disallowed interest under 163(j) generally in the same manner as do U.S. corporations. Proposed *Regulations Section 1.163(j)-8* provides rules for the application of Section 163(j) to foreign corporations. An outline of the basic rules under 163(j) is provided in § 17.09[2] above.

FOOTNOTES:

(n1)Footnote 65. *IRC § 882(d)*.

(n2)Footnote 66. *IRC § 861(a)(2)(B)*. See *Treas Reg § 1.1441-3(b)(2)(ii)*.

(n3)Footnote 67. *IRC § 884*.

(n4)Footnote 67.1. *IRC § 884(a), (e)(1)*.

(n5)Footnote 67.2. *IRC § 884(e)(1)(B)*.

(n6)Footnote 67.3. See *IRC § 884(e)(4)*.

(n7)Footnote 67.4. *IRC § 884(b)*.

(n8)Footnote 67.5. *IRC § 884(c)*.

(n9)Footnote 67.6. *IRC § 884(a), (b)*.

(n10)Footnote 67.7. See *IRC § 884(b)*.

(n11)Footnote 67.8. *IRC § 884(d)(2)*.

(n12)Footnote 67.9. *Treas Reg § 1.884-1(f)(1), (2)*.

(n13)Footnote 67.10. *IRC § 884(b)(1), IRC § 2510*.

(n14)Footnote 67.11. *IRC § 884(c)(1)*.

(n15)Footnote 68. *IRC § 884(c)(2)(A); Treas Reg § 1.884-1(d)*.

(n16)Footnote 69. *IRC § 884(c)(2)(B); Treas Reg § 1.884-1(e)*.

(n17)Footnote 71. *Temp Treas Reg § 1.884-2T*.

(n18)Footnote 72. *IRC § 861(a)(2)(B); IRC § 884(e)(3)*

(n19)Footnote 73. *IRC § 884(e)(4); Treas Reg § 1.884-5(a)*.

(n20)Footnote 73.1. *IRC § 861(a)(2)(B)*.

(n21)Footnote 73.2. *IRC §§ 881(a), 884(f)(1)(B); see Taiyo Hawaii Co, Ltd v Commr, 108 TC No 27 (1997)* .

(n22)Footnote 74. *IRC § 884(f)*.

(n23)Footnote 74.1. *IRC § 884(a)*.

(n24)Footnote 74.2. *IRC §§ 884(a), 1442*.

(n25)Footnote 75. *Treas Reg § 1.1031-1(c)*.

(n26)Footnote 76. *Treas Reg § 1.884-1(e)(3)(iii)*.

(n27)Footnote 77. *Treas Reg § 1.884-4(b)(8)*.

(n28)Footnote 77.1. See *IRC § 884*; see [1], above, for a discussion.

(n29)Footnote 77.2. See *IRC §§ 881(a), 1442*.

(n30)Footnote 78. *Notice 87-56, 1987-2 CB 367 ; Treas Reg § 1.884-1(g)(3)*. *Notice 87-56, 1987-2 CB 367* , also lists Aruba, Malta, and the Netherlands Antilles, but the treaties with these jurisdictions have since been terminated.

(n31)Footnote 79. *Treas Reg § 1.884-1(g)(4)*.

(n32)Footnote 80. *IRC § 163(j); IRC § 882.*

(n33)Footnote 81. *Prop Treas Reg § 1.163(j)-8(a).*

(n34)Footnote 82. *Prop Treas Reg § 1.163(j)-8(e).*

(n35)Footnote 83. *Prop Treas Reg § 1.163(j)-8(e); Treas Reg § 1.882-5(c).*

(n36)Footnote 84. *Prop Treas Reg § 1.163(j)-8(d).*

(n37)Footnote 85. *IRC § 884(f)(1)(B)*, as amended by the Small Business Job Protection Act of 1996 (Pub L No 104-188).

(n38)Footnote 86. *Id.*

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Federal Taxes Affecting Real Estate

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CHAPTER 17 Foreign Investment in U.S. Real Estate *

1-17 Federal Taxes Affecting Real Estate § 17.11

§ 17.11 Taxation of Aliens on Gains from U.S. Real Estate

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) added Section 897 to the Code and totally revamped the law governing the *disposition* of U.S. real property by non-resident aliens and foreign corporations. n87 Before the enactment of FIRPTA (*IRC Section 897*), significant tax-planning opportunities were available for nonresident aliens investing in U.S. real property. Generally, a nonresident alien did not have any U.S. tax liability on the disposition of real estate if he (1) owned U.S. real estate that was not used in a U.S. trade or business and (2) was not present in the United States for 183 days or more during the taxable year. n88 This was so even though the disposition generated U.S. source income. n89 In addition, gain from the sale of stock of a U.S. corporation also was not taxable under the above rules *even though* the corporation held nothing but U.S. real estate.

FIRPTA was Congress's response to the perceived abuses resulting from the widespread avoidance of U.S. taxes with respect to the disposition of U.S. realty by aliens.

[1] General Rule

The basic thrust of *IRC Section 897* is that the gain or loss from the disposition of any investment in U.S. realty, known as "United States real property interests," by a nonresident alien individual or a foreign corporation must be taxed as if it were effectively connected with the conduct of a trade or business in the United States. n90 In essence, this has the effect of taxing the gain as if the alien were a U.S. resident.

To enforce the collection of this tax, information return requirements n91 and withholding requirements n92-93 are imposed.

[2] Definitions

Although the basic premise of *IRC Section 897* is fairly straightforward, the definition of the type of property subject to taxation is typically complex. The key terms are defined below.

- (1) *United States real property interest (USRPI)*--An interest in real property located in the United States or Virgin Islands, and any interest, other than an interest *solely* as a creditor, in any *domestic* corporation. n94 Stock of a domestic corporation is not treated as a USRPI, however, in the following instances:

(a) The taxpayer establishes that the corporation was not a U.S. real property holding corporation during the shorter of the period during which the taxpayer held the stock, or the five-year period ending on the date of the disposition of the interest. n95

(b) The corporation holds no USRPI on the date of the disposition of its stock and any USRPI held by it during the shorter of (i) the period during which the taxpayer held the stock, or (ii) the preceding five-year period, was disposed of in transactions in which any realized gain was fully recognized or ceased to be U.S. real property interests by reason of the application of the rules described in this paragraph to another corporation. n96

(c) The stock is of a class of stock of a corporation that is regularly traded on an established securities market but only if the taxpayer did not hold more than 5 percent of such class of stock at any time during the shorter of (i) the period after June 18, 1980, during which the taxpayer held the stock, or (ii) the preceding five-year period. n97 The attribution rules of *IRC Section 318*, subject to certain modifications, must be used in determining this 5 percent threshold. n98

(2) *Interest in real property*--This includes any of the following interests:

(a) An outright ownership interest or leaseholds of land and improvements and options to acquire such interests. n99 Improvements include inherently permanent structures and their structural components as well, for example, wiring, plumbing, and the like. n100 This category is defined primarily by reference to the investment tax credit regulations.

(b) Moveable walls, furnishings, and other personalty associated with the use of property. n101 However, personal property must be used as an ordinary and necessary corollary to the real property's use. Personal property is associated with the use of real property only in limited circumstances, and only when both the personal property and the USRPI with which it is associated are held by the same person or by related persons. n102 Local law definitions of realty and personalty are also not determinative. n103 Under certain circumstances, personalty will not be treated as a USRPI if it is disposed of separately from the realty. n104

(c) *Growing* crops and timber; mines and wells; and unextracted ores, minerals, and other natural deposits. n105

(3) *Interest other than that solely as a creditor*--An interest solely as a creditor either in real property or in a domestic corporation does not constitute a USRPI. n106 If a person has any interest in realty or an entity other than that solely as a creditor, and also holds an interest solely as a creditor, those interests will generally be treated as separate and distinct interests, although they will be aggregated, and treated as interests other than those solely as a creditor, if the interest solely as a creditor has been separated from or acquired separately from the interest other than that solely as a creditor for a principal purpose of avoiding FIRPTA. n107 Extensive attribution rules apply in determining a person's interests in the property or entity. An interest that includes a right to a payment from an entity, the amount of which is contingent on the appreciation in value of an interest in the entity, the value of the assets of the entity, or the general gross or net proceeds or profits of the entity is not an interest "solely as a creditor." Accordingly, a debt instrument containing a participation feature will not be treated as an interest solely as a creditor. n108

(a) *Real estate*: This category includes a life estate; remainder interest; reversionary

interest; time-sharing arrangement; *any* direct or indirect right to share in the appreciation in value of realty or in the gross or net proceeds or profits generated by realty, for example, shared appreciation mortgages; and option, contract, or right of first refusal to acquire any interest that is other than that solely as a creditor. n109

(b) *Corporations*: Any interest that is considered as stock for federal income tax purposes; any direct or indirect right to share in appreciation in value of an interest in the above entity or a direct or indirect right to share in the appreciation in the value of the assets, or gross or net proceeds or profits derived by the corporation, or any right to indirectly acquire such an interest. n110

(c) *Partnerships*: Any interest that is considered as a partnership interest for federal income tax purposes, any direct or indirect right to share in the appreciation in value of an interest in the above entity or a direct or indirect right to share in the appreciation in the value of the assets; or gross or net proceeds or profits derived by the partnership, or any right to directly or indirectly acquire such an interest. n111 This definition would include an interest in a limited liability company that is taxed as a partnership for federal income tax purposes.

(d) *Estates and trusts*: Any interest as an owner or beneficiary of a trust or estate for federal income tax purposes; any direct or indirect right to share in appreciation in value of an interest in the above entity or a direct or indirect right to share in the appreciation in the value of the assets; or gross or net proceeds or profits derived by the estate or trust, or any right to directly or indirectly acquire such an interest. n112

(4) *United States Real Property Holding Corporation (USRPHC)*--As discussed above, if a domestic corporation is a USRPHC, then the stock of the corporation is a USRPI and the disposition of the stock of the corporation would be taxable under the FIRPTA rules. Regulations n112.1 set forth requirements to establish that a corporation is not a U.S. real property holding corporation. Unless those requirements are satisfied, it is presumed that a domestic corporation is a U.S. real property holding corporation. n112.2 Generally, a corporation is a USRPHC if the fair market value of its USRPIs equals or exceeds 50 percent of the sum of the fair market value of its U.S. real property interests, and interests in foreign real property, plus any of its other assets used or held for use in a trade or business. n113 However, the fair market value of a corporation's U.S. real property interests will be presumed to be less than 50 percent of the fair market value of its assets if the *book value* of its USRPIs is 25 percent or less of the book value of its real estate assets, assets used or held for use in a trade or business and stock of certain foreign real estate corporations. n114

Although only an interest in a *domestic* corporation can be a USRPI and be subject to tax upon disposition, n115 *any* corporation, foreign or domestic, can be a USRPHC. n116 However, *solely* for purposes of determining whether a corporation is a USRPHC, an interest in a foreign corporation will be considered to be a USRPI. n117

Example 1:

A nonresident alien (NRA) owns 100 percent of the stock of X, a foreign corporation. X's only asset is a parcel of U.S. realty. The stock of X is not a USRPI because X is a foreign corporation. Therefore, the NRA is not subject to tax under *IRC Section 897* upon his disposition of the X stock. X, however, would be subject to *IRC Section 897* if it disposed of the U.S. realty. A buyer of X stock would not obtain a step-up in the basis of the X stock. This preserves the inherent untaxed gain in the stock.

Example 2:

An NRA owns 100 percent of the stock of Y, a U.S. corporation. Y's only asset is 20 percent of the stock of foreign corporation X. X's only asset is a parcel of U.S. realty. Solely for purposes of determining whether Y is USRPHC, the stock of X will be treated as a USRPI. As a result, Y is a USRPHC and its stock is a USRPI which is subject to *IRC Section 897* if disposed of by the NRA. However, the stock of X is not a USRPI.

Special "look-through" provisions also apply. Generally, these provisions provide that assets held by a partnership, trust, estate, or controlled corporation will be treated as being held proportionately by the partners, beneficiaries, and stockholders upward through the chain of ownership. ⁿ¹¹⁸ Therefore, if in example 2 above, Y had held at least 50 percent of the fair market value of X's stock, X's ownership of the U.S. realty would have been attributed directly to Y. As a result, Y would have been a USRPHC whether or not X met that test.

[3] Operative Provisions

Although the general rule of *IRC Section 897* appears merely to bring dispositions of USRPI under the U.S. taxing jurisdiction, a closer reading reveals that in many instances such transactions are given inherently different treatment than the treatment given similar transactions involving U.S. taxpayers.

(1) *Distributions by foreign corporations*--Any gain realized by a foreign corporation upon the distribution of a USRPI (including a disposition in liquidation or redemption to a controlling parent corporation) generally must be recognized unless the distributee of the property would be subject to taxation on a subsequent disposition of the property *and* the basis of the property in the hands of the distributee is no greater than the adjusted basis of the property before distribution, increased by the amount of gain (if any) recognized by the distributing corporation, except to the extent that non-recognition is provided for in Regulations. ⁿ¹¹⁹ The IRS has issued a Revenue Procedure pursuant to which certain foreign corporations that would otherwise be subject to gain recognition on the distribution of U.S. real property interests can obtain non-recognition on the distribution by entering into a closing agreement with the IRS. ⁿ¹²⁰

(2) *Nonrecognition provisions*--Generally, except as provided in regulations, any nonrecognition provision of the Internal Revenue Code will apply to a transaction involving a USRPI only if it is exchanged for a U.S. real property interest which would be subject to U.S. tax upon sale. ⁿ¹²¹

(3) *Partnerships, estates, and trusts*--The sale or exchange of an interest in a partnership, estate, or trust will be treated as a pro rata disposition of the USRPIs held by the entity. ⁿ¹²² An interest in a partnership in which 50 percent or more in value of the gross assets consist of U.S. real property interests, and 90 percent or more of the value of the gross assets consist of U.S. real property interests and cash or cash equivalents, is considered entirely a U.S. real property interest for purposes of withholding on dispositions of such interests. ⁿ¹²³

(4) *Contribution of capital to a foreign corporation*--Generally, gain must be recognized by a non-resident alien individual or foreign corporation upon the contribution to capital of a USRPI to a foreign corporation. ⁿ¹²⁴

(5) *Qualified Investment Entities*--A "qualified investment entity" is either a REIT or--before 2008 only--a regulated investment company (RIC) that is a US real property holding corporation. ⁿ¹²⁵ Any distribution by a qualified investment entity to a nonresident alien individual, foreign corporation, or

other qualified investment entity is, to the extent attributable to gains from sales or exchanges of the qualified investment entity of US real property interest, treated as gain recognized by that nonresident alien individual, foreign corporation, or other qualified investment entity from the sale or exchange of a US real property interest. n125.1 There is an exception, however--any distribution by a qualified investment entity to a nonresident alien individual or a foreign corporation with respect to any class of stock that is regularly traded on an established securities market located in the United States is not treated as gain recognized from the sale or exchange of US real property interest if that individual or corporation did not own more than 5 percent of that class of stock at any time during the 1-year period ending on the date of the distribution. These distributions instead are treated as dividend distributions and are subject to dividend withholding. n126 The distribution of a US real property interest by a domestically controlled qualified investment entity will generally be treated for purposes of the FIRPTA rules the same as distributions from a foreign corporation, to the extent of the foreign investors' interests. n127 The sale of stock in a domestically controlled qualified investment entity is not taxable under FIRPTA because stock in a domestically controlled investment entity is not a US real property interest. n127.1 A domestically controlled qualified investment entity is one in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons. n128 The testing period is the 5-year period ending on the date of the distribution or disposition, or, if shorter, the period during which the qualified investment entity was in existence. n128.1

(6) *Election by a foreign corporation to be treated as a domestic corporation*--If, under a treaty obligation of the United States, a foreign corporation is entitled to nondiscriminatory treatment, that is, pursuant to a treaty the United States cannot treat a foreign taxpayer more unfavorably than a U.S. taxpayer, the foreign corporation may make an election to be treated as a domestic corporation for purposes of *IRC Section 897*. n129

Essentially, the effect of this election is to tax the corporation as if it were a U.S. corporation for dispositions of USRPI and to exempt it from the special rules discussed above. However, it also would mean that the stock of the foreign corporation could then be treated as a USRPI for all purposes. n130 Once the election is made, it is binding in all future taxable years unless the Service consents to a revocation. n131

[4] Withholding and Reporting Requirements

Special withholding requirements apply when a nonresident or foreign corporation disposes of an interest in US real property. In general, any person acquiring a USRPI from a foreign person to deduct and withhold a tax equal to the lesser of 10 percent of the total amount realized by the transferor on the disposition, or the transferor's maximum tax liability (as determined by the Service) if the transferor requested the Service to determine its maximum tax liability. n132 Alternatively, the transferor or transferee can lower the amount withheld, upon request to the IRS, if a lower amount will not jeopardize collection of the total tax due. n133 Transferees must generally report and pay over any tax withheld within 20 days after the date of transfer. n134 Reporting and payment may be delayed, however, when there is a pending application for a withholding certificate. n135

Special rules apply with regard to withholding on distributions and certain other transactions by corporations, partnerships, trusts and estates. n136 Special withholding requirements also apply to joint transferees of US real property interests n137 and for options to acquire a US real property interest. n138 No withholding is required on the initial grant of an option to acquire a US real property interest to a nonresident alien, but if the alien disposes of the option before exercising it, the transferee must deduct and withhold a tax equal to 10 percent of the amount realized by the transferor upon the disposition. n138.1

All transferees are required to withhold the amounts described above upon the acquisition of a USRPI from *anyone* unless one of the following exceptions is met: n139

(1) The transferor furnishes the transferee a U.S. taxpayer identification number and an affidavit stating that the transferor is not a foreign person. This exception does not apply if the transferee knows that the affidavit is false, or if the transferee fails to furnish a copy of the affidavit to the Secretary. n140 Alternatively, in lieu of furnishing a the non-foreign affidavit to the transferee, a transferor may furnish it to a "qualified substitute," who must then furnish a statement to the transferee stating, under penalties of perjury, that the qualified substitute has the affidavit in his or her possession. n140.1 A "qualified substitute" means (1) the person, including any attorney or title company, responsible for closing the transaction, other than the transferor's agent, and (2) the transferee's agent. n140.2 This exemption does not apply if the transferee or qualified substitute has actual knowledge that the affidavit or statement is false, if the transferee or qualified substitute receives a notice from a transferor's agent, transferee's agent, or qualified substitute that the affidavit or statement is false, or if the transferee or qualified substitute fails to meet a regulatory requirement that the transferee or qualified substitute furnish a copy of the affidavit or statement to the Secretary. n140.3

(2) In the case of a U.S. transferor corporation, the corporation time provides the transferee with an affidavit stating that the corporation is not, and has not been, a U.S. real property holding corporation or that, as of the date of the disposition, the interests in the corporation are not US real property interests by reason of *IRC Section 897(c)(1)(B)*. Again, this exception is inapplicable if the transferee knows that the statements are false. n141

(3) The transferee receives a "qualifying statement" regarding the transferor. A qualifying statement is a statement received from the Internal Revenue Service declaring that (1) the transferor has either reached an agreement with the Service to pay the tax or is exempt from tax on the gain recognized, and (2) any unpaid withholding tax has been satisfied by the transferor or transferee, or a security agreement has been provided. n142

(4) In the case of a personal residence in the hands of the transferee, the amount realized for the property does not exceed \$300,000. n143

(5) The disposition is of stock regularly traded on an established securities market. n144

(6) The disposition is treated as a disposition of a US real property interest solely by reason of the FIRPTA wash sale rule. n144.1

Final regulations have been issued on withholding required upon the disposition of a U.S. real property interest by a publicly traded partnership, publicly traded trust, or REIT. The regulations impose the withholding obligation on the transferee of a U.S. real property interest, with respect to each holder of an interest in the entity that is a foreign person. n145 Accordingly, it is now a standard practice to include a provision in a contract for the purchase of real estate or of an interest in a corporation requiring the transferor to certify whether or not it is a foreign person. n146

Any withheld tax must be reported on Forms 8288 and 8288-A and paid over by the 20th day after the date of the transfer. The Forms are required to be filed with the Internal Revenue Service Center in Philadelphia, Pennsylvania. n147 Extensions of time for filing the form may be granted by private letter ruling. n148 The Regulations contain specific rules regarding distributions by REITs. n149 The amount subject to withholding for a REIT is the amount of any distribution designated by a REIT as a capital dividend, determined on a per share basis, multiplied by the number of shares owned by the foreign person. The largest amount of any distribution by a REIT that could be designated as a capital gain dividend under *IRC Section 857(b)(3)(C)* is designated as a capital dividend. Thus, this type of distribution automatically is subject to withholding. n150

Although the primary responsibility to withhold is with the transferee, duties are also imposed upon the agents of the transferee and the transferor and on qualified substitutes. A transferor's agent, transferee's agent, or qualified substitute who has actual knowledge that the affidavit or statement is false must notify the transferee in the time and manner to be specified by regulations. n151 One who fails to do so has the same duty to deduct and withhold that the transferee would have had if notice had been properly given. n152 An agent's or qualified substitute's liability under these circumstances, however, is limited to the amount of the compensation that the agent or qualified substitute derives from the transaction. n152.1

To the extent required in Regulations, a return must be filed by all foreign persons holding "direct investments in United States real property interests" stating:

- (1) the person's name and address;
- (2) a description of the property held; and
- (3) such other information as regulations may prescribe. n153

No regulations have been proposed or adopted under *IRC Section 6039C*, however, so, at this time, no return is required.

A foreign person is treated as holding a "direct investment in United States real property interests" only if (1) he did not engage in a trade or business in the United States at any time during the calendar year, and (2) the fair market value of the USRPI held by the person is \$50,000 or more. n154

Taxpayers must report their reliance on a treaty that overrules or modifies any provisions in the Code. This reporting requirement includes reporting of reliance on treaty provisions that affect FIRPTA and the branch-profits tax rules. n155 These regulations require disclosure on tax returns when the taxpayer has a "treaty-based return position" that reduces the tax liability. Penalties are imposed for failure to comply with the regulations. For each material failure to disclose, a penalty of \$10,000 for C corporations and \$1,000 for individuals may be imposed. n156

FOOTNOTES:

(n1)Footnote 87. *IRC § 897*.

(n2)Footnote 88. *IRC §§ 871(a), (b); 881(a); 882(a); 864(c)*.

(n3)Footnote 89. *IRC § 861(a)(5)*.

(n4)Footnote 90. *IRC § 897(a)(1)*.

(n5)Footnote 91. *IRC § 6039C*.

(n6)Footnote 92-93. *Treas Reg §§ 25.2512*.

(n7)Footnote 94. *IRC § 897(c)(1)(A)*.

(n8)Footnote 95. *IRC § 897(c)(1)(A)(ii); Treas Reg § 1.897-1(c)(1)(ii)*.

(n9)Footnote 96. *IRC § 897(c)(1)(B); Treas Reg § 1.897-1(c)(2)(ii)*.

(n10)Footnote 97. *IRC § 897(c)(3); Treas Reg § 1.897-1(c)(2)(iii)*.

(n11)Footnote 98. *IRC § 897(c)(6)(C)*.

(n12)Footnote 99. *IRC § 897(c)(6)(A)*.

(n13)Footnote 100. *Treas Reg § 1.897-1(b)(3)*.

(n14)Footnote 101. *IRC § 897(c)(6)(B); Treas Reg § 1.897-1(b)(4)*.

(n15)Footnote 102. *Treas Reg § 1.897-1(b)(4)(i)*.

(n16)Footnote 103. *Treas Reg § 1.897-1(b)(1)*.

(n17)Footnote 104. *Treas Reg § 1.897-1(b)(4)(ii)*.

(n18)Footnote 105. *Treas Reg § 1.897-1(b)(2)*.

(n19)Footnote 106. *Treas Reg § 1.897-1(d)(1)*.

(n20)Footnote 107. *Treas Reg § 1.897-1(d)(4)*.

(n21)Footnote 108. *Treas Reg § 1.897-1(d)(3)(i)(D)*.

(n22)Footnote 109. *Treas Reg § 1.897-1(d)(2)*.

(n23)Footnote 110. *Prop Treas Reg § 1.72-1(e)(1)-1(d)(3)(A); -(d)(3)(D)*.

(n24)Footnote 111. *Treas Reg §§ 1.897-1(d)(3)(B); -(d)(3)(D)*.

(n25)Footnote 112. *Treas Reg § 1.897-1(d)(3)(C)*.

(n26)Footnote 112.1. See *Treas Reg § 1.897-2*.

(n27)Footnote 112.2. See *Rev Proc 2008-27*, § 2.02, *2008-21 IRB 1014*.

(n28)Footnote 113. *IRC § 897(c)(2); Treas Reg § 1.897-2(b)(1)*.

(n29)Footnote 114. *Treas Reg § 1.897-2(b)(2)*.

(n30)Footnote 115. *IRC § 897(c)(1)(A)(ii)*.

(n31)Footnote 116. *IRC § 897(c)(2)*.

(n32)Footnote 117. *IRC § 897(c)(4)(A); Treas Reg § 1.897-2(e)(1)*.

(n33)Footnote 118. *IRC § 897(c)(4), (5); Treas Reg § 1.897-2(e)(2), (3)*.

(n34)Footnote 119. *IRC § 897(d). Treas Reg § 1.897-5T(c)*. The IRS has announced the temporary suspension of the return filing requirements of the Temporary Regulations in certain circumstances (*Notice 89-57, 1989-1 CB 698*) and has announced that certain rules in the Temporary Regulations under *IRC §§ 897(d)* and *(e)* concerning transfers of U.S. real property interests will be revised. *Notice 89-85, 1989-2 CB 403* . See also *Rev Rul 90-76 1990-2 CB 176* , requiring a foreign corporation to recognize gain on a distribution of a U.S. real property interest under *Treas Reg § 1.897-5T* as in effect prior to August 1, 1989.

(n35)Footnote 120. *Rev Proc 90-19, 1990-1 CB 495* .

(n36)Footnote 121. *IRC § 897(e). Treas Reg § 1.897-6T*. See *Rev Rul 84-160, 1984-2 CB 125* , for the application of *IRC § 897(e)* to an *IRC § 351* exchange and *Rev Rul 87-66, 1987-2 CB 168* , for the application of *IRC § 897(d)* and

(e) to certain reorganization and liquidation transactions. See Ltr Rul 200137037 (IRS rules that a foreign corporation's exchange of stock qualified as a disposition of a US real property interest that was eligible for nonrecognition under *IRC* § 351). See Ltr Rul 200339054 (holding that a tax-free *IRC* § 368(a)(1)(E) recapitalization of a second-tier subsidiary that was a USRPI and the contribution of the recapitalized shares to a first-tier subsidiary under *IRC* § 351 were eligible for nonrecognition under *IRC* § 897(e).

(n37)Footnote 122. *IRC* § 897(g).

(n38)Footnote 123. *IRC* §§ 897(g), 1445(e). See *Temp Treas Reg* § 1.897-7T.

(n39)Footnote 124. *IRC* § 897(j).

(n40)Footnote 125. *IRC* § 897(h)(4)(A). See also § 17.08[1], above, for further discussion.

(n41)Footnote 125.1. *IRC* § 897(h)(1).

(n42)Footnote 126. *IRC* § 897(h)(1); also see *IRC* § 857(b)(3)(F).

(n43)Footnote 127. *IRC* § 897(h)(3), (d).

(n44)Footnote 127.1. *IRC* § 897(h)(2).

(n45)Footnote 128. *IRC* § 897(h)(4)(B).

(n46)Footnote 128.1. *IRC* § 897(h)(4)(D).

(n47)Footnote 129. *IRC* § 897(i). The conversion of a foreign corporation into a domestic corporation can be treated as a type-F reorganization, *Rev Rul* 88-25, 1988-1 CB 116, although non-recognition of gain is also controlled by *IRC* § 897(d) and (e).

(n48)Footnote 130. *Treas Reg* § 1.897-1(j).

(n49)Footnote 131. *IRC* § 897(i)(2).

(n50)Footnote 132. *IRC* § 1445(a). *Rev Proc* 2000-35, 2000-35 IRB 211, and *Treas Reg* § 1.1445-3 set forth elaborate procedures for the obtaining of a reduced withholding certificate from the IRS.

(n51)Footnote 133. *IRC* § 1445(c)(2).

(n52)Footnote 134. *Treas Reg* § 1.1445-1(c)(1).

(n53)Footnote 135. *Treas Reg* § 1.1445-1(c)(2).

(n54)Footnote 136. *IRC* § 1445(e); *Treas Reg* § 1.1445-1.

(n55)Footnote 137. *Treas Reg* § 1.1445-1(b)(1), (2).

(n56)Footnote 138. *Treas Reg* §§ 25.2701.

(n57)Footnote 138.1. *Treas. Reg.* § 1.1445-1(b)(3)(iii); Chief Counsel Memo 200522020.

(n58)Footnote 139. *IRC* § 1445(b)(1); *Treas Reg* § 1.1445-2.

(n59)Footnote 140. *IRC* § 1445(b)(2),(7); *Treas Reg* § 1.1445-2(b)(2).

(n60)Footnote 140.1. *IRC § 1445(b)(9)(A)*, effective for dispositions after July 30, 2008 [Pub Law 110-289, § 1324(d)].

(n61)Footnote 140.2. *IRC § 1445(f)(6)*.

(n62)Footnote 140.3. *IRC § 1445(b)(7)*.

(n63)Footnote 141. *IRC § 1445(b)(3), (7); Treas Reg § 1.1445-2(c)(3); Ltr Rul 199942024 and Ltr Rul 200745012* (extension of time granted for filing statement). The IRS has issued a revenue procedure that provides a simplified method to request relief for late filings under the regulation [*Rev Proc 2008-27, 2008-21 IRB 1014*]. The procedure is in lieu of the private letter ruling request procedures and accompanying user fees that ordinarily apply with respect to them [*Rev Proc 2008-27, § 3, 2008-21 IRB 1014*].

(n64)Footnote 142. *IRC § 1445(b)(4)*.

(n65)Footnote 143. *IRC § 1445(b)(5); Treas Reg § 1.1445-2(d)(1)*.

(n66)Footnote 144. *IRC § 1445(b)(6)*.

(n67)Footnote 144.1. *IRC § 1445(b)(8)*; see *IRC § 897(h)(5)* and *§ 17.08[2]*, above, for a discussion of the FIRPTA wash sale rule.

(n68)Footnote 145. *Treas Reg § 1.1445-8(b)(1)*.

(n69)Footnote 146. See *Treas Reg §§ 1.1445-5(c), 1.1445-8(b)*.

(n70)Footnote 147. *Treas Reg § 1.1445-1(c)(1)*.

(n71)Footnote 148. See *Ltr Rul 9824030* .

(n72)Footnote 149. *Treas Reg § 1.1445-8*.

(n73)Footnote 150. *Treas Reg § 1.1445-8(c)(2)*.

(n74)Footnote 151. *IRC § 1445(d)(1)*; see *Treas Reg § 1.1445-4*.

(n75)Footnote 152. *IRC § 1445(d)(2)(A)*.

(n76)Footnote 152.1. *IRC § 1445(d)(2)(B)*.

(n77)Footnote 153. *IRC § 6039C*.

(n78)Footnote 154. *IRC § 6039C(b)*.

(n79)Footnote 155. *Treas Reg § 301.6114-1(b)(2)* and (3).

(n80)Footnote 156. *IRC § 6712; Treas Reg § 301.6712-1(a)*.

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Federal Taxes Affecting Real Estate

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CHAPTER 18 Estate Planning for Real Estate *

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CHAPTER 18 Estate Planning for Real Estate *

2-18 Federal Taxes Affecting Real Estate Scope

Scope

SCOPE

The previous chapters of this book focus on how the federal income tax affects real estate. This chapter shifts gears and addresses the impact of the federal transfer taxes (estate, gift, and generation skipping) on real estate. This book's goal is "to describe the tax significance of owning, operating, and disposing of real property." This objective cannot be achieved without some consideration given to the transfer tax system. The entire chapter is a survey of the estate planning implications of ownership of real property, not a do-it-yourself estate planning guide.

The first part of this chapter provides an overview of the transfer tax system. The latter sections discuss some of the methods that can be employed to alleviate the impact of these taxes.



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CHAPTER 18 Estate Planning for Real Estate *

2-18 Federal Taxes Affecting Real Estate § 18.01

§ 18.01 Special Note Regarding Repeal of Federal Estate Tax and Generation-Skipping Tax

[1] In General

Legislation enacted in 2001 n1 repealed the federal estate tax and generation-skipping tax (GST), effective for decedents dying after 2009. n1.1 The repeal, however, lasts only for one year because the 2001 legislation contains a built-in sunset provision that reinstates the federal estate tax and GST for estates of decedents dying after 2010. n1.2 After 2010, the federal estate tax and GST law, *as in effect before the enactment of the 2001 legislation*, will apply. n1.3 Thus, absent new legislation, for decedents dying after 2010, the maximum estate tax rate is 55 percent (plus an additional 5 percent for estates over \$10 million), n1.4 and the estate tax exemption amount is only \$1 million. n1.5

[2] Repeal of IRC Section 1014 Stepped Up Basis Provisions

The "cost" for not having an estate tax--for decedents dying in 2010--is the loss of stepped-up basis in property acquired from a decedent. Instead, a modified carryover basis rule applies, under which those receiving property from a decedent will take as a basis in the property the lesser of its adjusted basis to the decedent or its fair market value on the date of the decedent's death. n1.6

There is a notable exception, however. An executor may choose to increase the basis in certain assets owned by the decedent and acquired by beneficiaries at death. Under this rule, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of \$1.3 million. This \$1.3 million figure is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. n1.7 In addition, the basis of property transferred to a surviving spouse can be increased by an additional \$3 million. n1.8 Thus, the basis of property transferred to surviving spouses can be increased by a total of \$4.3 million. n1.9

Nonresidents who are not US citizens are allowed to increase the basis of property acquired from a decedent dying in 2010 only by \$60,000, and they may not increase that amount by any built-in losses or carryovers. n1.10

For decedents dying after 2010, absent new legislation, *IRC Section 1014* is re-instated and the pre-2010 stepped-up basis rules for property acquired from decedent apply. n1.11

[3] Gift Taxes

Unlike the federal estate tax and GST, there is no repeal of the gift tax for 2010. There is, however, a reduction in the maximum federal gift tax rate for taxable gifts made in 2010. The maximum marginal tax rate for 2010 is 35 percent, for aggregate taxable gifts over \$500,000. n1.12

The unified credit exemption amount for gift taxes for all years after 2001 is \$1 million. n1.13 For gifts made after 2010, the gift tax rate reverts to the same rate as for federal estate taxes, with a maximum marginal tax rate of 55 percent, imposed on aggregate taxable gifts over \$3 million. n1.14

[4] Congressional Response to Estate Tax Repeal

As of June 2010, Congress has not enacted new estate tax legislation. So the current state of the law is that decedents dying in 2010 will have to pay no federal estate taxes. n1.15 For decedents dying after 2010, the pre-2001 estate tax and generation-skipping tax provisions will apply. n1.15.1 Nobody is satisfied with this situation, and nearly everyone expects it to change. But what will happen is anyone's guess. One bill that has received substantial attention would re-instate the federal estate tax retroactively to January 1, 2010, and establish a permanent \$3.5 million exemption amount for estate taxes. n1.15.2 There does seem to be agreement that a permanent estate tax exemption amount--rather than one that changes from year to year--is likely. There also seems to be a consensus that the exemption should be in excess of the \$1 million exemption that will apply if there is no new estate tax legislation. n1.15.3

[5] Estate Planning After 2009

The uncertain state of the law after 2009 both as to the estate tax exemption amount and estate tax rates makes it impossible to estimate the likely amount of estate taxes for a client. Assuming that an estate tax is imposed after 2010, however, planning will involve the same issues as under pre-2010 law, regardless of the specific amount of the federal estate tax exemption amount or tax rates that may be enacted. The specifics will depend on the eventual content of estate tax legislation.

[6] Continued Compliance with Statutory Requirements Required for Estate Tax Benefits for Estates of Decedents Dying Before 2010

For decedents dying before 2010, various estate tax benefits are available (such as reduced valuation, deductions, or extended estate tax payment options) provided that statutory conditions are satisfied. Various compliance requirements extend for several years after the date of the decedent's death. The repeal of the estate tax does not eliminate these compliance requirements in order to avoid recapture of the estate tax (or acceleration of installment payments, when the estate tax is being paid in installments). Among the requirements that taxpayers must continue to meet are the following:

- not retaining a development right with respect to property for which a conservation easement deduction is claimed; n1.15.4
- continuing to use property for which a special-use valuation election is made in a qualifying use for 10 years after the decedent's death; n1.15.5
- materially participating in a qualified-family owned business interest for which the deduction under *IRC Section 2057* is claimed for at least 10 years following the decedent's death; n1.15.6 and
- complying with any payment conditions when estate taxes are paid in installments because the estate consists largely of an interest in a closely held business; n1.15.7
- Complying with various distribution restrictions relating to noncitizens; an estate tax will be imposed

on (1) any distribution prior to January 1, 2021, from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse if such surviving spouse dies before January 1, 2010. n1.16-1.20

FOOTNOTES:

(n1)Footnote 1. Pub Law No 107-16 (HR 1836).

(n2)Footnote 1.1. *IRC §§ 2210(a), 2664.*

(n3)Footnote 1.2. Pub Law No 107-16, § 901.

(n4)Footnote 1.3. Pub Law No 107-16, § 901; *IRC §§ 2001-2210, 2601-2664, before amendment by Pub Law No 107-16.*

(n5)Footnote 1.4. *IRC § 2001(c)(1), (2), before amendment by Pub Law No 107-16.*

(n6)Footnote 1.5. *IRC § 2010(c), before amendment by Pub Law No 107-16.*

(n7)Footnote 1.6. *IRC § 1022(a).*

(n8)Footnote 1.7. *IRC § 1033(b)(1), (2).*

(n9)Footnote 1.8. *IRC § 1022(c).*

(n10)Footnote 1.9. *IRC § 1022(b), (c).*

(n11)Footnote 1.10. *IRC § 1022(b)(3).*

(n12)Footnote 1.11. Pub Law No 107-16, § 901.

(n13)Footnote 1.12. *IRC § 2502(a)(2);* the rate is intended to be equivalent to the maximum individual income tax rate.

(n14)Footnote 1.13. *IRC §§ 2001(c)(2), 2010(c), 2505(a).*

(n15)Footnote 1.14. *IRC §§ 2001(c)(1), 2502(a), before amendment by Pub Law No 107-16; See Pub Law No 107-16, § 901 (sunset provision for post-2009 federal gift tax rate schedule).*

(n16)Footnote 1.15. *IRC § 2010(a).*

(n17)Footnote 1.15.1. *IRC §§ 2001-2210, 2601-2664, before amendment by Pub Law No 107-16.*

(n18)Footnote 1.15.2. HR 4154.

(n19)Footnote 1.15.3. *See IRC § 2010(c), before amendment by Pub Law No 107-16.*

(n20)Footnote 1.15.4. *See IRC §§ 2031(c), 2055(f).*

(n21)Footnote 1.15.5. *See IRC § 2032A.*

(n22)Footnote 1.15.6. *See IRC § 2057.*

(n23)Footnote 1.15.7. *See IRC § 6166.*

(n24)Footnote 1.16-1.20. *IRC § 2210(b)*.

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CHAPTER 18 Estate Planning for Real Estate *

2-18 Federal Taxes Affecting Real Estate § 18.01A

§ 18.01A Overview of Federal Transfer Taxes

[1] In General

[a] Tax Rates

Historically, the federal transfer tax system is made up of three separate taxes: the gift tax, the estate tax, and the generation-skipping tax. n1.21 Transfer taxes are also imposed on United States citizens or residents who receive gifts or bequests from expatriates. n1.22 Through equivalent tax rates, the gift tax and estate tax have historically worked in tandem to tax both lifetime gifts and testamentary bequests in an equivalent manner.

The estate and gift tax rate depends on the taxpayer's date of death or date of the gift. The maximum tax rate for both estate and gift taxes is 55 percent, for taxable gifts made or decedents dying before 2002, 50 percent for taxable gifts made or decedents dying in 2002, 49 percent for taxable gifts made or decedents dying in 2003, 48 percent for taxable gifts made or decedents dying in 2004, 47 percent for taxable gifts made or decedents dying in 2005, 46 percent for taxable gifts made or decedents dying in 2006, and 45 percent for taxable gifts made or decedents dying in 2007 through 2009. n2

For decedents dying in 2010, there is no estate tax due, because the estate tax has been repealed. n3 The repeal, however, lasts only for one year because the 2001 repealing legislation contains a built-in sunset provision that reinstates the federal estate tax and GST for estates of decedents dying after 2010. n3.1 After 2010, the federal estate tax law, *as in effect before the enactment of the 2001 legislation*, will apply. n3.2 Thus, absent new legislation, for decedents dying after 2010, the maximum estate tax rate is 55 percent (plus an additional 5 percent for estates over \$10 million). n3.3 In contrast, the gift tax is imposed on taxable gifts made in 2010; the maximum tax rate is 35 percent, on aggregate taxable gifts of over \$500,000. n3.4 For gifts made after 2010, absent new legislation, the gift tax rate reverts to the same rate as for federal estate taxes, with a maximum marginal tax rate of 55 percent, imposed on aggregate taxable gifts over \$3 million. n3.5

[b] Unified Credit

A unified credit is available to offset either the gift tax or the estate tax that would otherwise be paid. Any credit that an individual uses during life to offset the gift tax reduces the amount of credit remaining to offset any applicable estate tax due at death. The credit has the effect of an exemption for a transfer of property. The amount of the credit, and the

2-18 Federal Taxes Affecting Real Estate § 18.01A

amount of the effective exemption, depends on the year of the gift or the decedent's death, as follows: n4

Year of Death or Gift	Estate tax exemption amount	Gift tax exemption amount
Before 1998	\$600,000	\$600,000
1998	\$625,000	\$625,000
1999	\$650,000	\$650,000
2000 or 2001	\$675,000	\$675,000
2002 or 2003	\$1 million	\$1 million
2004 or 2005	\$1.5 million	\$1 million
2006-2008	\$2 million	\$1 million
2009	\$3.5 million	\$1 million
2010	N/A (estate tax repealed)	\$1 million
2011 and future years	\$1 million	\$1 million n4.1

[c] Generation-Skipping Tax

The generation-skipping tax (GST) is designed to tax certain multigenerational transfers that may have escaped taxation under the other two transfer tax provisions. The GST is separate from the other transfer taxes and is paid *in addition* to any other gift or estate taxes that are payable with respect to a transfer. *All* transfers to which the GST applies are taxed at the highest uniform transfer tax rate. This rate structure, in conjunction with the other transfer taxes, can result in situations in which the total transfer taxes paid could actually exceed the value of the asset transferred. n5 The generation-skipping tax is repealed, effective for generation-skipping transfers after December 31, 2009. n5.1 The repeal, however, lasts only for one year because the 2001 legislation contains a built-in sunset provision that reinstates the GST for estates of decedents dying after 2010. n6 After 2010, absent new legislation the GST law, *as in effect before the enactment of the 2001 legislation*, will apply. n7

[2] Estate Tax

[a] In General

NOTE:

The estate tax has been repealed, effective for decedents dying after 2009. n8 See § 18.01, above, for a detailed discussion.

The estate tax is imposed on the decedent's "taxable estate," which is determined by subtracting from the decedent's "gross estate" certain deductions authorized by statute. The gross estate consists of all property owned outright at death, as well as property in which the decedent has shared an interest or retained certain powers. n9

After determining the gross estate, certain deductions are allowed before computing the estate tax. A taxpayer is allowed to pass an unlimited amount of qualified marital-deduction property to his or her spouse (the "unlimited marital deduction"). n10 In addition, the estate is allowed a deduction for any charitable bequests, n11 for debts of the decedent and for expenses of administration that the estate incurs. n12 A deduction is allowed for an unpaid mortgage on property where the value of the decedent's interest in the property, undiminished by the mortgage, is included in the value of the gross estate. n12.1 Where only part of the security for a mortgage is included in a decedent's gross estate, the deduction cannot exceed the amount of the security included in the estate. n12.2 If the decedent was a co-obligor on an unpaid mortgage, a deduction is ordinarily allowed for the decedent's ratable portion of the loan. n12.3 The cost of maintaining a decedent's property during the pendency of estate tax proceedings and interest on funds borrowed for that

purposes may be deductible as administrative expenses. n12.4 The value of the gross estate (including taxable gifts made after December 31, 1976), less deductions, is called the "taxable estate" and it is upon that amount that the estate tax is levied. n13 The final step in determining the actual tax due is the application of the unified transfer tax rate schedule against the taxable estate to arrive at the tentative estate tax; from that amount is subtracted the unified transfer tax credit, plus the amount of gift taxes payable on gifts made after December 31, 1976, and credits for state and foreign death taxes. n14

The unified credit is available to offset either the gift tax or the estate tax that would otherwise be paid. The amount varies, depending on the year of the gift or date of death. n15-16 See § 18.01A[1][b], above, for the amount of the credit.

[b] Marital Deduction

The marital deduction applies to qualifying *inter vivos* and testamentary transfers to one's spouse. For estate tax purposes, the value of the transferred property interest can be considered in calculating the marital deduction "only to the extent that such interest is included in determining the value of the gross estate." n17 In addition, if the surviving spouse has only a "terminable" interest in the transferred property, no marital deduction generally may be available on the property. n18 The purpose behind this limitation is to ensure that property transfers afforded the marital deduction in the first estate will be eventually taxed in the second spouse's estate. One exception to this general rule applies to qualified terminable interest property (QTIP). Treatment of terminable property interests as QTIP interests is an elective provision made by the executor of the decedent's estate. n19 The decedent's will can either direct the executor to make the election or leave it to the executor's discretion.

Property eligible for the QTIP election must meet two conditions: (1) the property must pass from the decedent, n20 and (2) the surviving spouse must have a qualifying income interest in the property for life. n21 The principal attraction of the QTIP is that the decedent can obtain the benefit of the marital deduction in the estate of the first spouse, and yet can still predetermine the ultimate disposition of the property upon the death of the surviving spouse, and the executor can select the amount of qualifying QTIP property to which the election will apply.

The IRS has issued a revenue procedure that provides relief for surviving spouses and their estates in situations where a predeceased spouse's estate made an unnecessary QTIP election that did not reduce the estate tax liability of the estate. n21.1 The revenue procedure describes the circumstances in which these QTIP elections will be treated as a nullity for federal tax purposes, so that the property will not be subject to transfer tax with respect to the surviving spouse. n21.2

Revenue Procedure 2001-38 applies to QTIP elections where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. This can occur when a QTIP election was made when the taxable estate (before allowance of the marital deduction) was less than the applicable exclusion amount. n21.3 It can also occur in the following situation--the decedent's will provided for a "credit shelter trust" to be funded with an amount equal to the applicable exclusion amount, with the balance of the estate passing to a marital trust intended to qualify as a QTIP trust. The estate made QTIP elections for both the credit shelter trust and the marital trust. The QTIP election for the credit shelter trust was not necessary because no estate tax would have been imposed whether or not the QTIP election was made for that trust. n21.4

Revenue Procedure 2001-38 does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero. It also does not apply to elections that are stated in terms of a formula designed to reduce the estate tax to zero. n21.5 It also does not apply to protective elections. n21.6

For a QTIP election within the scope of *Revenue Procedure 2001-38*, the IRS will disregard the election and treat it as null and void. The property for which the election is disregarded will not be includable in the gross estate of the

surviving spouse under *Treas Reg* §§ 25.2702, and the surviving spouse will not be treated as making a gift under *IRC Section 2519* if he disposes of the income interest with respect to the property. Further, the surviving spouse will not be treated as the transferor of the property for generation-skipping transfer tax purposes. n21.7

To establish that an election within the scope of *Revenue Procedure 2001-38*, the taxpayer must provide sufficient evidence to that effect. This can be done by producing a copy of the estate tax return filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. This information, including an explanation of why the election should be treated as void under *Revenue Procedure 2001-38*, should be submitted either with the estate tax return filed for the surviving spouse's estate, or with a request for a private letter ruling submitted at any time prior to filing that return. n21.8

[3] Gift Tax

The "gross" gift tax is imposed on the sum of current taxable gifts and all prior taxable gifts; a reduction from the gross tax is then allowed for the taxes paid on the prior gifts. n22 The gift tax is structured in this manner to ensure that each year's gifts are taxed at the highest effective rate possible, taking into consideration the donor's prior gift history. A "gift" is any gratuitous transfer not made for full and adequate consideration. Thus, a gift can exist when an entire property is given away, when a life estate is given away, or even when property is sold for less than its fair market value (the difference between the sales price and the FMV is a gift).

To avoid taxing every conceivable gift, Congress has allowed a donor to give a certain amount to each donee annually without incurring a gift tax. This annual exclusion amount for gifts made before 2002 is \$10,000, or \$20,000 if a husband and wife make a gift jointly ("gift splitting"). n23 For gifts made after 1998, these amounts are subject to adjustment for inflation. n24 The annual exclusion amount for gifts made in 2002 through 2005 is \$11,000, or \$22,000 for spousal joint gifts. n24.1 The annual exclusion amount for gifts made in 2006, 2007, and 2008 is \$12,000, or \$24,000 for spousal joint gifts n24.2 The annual exclusion for gifts made in 2009 and 2010 is \$13,000, or \$26,000 for spousal joint gifts. n24.3 Exclusions from gift taxes are also permitted for gifts of tuition payments made directly to an educational institution and medical payments made directly to a person who provides medical care. n25 In addition, gift tax deductions for charitable donations and interspousal gifts are allowed for purposes of determining the taxable gift. n26 The tax is computed from the unified rate tables and the amount of unified credit available must be used to reduce the amount of tax currently payable. n27

A gift tax unified credit is also available which in effect gives an exemption for the gift. The amount of the credit and effective exemption depends on the year of the gift. For years after 2001, the exemption amount is \$1 million. n27.1

The donor is liable for any amount of tax that is currently payable; n28 however, the parties may agree that the donee will pay this tax. A gift transferred under such an agreement is called a "net gift."

[4] Generation-Skipping Transfer Tax

Note About Repeal of the Generation-Skipping Transfer Tax:

The generation-skipping tax has been repealed, effective for generation-skipping transfers after 2009. n28.1 See § 18.01, above, for a detailed discussion.

The generation-skipping transfer tax (GSTT) is an additional tax imposed on transfers for the benefit of a person at least two generations below the transferor. This tax is designed to prevent circumvention of the "normal" operation of the transfer tax system through the use of "multigeneration" or "skip-generational" gifts. n29 There is a lifetime exemption amount for every individual. Property to which the transferor allocates the exemption amount is not subject to the GST.

n29.1 The GST exemption amount depends upon the calendar year in which the generation-skipping transfer is made, as follows: n30

Calendar Year	GST Exemption
Before 2004	\$1 million n30.1
2004-2005	\$1.5 million
2006-2008	\$2 million
2009	\$3.5 million
2010	N/A (GST repealed)
2011 and later years	\$1 million, subject to cost-of-living adjustments n30.2

The following situation illustrates such a transfer.

Example:

A grantor sets up a trust giving his daughter a life estate, the remainder to be distributed to the daughter's children. At the death of the daughter, the trust property is not included in the daughter's estate since the daughter had only a life estate. The objective of the GST is to impose a transfer tax on the trust property at the time that the daughter's interest terminates (at her death). The tax is imposed even if the grantor were to make a transfer directly to her grandchildren ("direct skips"). If the GST exemption amount is less than the amount of GST transfers, the donor/transferee/trustee is liable for the tax, depending on the manner and type of generation-skipping transfer involved. n31

FOOTNOTES:

(n1)Footnote 1.21. *Treas Reg §§ 25.2702, 2501-2524, 2601-2663; see IRC §§ 2701-2704* (special valuation rules).

(n2)Footnote 1.22. *IRC § 2801*.

(n3)Footnote 2. *IRC § 2001(c)(1), (2), 2502(a)*.

(n4)Footnote 3. *IRC §§ 2210(a), 2664*.

(n5)Footnote 3.1. Pub Law No 107-16, § 901.

(n6)Footnote 3.2. Pub Law No 107-16, § 901; *IRC §§ 2001-2210, 2601-2664, before amendment by Pub Law No 107-16*.

(n7)Footnote 3.3. *IRC § 2001(c)(1), (2), before amendment by Pub Law No 107-16*.

(n8)Footnote 3.4. *IRC § 2502(a)(2)*; the rate is intended to be equivalent to the maximum individual income tax rate.

(n9)Footnote 3.5. *IRC §§ 2001(c)(1), 2502(a), before amendment by Pub Law No 107-16; See Pub Law No 107-16, § 901* (sunset provision for post-2009 federal gift tax rate schedule).

(n10)Footnote 4. *IRC §§ 2010(a), (c), 2505(a)*.

(n11)Footnote 4.1. See *IRC §§ 2010(c), 2505(a)(1), before amendment by Pub Law No 107-16*.

(n12)Footnote 5. See *IRC* §§ 2601-2663.

(n13)Footnote 5.1. *IRC* § 2664.

(n14)Footnote 6. Pub Law No 107-16, § 901.

(n15)Footnote 7. Pub Law No 107-16, § 901; *IRC* §§ 2001-2210, 2601-2664, *before amendment by* Pub Law No 107-16.

(n16)Footnote 8. *IRC* § 2210(a).

(n17)Footnote 9. *IRC* §§ 2031-2046.

(n18)Footnote 10. *IRC* § 2056.

(n19)Footnote 11. *IRC* § 2055.

(n20)Footnote 12. *IRC* § 2053.

(n21)Footnote 12.1. *IRC* § 2053(a)(4).

(n22)Footnote 12.2. *Estate of Fawcett v Commr*, 64 TC 889 (1975) .

(n23)Footnote 12.3. *Estate of Atkins v Commr*, 2 TC 332 (1943) ; but see *Estate of Hendrickson v Commr*, TC Memo 1999-357 (deduction denied because other obligors had effectively assumed the decedent's portion of the loan by the time of her death, and there was evidence that the decedent was merely a guarantor or accommodation party with respect to the loan, and not an obligor).

(n24)Footnote 12.4. *Estate of Thompson et al v Commr*, TC Memo 1998-325 ; *Lockett v Commr*, TC Memo 1998-50 ; see *IRC* § 2053(a)(2); but see *Estate of Millikin*, TC Memo 1998-456 .

(n25)Footnote 13. *IRC* § 2001(a).

(n26)Footnote 14. *IRC* §§ 2010-2015.

(n27)Footnote 15-16. *IRC* §§ 2010(c), 2505(a)(1).

(n28)Footnote 17. *IRC* § 2056(a).

(n29)Footnote 18. A "terminable interest" is defined by *IRC* § 2056(b) as an interest that will terminate or fail upon the occurrence or nonoccurrence of an event, or a mere lapse of time. The clearest example is a life estate that terminates upon the "occurrence of an event"--namely, the death or remarriage of the life tenant.

(n30)Footnote 19. *IRC* § 2056(b)(7).

(n31)Footnote 20. *IRC* § 2056(b)(7)(B)(i)(I).

(n32)Footnote 21. *IRC* § 2056(b)(7)(B)(i)(II).

(n33)Footnote 21.1. *Rev Proc* 2001-38, 2001-24 IRB 1335 .

(n34)Footnote 21.2. *Rev Proc* 2001-38, 2001-24 IRB 1335 .

(n35)Footnote 21.3. See *IRC* § 2010(c).

(n36)Footnote 21.4. *Rev Proc 2001-38, 2001-24 IRB 1335* .

(n37)Footnote 21.5. See *Treas Reg § 20.2056(b)-7(h)*, Examples 7 and 8.

(n38)Footnote 21.6. *Rev Proc 2001-38, 2001-24 IRB 1335* ; see *Treas Reg § 20.2056(b)-7(c)*.

(n39)Footnote 21.7. *Rev Proc 2001-38, 2001-24 IRB 1335* .

(n40)Footnote 21.8. *Rev Proc 2001-38* , § 4, *2001-24 IRB 1335* .

(n41)Footnote 22. *IRC §§ 2501(a); 2502(a)*.

(n42)Footnote 23. *IRC §§ 2503(b); 2513*.

(n43)Footnote 24. *IRC § 2503(b)(2)*.

(n44)Footnote 24.1. *Rev Proc 2001-59* , § 3.19, *2001-2 CB 623* ; *Rev Proc 2002-70, 2002-2 CB 845* ; *Rev Proc 2003-85, 2003-2 CB 1184* ; *Rev Proc 2004-71, 2004-2 CB 974* .

(n45)Footnote 24.2. *Rev Proc 2005-70, 2005-2 CB 979* ; *Rev Proc 2006-53, 2006-2 CB 996* ; *Rev Proc 2007-66, 2007-45 IRB 970* .

(n46)Footnote 24.3. *Rev Proc 2008-66* , § 3.30, *2008-45 IRB 1107* ; *Rev Proc 2009-50, 2009-45 IRB 617* .

(n47)Footnote 25. *IRC § 2503(e)*.

(n48)Footnote 26. *IRC §§ 2422, 2522, 2523, 2524*.

(n49)Footnote 27. *IRC §§ 2502(a)(1), 2505, 2510*.

(n50)Footnote 27.1. *IRC § 2505(a)(1)*.

(n51)Footnote 28. *IRC § 2501(a)(1)*.

(n52)Footnote 28.1. *IRC § 2664*.

(n53)Footnote 29. *IRC § 2601, 2611, 2612, 2613*.

(n54)Footnote 29.1. *IRC § 2631(a)*.

(n55)Footnote 30. *IRC §§ 2631(a), (c), 2010(c)*.

(n56)Footnote 30.1. Under cost of living adjustments, this amount is \$1.1 million for calendar year 2002 (*Rev Proc 2001-59, § 3.20, 2001-52 IRB 623*).

(n57)Footnote 30.2. *IRC § 2631(c), before amendment by Pub Law No 107-16*.

(n58)Footnote 31. *IRC §§ 2601, 2603, 2631*.

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Federal Taxes Affecting Real Estate

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CHAPTER 18 Estate Planning for Real Estate *

2-18 Federal Taxes Affecting Real Estate § 18.02

§ 18.02 Transfers to Reduce Taxable Estate

In this section, some of the more common methods for reducing the taxable estate are discussed. The premise for each of these is the same--i.e., *inter vivos* transfers will remove the property *and its future appreciation* from the donor's estate, at a tax cost (or a consumption of the unified credit) based on only the current fair market value. The following list is by no means exhaustive; however, it attempts to discuss those techniques most suited to real property.

[1] Transfer of a Fee Interest

A transfer of a fee interest is an outright transfer of the entire interest in the real property. The transferor parts with all present and future control, and the transferee can do what he or she wishes with the property.

[a] Gift of Fee Interest

One method that clearly reduces the taxable estate of an individual who owns real estate is simply giving away a fee interest in the real property, assuming that the transferor survives for at least three years. n32 A grantor may wish to transfer the property to heirs. A gift allows this easily, without heirs incurring costs associated with a sale/purchase arrangement. A transfer by gift also removes any future appreciation in the property from the donor's estate.

NOTE:

Planning related to lifetime gifts in excess of the amount of the gift tax unified credit involves a great degree of uncertainty, involving the amount by which the transferred gift is likely to appreciate and the unified credit and estate tax that will be in effect should the transferor die. In addition, the sunset provision that repeals all 2001 estate tax amendments for decedents dying after 2010 unless the amendments are later re-enacted adds uncertainty to any gift and estate tax planning. n32.1 A gift will shelter the transferred asset from further transfer taxes imposed on the transferor, but the uncertainty surrounding the estate tax repeal for decedents dying in 2010 (including the possibility of a re-imposition of the estate tax retroactive to January 1, 2010) and the uncertainty of the estate tax exemption amount for decedents dying after 2010 make evaluating the pros and cons of a gift difficult. The recent and continuing decline in most real estate values may in some cases make property basis considerations an important one in determining whether a gift should be made. If the donor's adjusted basis in the property is greater than the fair market value of the property at the time of the gift, then the donee takes the fair market value as a basis for purposes of determining loss. n32.2 n32.3- In contrast, if the donor were to

sell the property, the donor would be able to recognize a loss, and give the proceeds to the donee.

An inter vivos transfer of real estate to an irrevocable trust can be a useful tool to take advantage of multiple annual gift tax exclusions and thereby reduce a decedent's estate. In one case, a decedent, when living, transferred a commercial building to an irrevocable trust. The decedent's two children were the co-trustees and primary beneficiaries of the trust, each having a one-half interest in trust corpus and income. Each also had a power of appointment with respect to a one-half share of the trust. Under this power, 16 contingent remainder beneficiaries of the trust were designated. Each of the beneficiaries had a power to demand from the trust an immediate distribution to them of property up to the annual gift tax exclusion. n32.4 The power lapsed 30 days after the transfer of property to the trust. None of the beneficiaries demanded a distribution under this power. Nevertheless, the estate tax return of the decedent was allowed 16 annual gift tax exclusions with regard to the transfer of the building to the trust. The value of those exclusions was therefore excluded from the decedent's taxable estate. The unrestricted right of beneficiaries to demand immediate distributions of trust property was held to be a present interest that qualified for the annual gift tax exclusion. n32.5 This technique can be attacked by the IRS, however, if there is an underlying understanding among the parties that the rights to demand distributions will not be exercised, or if beneficiaries are not notified of those rights. n32.6

However, a gift of real property has numerous disadvantages, in addition to the above-described uncertainties relating to the increasing estate tax unified credit and repeal of the estate tax. n32.7 First, the grantor often incurs a gift tax (resulting either in the consumption of the unified credit or the actual payment of a tax). n33 The upfront costs are avoided by using the unified credit, although this limits the amount of credit available to be used against future gift tax or the estate tax. n34

Second, gifts receive a carryover basis in the hands of the donee, adjusted only for the amount of gift tax attributable to the appreciation element. n35 Thus, if the donee were to sell appreciated real property received through a gift for an amount equal to its fair market value at the time of the gift, the donee would have to pay tax on any built-in gain. n36 On the other hand, if this property were to pass through the estate (subjecting it to the estate tax), it would receive a substituted, often stepped-up, basis, and the taxable gain on the sale would be eliminated. n37

Third, if the property is gifted within three years of death, the gifted property and also the amount of gift tax paid are included in the decedent's gross estate. n38

In addition, the grantor must give up all dominion and control to achieve the desired estate planning benefits. If the grantor retains certain powers or economic interests in the transferred property, the entire value of the property is included in his or her estate. n39 A decedent's gross estate includes the value of property interests transferred by the decedent during his or her lifetime (other than a bona fide sale for full and adequate consideration) if the decedent retains for life the possession or enjoyment of the property or the right to income from the property. n39.1 Even a transfer of legal title to property during the decedent's lifetime will not remove property from a decedent's estate if there is an implied agreement that the transferor may continue to use or control the property after the transfer. n39.2

[b] Sale of Fee Interest

A sale of a fee interest has some of the same advantages as a gift in fee; it is a fairly simple procedure, and it removes the future appreciation from the estate. In addition, it provides a number of other advantages: first, the grantor is not subject to the gift tax; second, when the property is sold, the buyer receives a basis equal to his purchase price. These two advantages can be seen clearly with an example:

Example:

Suppose real property has a fair market value of \$100,000 and has been depreciated so that its basis

is \$10,000. If given away, the donor incurs a gift tax on \$23,800 (assuming the annual exclusion is not available and the taxpayer has already taken advantage of the maximum unified credit). The donee's depreciable basis is limited to \$31,420 (\$10,000 basis plus gift tax paid relating to net appreciation: $\$23,800 \times .9 = \$21,420$). If the property is acquired through a purchase, no gift tax is incurred and the buyer can depreciate the full \$100,000. n39.3

There are some disadvantages to sales of fee interests, however. First, the buyer must be able to come up with the purchase price. Often, the younger generation may not be able to provide the purchase price. Second, the seller is faced with income tax on his gain. Third, the sales proceeds are included in the estate of the decedent, unless they are disposed of. Finally, if the price is not adequate, the seller is deemed to have made a gift, subject to the gift tax, in an amount equal to the excess value.

[i] Sale and Leaseback Transactions

One problem inherent in the outright sale or gift of a fee interest is that the seller loses all control of the property. This problem can be mitigated through a sale and leaseback arrangement. The sale removes the asset from the estate, while the leaseback allows the seller to retain use or control over the property. Moreover, the rent that is paid to the buyer may be deductible by the seller, if there is a business purpose to the lease. The leaseback should be priced carefully to make sure that the rental is at arm's-length in order to avoid a possible recharacterization as a transfer with a retained interest, a recharacterization that could well cause the property to remain in the transferor's estate. The rent expense should be deductible if an arm's length rental is charged, but will not be deductible if the rent is excessive. n40

Example:

Assume that an individual has depreciable business property worth \$200,000 that he wants to remove from his estate. The sale of this property would trigger gain to him if the purchase price exceeds the individual's basis in the property--as with any sale--unless the lease has a term of 30 years or more and the transaction qualifies as a like-kind exchange under *IRC Section 1031*. n41 The seller could then agree to leaseback the property, paying a fair rental value for its use. Since this is business property, the rent should be deductible for income tax purposes. In addition, the buyer is receiving a steady cash flow from the rental income and would be able to depreciate the full \$200,000 cost of the property, subject only to the at-risk and passive activity loss provisions of the Code.

This technique works well for intrafamily sales where the property has appreciated or has been fully depreciated and the seller is in a higher tax bracket than the buyer, and the seller has net operating losses or capital losses (or loss carry forwards) to offset against the income or gain. The seller receives a rent deduction, which more than offsets the tax on the rental income to the buyer.

[ii] Sale of Building, Lease of Land

This method is also derived from the simple sale of the fee interest. The seller sells the building, but retains the land. The seller then leases the land to the buyer.

One advantage of this method is that the income tax on the sale is reduced, since only the building is sold. In addition, the lease provides a steady stream of income to the seller. Another benefit is that upon the death of the seller the building is not included in the estate, and the estate gets a step-up in basis for the land. This technique works best if an individual plans to sell the fully depreciated property but does not want to recognize the full gain, particularly when the majority of the appreciation is associated with the land.

[2] Bargain Sales

A bargain sale is partly a gift and partly a sale. It enables one to remove property from his estate with a lower gift tax than an outright gift and with lower cash requirements from the buyer than an outright sale. Gift tax will be due only on an amount equal to the excess of the value of the property over the amount paid. ^{n41.1} A simple example will demonstrate the dynamics of this technique.

Example:

Assume an older couple wishes to transfer real property to their daughter. The property is worth \$100,000 and has a basis of \$50,000. First, they consider making a gift. They can give \$20,000 without being subject to the gift tax, assuming they elect to gift-split. The remaining \$80,000 would be a taxable gift, which either results in gift tax of \$18,200, or a depletion of any remaining unified credit. Second, they consider an outright sale. If they sell the property to their daughter for its full value, they will have a gain of \$50,000. In addition, an outright sale will leave them with net cash in an amount equal to the \$100,000 (less income taxes on the \$50,000 of gain) in their estate and will require their daughter to fund the full \$100,000 purchase price. Finally, they consider selling the property for less than its fair market value--a "bargain sale." If they sell the property for \$50,000, they will have made a taxable gift of only \$30,000 (after their \$20,000 annual exclusions)--far less than the \$80,000 gift under the outright gift scenario. They will also recognize \$0 gain (since their sales price is exactly equal to their adjusted basis), whereas an outright sale results in \$50,000 gain. The bargain sale enables them to limit their taxable gain on sale and reduces their gift tax liability. Their daughter also benefits from the reduced amount of cash required from her to fund the purchase.

One advantage of the bargain sale is its flexibility. Computations can be made easily at a range of sales prices, determining the gift tax and income tax due under each, as well as the cash outlay required. In this manner, the transaction can be tailored to the client's needs. If a decedent transferor does not receive adequate and full consideration in a sale (and this will always occur in a bargain sale), the fair market value of the property at the time of death is included in the gross estate, offset by any consideration received. ⁿ⁴² In addition, since a bargain sale inherently contains a gift element, the estate tax risks associated with the transaction are higher. ⁿ⁴³ Thus, leasebacks of property sold in a bargain sale should normally be avoided; if they cannot, extreme care should be taken to ensure they are arm's-length in nature, as bargain rental may be viewed as a retained interest in the transferors which could cause the property to be included in their estate at death.

[3] Installment Sales/Gifts

One problem that is inherent in the methods discussed so far is the immediate tax faced by the seller. If an outright gift is made, a current gift tax may be due. If a sale is made, there is income tax to be paid. The latter may be alleviated by spreading out the transaction through the installment sale method, but the installment sale gain must ultimately be recognized, even if installment payments are received after the transferor's death. ⁿ⁴⁴ (See Chapter 7 for further discussion of installment sales.)

Example:

Assume that a piece of property has a fair market value of \$100,000 and a basis of \$40,000. Instead of selling the property for \$100,000, payable immediately, a seller might consider spreading out the gain by selling the property for a series of notes. These notes might be \$20,000 (plus interest) a year for five years. The seller recognizes the \$60,000 gain ratably over the five-year period--\$12,000 per year. In addition, the seller has interest income for each year's interest payment. (Note, however, that the benefits

of the installment method may be significantly reduced when property used in a trade or business is the subject of the installment sale. For example, all depreciation recapture income must be recognized in the year of the sale. *IRC Section 453(i)*. In addition, if the transferor disposes of the property before the installment payments are completed, the installment gain may be accelerated. n45

A second benefit of an installment sale (the first being the tax deferral for the seller) is that the buyer can pay for the property over time. The buyer may even be able to pay for the property with the cash flow that the property produces. The interest must be at a statutorily-prescribed adequate stated rate, n46 unless the size of the transaction is below certain de minimis amounts. However, there is some flexibility allowed in setting the interest rate to either minimize the seller's tax on interest income or maximize the buyer's interest deduction.

There are certain characteristics associated with installment sales which need to be pointed out. First, the buyer may be unable to deduct interest on the note because of investment interest limitations. n47 (See Chapter 7 for a discussion of investment interest limitations.) Second, the value of the tax deferral is limited, in the case of large transactions, through the imposition of additional interest on the deferred tax liability if installment receivables exceed \$5 million. n48 Third, if the sale is to a related party, and this buyer sells within two years of the purchase, taxation of the original seller's deferred gain is triggered. n49 This puts limits on the subsequent transferability of the installment-sale property. Fourth, if the seller dies before the note is fully paid off, income is recognized when payments are made to the decedent's estate or heirs. Fifth, the balance of the installment obligations, as of date of death, is included in the decedent's gross estate. n50 These provisions need to be examined carefully to determine if a contemplated installment sale will provide the benefits sought in each case.

[a] Self-Canceling Installment Notes (SCIN)

Self-cancelling installment notes (SCINs) are installment notes that automatically cancel or extinguish at the seller's death. Since the buyer need not continue making payments after the death of the seller, there is a chance that the buyer will be able to obtain the property without paying the full purchase price. On the other hand, if the seller lives longer than the term of the loan, future payments need not be made past the term of the notes. The buyer must pay a premium for this feature, which is expressly included in the sales agreement; the premium may be a higher purchase price or a higher interest rate than an ordinary installment sale. The major benefit to the seller is not the higher interest rate premium or the higher purchase price but the possibility that his or her estate will not include the value of any installment obligations outstanding at the time of his death.

This technique has been written on extensively since the Tax Court case of *Estate of Moss v. Commissioner*. n51 The Service clarified some of the uncertainties in this area with *Revenue Ruling 86-72* n52 and *GCM 39503*. n53 In these pronouncements, the Service recognized the "SCIN" and noted the differences between the SCIN and other arrangements, such as private annuities.

SCINs have other characteristics that should also be considered. Like other installment payments, the remaining deferred gain is recognized upon the death of the seller. n54 In a 1993 case, *Estate of Frane v. Commissioner*, n55 the court held that the remaining deferred gain is taxed in the decedent's estate. Additionally, there is still some uncertainty about whether the premium can be expressed as an increased interest rate or an increased purchase price. There is also uncertainty about how large this premium should be. Some commentators have suggested taking a weighted average of the risk inherent in each of the payments: the risk could be determined from the estate tax annuity tables. n56 Finally, the fact that this technique works best if the seller were to die shortly after entering the transaction, may make certain individuals and their estate planners very hesitant. Typically, an estate's position is that the estate tax value of a SCIN is zero because the note was cancelled on the decedent's death. The IRS can seek either (1) to increase the value of the estate, claiming that the SCIN was not a bona fide sale and because full and adequate consideration was not received, or (2) to assert that the sale transaction, if valid, was a bargain sale gift to the purchaser. The gift argument is likely to be

successful if payment terms of the SCIN are not complied with, because failure to enforce the payment provisions indicates that the parties intended a gift. n56.1 In addition, if a decedent-seller retains any power to revoke the transfer, the value of properties transferred under s SCIN may be included in the decedent's estate under *IRC* § 2038.

A special danger can arise in the SCIN installment sale area if the parent-seller transfers a personal residence to a child and stays in the house under a purported lease arrangement with the child. In that case, courts have sometimes found that, notwithstanding a written lease, there was an implied agreement among the parties that the parent actually retain a life estate in the home. n57 This finding will cause the fair market value of the home at the time of the parent's death to be included in his or her estate. n58 Thus, not only will the estate reduction intended at the time of the transfer be thwarted, but any increase in the fair market value of the property between the date of that transfer and the date of the decedent's death will be added to the estate. This kind of arrangement is especially suspect if the amount the child is paid in rent is nearly equal to the amount of the child's interest payments on the installment note. n59 The best way to avoid this problem is to have the parent transfer the home to a qualified personal residence trust. n60

[b] Sale and Debt Forgiveness

This technique is identical to the installment method, with one notable addition. When each payment becomes due, it is forgiven by the seller. In this manner the property can be transferred to the buyer free of charge. Of course, the seller has made a gift, but the amount is only the value of the forgiven note (not the entire property).

One advantage to the sale and debt forgiveness method is that the seller is able to use the annual exclusion every year. This technique works perfectly when a payment of \$10,000 (or \$20,000 if gift-splitting) is due each year. If the intent to cancel the debt is determined to be "prearranged," however, it is arguable that the *entire* transaction will be accelerated and treated as a gift up front.

Understandably, this technique has been litigated by the Service. However, in *Kelley v Commissioner*, n61 the Tax Court held these arrangements are valid as long as the indebtedness itself is valid. The sellers should have all the rights of ordinary creditors and interest should be charged and collected to support the position that these are valid notes. It is important to provide substantiation that the sale was a bona fide sale and the notes were valid evidences of indebtedness, because the Service may well take the position that there was a gift at the onset of the transaction. n62

With this technique, the seller will still have income to recognize when the notes become due. The forgiveness of an installment note is considered a "disposition" for installment sale purposes, and the seller will have to recognize gain as if he were paid. Therefore, this method is best suited when the fair market value of the property is not far in excess of its adjusted basis.

[c] Partnership Transfers

The benefit of giving property away piece-by-piece is demonstrated by the debt-forgiveness method discussed above. Thus, some taxpayers may wish to give away undivided interests in property each year to a younger family member over an extended period of years, in order to take advantage of the annual gift tax exclusion. n62.1 The problem is that, while gifts may be easily accomplished with stocks and bonds, they are far more difficult with parcels of real property. Every year, the donor would have to deal with the difficulties of transferring title to a portion of the property to the other family member. One way of avoiding these difficulties is through the use of a partnership.

Real property is contributed to a partnership in which the former owner and his family members are partners. The partnership would usually be organized as a limited partnership, with the donor (or an entity owned by the donor) as the general partner and the donor and the prospective donees as limited partners. There would be no gain recognized on the contribution of property to the partnership. n63 However, depending on whether the younger family members have personal assets to contribute to the partnership, there may be a gift to the other family members equal to the value of

their initial partnership interests. Every year, the partnership interests of the younger family members could be increased by gift, in an amount designed to use the annual exclusion. For example, property with a fair market value of \$100,000 is owned by an individual who wants to retain control of the property but eventually pass the property to his two daughters. He contributes the real property to a partnership and receives an 80 percent interest in the partnership. His two daughters receive a 10 percent interest worth \$10,000 or less each. The gifts of the partnership interests are not taxable, since they do not exceed the annual exclusion amount. In the second year, the value of the property has increased to \$120,000. The original owner transfers a portion of his interest in the partnership to each of his daughters--8.33 percent to each, or \$10,000. This leaves him with an interest of 63.33 percent, worth \$76,000. This technique is repeated every year; the only transfer of land title required was in the initial year when the property was contributed to the partnership.

The value of the limited partnership interests may be less than a pro rata portion of the value of the property because of discounts for lack of control and lack of marketability resulting from the status of the limited partnership interest as minority interests. n64

A word of caution--if the property is appreciating at a rapid pace it might be prudent to give a larger partnership interest each year, if not the entire fee interest. This may entail using up some or all of the available unified credit to avoid the payment of gift tax, though it is probably prudent to get the property out of the potential estate before it has appreciated even more. This can be especially useful after 2001, when the unified credit effective exemption amount for gift taxes is increased to \$1 million. n64.1

There are a number of requirements that must be met by family partnerships. First, capital must be a material income-producing factor. If it is not, the donor might continue to be taxed on the income generated by the partnership, pursuant to assignment of income-type principles. This should not prove to be a problem for real estate holdings. However, a partner who provides services to the partnership should be adequately compensated for those services. If services are provided without adequate compensation, it begins to look like capital is not the material income-producing factor. Second, the donee must be the real party in interest--she must have an interest in both the profits and losses *and* the capital of the partnership. The gist of these requirements is that the interest that the donee obtains must not be an illusory interest that can be recharacterized as an assignment of income. Therefore, the allocation of powers between the donor and donee partners should be scrutinized carefully. Be cautioned that there is some uncertainty in this area because of the unwillingness of the Service to issue rulings on the validity of a family partnership in which capital is not a material income-producing factor. n65 It should also be noted that a transfer of legal title to property to a family partnership will not remove that property from a decedent's estate if the transferor retains possession and enjoyment of the property or the right to income from the property, or if the transferor does not receive in exchange for the property full and adequate consideration in the form of partnership interests. For example, if there is an implied agreement among the parties that the transferor may continue to use or control the property after the transfer, the property will be included in the decedent's estate. n65.1

A pre-death partnership transfer will also be ignored if the formation of the partnership and the transfer of property to it does not alter the transferor's relationship to the property, if proper formalities are not observed in the establishment of the partnership, or if parties ignore the partnership. In that case *IRC Section 2036* will cause the full value of transferred property to be included in the decedent's gross estate. n65.2

IRC Sections 2701-2704 may limit the efficacy of such transfers also, depending on the type of partnership interests involved. These provisions impose special valuation rules to be used for purposes of determining the value of interests in partnerships and corporations created in transactions generally referred to as "estate freeze" transactions. See § 18.02[8], below, for further discussion.

[4] Transfer of a Remainder Interest

The current owner of real property may want to retain a current beneficial interest in the property, despite the estate tax advantages of transferring the property during his or her life. As mentioned in the preceding section, an annual gifting program or installment sale may not satisfy this desire. Another way to split up property is to separate the present from the future interest. The older generation may retain some control over the property by retaining a present interest (life estate), while the younger generation can hold a future interest (remainder) in the property. The principal estate planning drawback to the retention of a life estate and gift of a remainder interest is that at the death of the life tenant the property is included in his or her estate. n66 Thus, no long-term estate tax benefits are derived from this technique.

IRC Sections 2701 through 2704 also may require the value of the retained interest to be included in the value of the gift for gift tax purposes. See § 18.02[8], below, for further discussion.

[a] Joint Purchase

Some estate planners seek to avoid the adverse estate tax implications of a transfer with a retained life interest, and still separate the present and future interests by arranging a joint purchase of property from a third party, in which the older generation buys the life estate and the younger generation acquires the remainder.

Example:

A 65-year old widow wants to buy a vacation home for \$100,000. She wants her children to have it when she dies and does not want it to be included in her estate. She can purchase a life estate while her children can buy the remainder interest in the property. In this example, the actuarial tables indicate that her life estate would be worth \$67,970; the remainder interest would be worth \$32,030. n67 If the widow and her children pay these amounts, she will own the life estate, and her children will own the remainder. Upon her death, the vacation home will be owned completely by the children, and no amount of the home would be included in her estate.

The primary advantage of this type of purchase is that nothing is included in the estate of the life tenant, yet the life tenant has certain controls over, and beneficial interests in, the property. In the example, the widow can use the vacation home during her lifetime and is entitled to any income or deductions should the property be rented out. *IRC Section 167(e)* prohibits the holder of a term interest in property from taking any depreciation or amortization deductions where the remainder interest in the property is held by a related person. n68 In the example above, the widow and her children would be treated as related persons, n69 and the widow would therefore not be entitled to depreciation or amortization deductions on the property.

There are some disadvantages in this technique--it requires that the younger generation come up with all or part (if a mortgage is used) of the purchase price of the remainder interest, and, in addition, the life tenant has no power to dispose of the property at death. It is also possible that *IRC Section 2702(c)(2)* may recast these types of transactions in such a way that the older-generation individual is considered to have made a taxable transfer of the life estate to the younger-generation individual. See § 18.02 [8], below, for further discussion.

[b] Sale

An older-generation individual may consider selling a remainder interest in property to someone in a younger generation. As with the joint purchase, the value of the life estate is not included in the estate of the life tenant when he dies and yet control over the property is retained during his life. n70 Special valuation rules may come into play with an intergenerational sale of a remainder interest, however. n70.1 See § 18.02[8], below.

Valuation is a primary concern from the onset in a transaction of this sort. The annuity tables in *Regulations Section 25.2512-5* should be used in determining the allocation. Carrying over the prior example, if the widow wanted to sell a remainder interest to her children, she should charge them at least \$32,030. This valuation of the remainder interest

inherently assumes that the property itself has a value of \$100,000. In the context of a joint purchase, since the property is being acquired from a third party, the property valuation is readily determinable and supportable. When property has been held for some time, it is not always easy to determine its present fair market value. An appraisal may be required.

The concern about the value of the property is prompted by *IRC Section 2036(a)*. This section holds that the decedent's estate includes the value of all transferred property in which the decedent retained a life estate, unless "adequate and full consideration" has been paid. Therefore, if the remainder was sold to the younger generation for \$20,000 when the actuarial value was \$32,030, the full value of the property (\$100,000 *plus* any appreciation since the time of sale) would be included in the estate. The primary purpose for transferring the remainder interest is completely frustrated, as the property is included in the estate. n71

There is some uncertainty on what "adequate and full consideration" refers to. One interpretation is that the consideration must be equal to the entire value of the property, while another line of thought is that the consideration must only be equal to the value of the remainder interest itself. The latter reasoning is held by the vast majority of commentators and has been adopted by at least one circuit court. n72 To hold to the contrary would mean that one would have to sell a remainder interest for an amount far in excess of its present value, virtually eliminating the benefits associated with the sale of a remainder interest.

The sale of a remainder interest cannot be accomplished unless such a sale is allowed by local law. In addition, even if local law provides for sales of remainder interests, there are a number of practical problems inherent with joint ownership. How will the life tenant and the remainderman decide what work can be done on the property? Who will determine if and when the property can be sold? These are matters that should be set out clearly in the purchase agreement.

There are other drawbacks related to the sale of remainder interests. First, the remainderman must come up with the purchase price for the remainder. If the life tenant loans or gives the remainderman the money to make the purchase, the Service is likely to assert that the transactions should be collapsed and, thereafter, apply *IRC Section 2036(a)*. Second, the remainderman will have a very low basis in the property--equal only to the cost of the remainder interest. (At the death of the life tenant, the entire property transfers to the remainderman, yet his basis in the property is only the original cost of the remainder. This may cause a substantial gain to be recognized upon the sale of the property.) Third, as previously mentioned, it may be necessary for the parties to obtain an appraisal of the property, which may be quite costly. In addition, if the remainderman pays for the remainder other than by paying cash outright, there may be a need to appraise the value of the property or note received from the remainderman. Fourth, the life tenant will probably have some gain to recognize on any disposition of the remainder interest. Last, as indicated earlier, the life tenant has no choice in the disposition of the property at death--it automatically passes to the remainderman by operation of law.

An example of this technique may help put the aspects of this type of transaction into perspective.

Example:

A 70-year old widower wants to transfer a \$100,000 property to his daughter. At his age, the actuarial value of the life estate is worth \$60,522, and the value of the remainder is \$39,478. n73 Assume that the property has a basis of \$40,000; when the daughter pays the \$39,478, the father will have gain to recognize. The gain is calculated by allocating a portion of the basis to the remainder; n74 in this case the basis would be \$15,791 ($\$40,000 \times .39478$), and \$23,687 of gain would be recognized. After the transfer, the life tenant-widower cannot depreciate his basis in the property, even if it is used in a trade or business. n74.1 His basis is nevertheless reduced by any disallowed depreciation deduction. The basis of the remainder interests in the property is increased by the amount of disallowed deductions, however. n74.2 The widower-life tenant is entitled to all of the income that the property produces. At the death of the life tenant, the property is not included in his estate. The daughter obtains the property outright, though she has only the cost of her remainder interest (as increased by the depreciation deductions

disallowed to the life tenant) to depreciate. n74.3

One final note: except for personal residence trusts, discussed in § 18.02[8] [b], a *gift* of a remainder interest will not produce any benefits whatsoever. First, the annual exclusion is not available for gifts of future interests. n75 Second, and most important, the *gift* of a remainder interest triggers the operation of *IRC Section 2036(a)*, as there is a transfer of property with a retained life estate for less than "adequate and full consideration." Thus, the property would be included in the life tenant's estate--at its full value as of the date of death. n76

[5] Private Annuities

A private annuity is a transfer of property made in exchange for periodic payments that will continue for the remainder of the transferor's life. This can also be structured as a "joint and survivor" annuity whereby the payments continue until the seller or his spouse dies. Upon the death of the first spouse, the annuity can pass to the surviving spouse without tax--due to the unlimited marital deduction. Upon the death of the second spouse, there is no associated estate tax since the annuity obligation is automatically canceled. As with the other techniques discussed in this chapter, this removes the property from the estate of the transferor.

Historically, the IRS took the position that each annuity payment based on an unsecured promise to pay consisted of a nontaxable return of basis, capital gain, and an ordinary income component. n77 Thus, annuitants could postpone tax on the exchange of appreciated property for a private unsecured annuity. The rationale of the IRS position was originally based in part on the assumption that the value of a private annuity contract could not be determined for federal income tax purposes. n77.1 The IRS position also had its roots in authorities that applied the "open transaction doctrine," under which if an amount realized from a sale cannot be determined with certainty, the seller recovers the basis of the property sold before any income is realized on the sale. n77.2 A simplified example of this follows:

Example:

Property with a basis of \$40,000 and a fair market value of \$100,000 is sold for an annuity of \$15,000 per year. The seller has a life expectancy of 10 years. Of each \$15,000 payment, \$4,000 is a return of basis, \$6,000 is a capital gain, and \$5,000 is ordinary income (interest). At the end of 10 years, the seller would have received \$150,000, of which \$40,000 was a return of basis, \$60,000 was capital gain, and the balance would be ordinary income.

The above result applied only if the promise to pay was unsecured. For cases involving a secured annuity, the result is different. In one case, the taxpayers transferred stock in two closely held corporations in exchange for an annuity contract. The fair market value of the stock substantially exceeded the value of the annuity contract. The stock transferred was placed in escrow to secure the promise of the transferees. As further security, the annuity agreement provided for a cognovit judgment against the transferees in the event of default. Because of the secured nature of the annuity, the following tax results ensued: n77.3

- The difference between the value of the stock and the value of the annuity contract constituted a gift;
- The difference between the adjusted basis of the stock and the value of the annuity contract constituted gain that was taxable in the year of the transfer; and
- The investment in the annuity contract equaled the present value of the annuity.

In another case with a secured annuity, a court held that the entire amount of gain realized from the exchange of appreciated real property for an annuity contract was fully taxable in the year of the exchange because the annuity contract was secured by the following: n77.4

- An agreement that the annuity payments would be considered a charge against the rents from the property;
- An agreement not to mortgage or sell the property without written consent of the transferors; and
- The authorization of a confession of judgment against the transferee in the event of default.

In late 2006, the IRS unexpectedly reversed its longstanding historical position and issued proposed regulations that would declare *Revenue Ruling 69-74* and its treatment of unsecured annuities obsolete. The proposed regulations would apply the same rule to exchanges for both private annuities and commercial annuities. n77.5 (Charitable gift annuities would not be affected. n77.6 The change in the IRS position is partly triggered by the fact that some taxpayers are inappropriately avoiding or deferring gain on the exchange of highly appreciated property for the issuance of annuity contracts, even though numerous mechanisms are used secure the payment of amounts due under the annuity contracts. Many of the transactions involve typical family business transfers, where private annuity contracts are issued by family members or by business entities that are owned, directly or indirectly, by the annuitants themselves or by their family members. The IRS also no longer feels that the open transaction approach n77.7 or the ratable recognition approach n77.8 clearly reflects the income of the transferor of property in exchange for an annuity contract. Contrary to the premise underlying these authorities, the IRS now takes the position an annuity contract--whether secured or unsecured--may be valued at the time it is received in exchange for property. n77.9

Under proposed regulations, the IRS taxes the transferors in the same manner, whether they exchange property for an annuity or sell that property and use the proceeds to purchase an annuity. Thus, if an annuity contract is received in exchange for property (other than money), the following tax results ensue: n77.10

- The amount realized attributable to the annuity contract is the fair market value (as determined under *IRC Section 7520*) of the annuity contract at the time of the exchange;
- The entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and
- For purposes of determining the initial investment in the annuity contract, n77.11 the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (the fair market value of the annuity contract). Thus, in situations where the fair market value of the property exchanged equals the fair market value of the annuity contract received, the investment in the annuity contract equals the fair market value of the property exchanged for the annuity contract.

In order to apply the proposed regulations to an exchange of property for an annuity contract, taxpayers will need to determine the fair market value of the annuity contract as determined under *IRC Section 7520*. In the case of an exchange of property for an annuity contract that is in part a sale and in part a gift, the proposed regulations apply the same rules that apply to any other such exchange, and the transferor will have a gain to the extent that the amount realized exceeds the transferor's adjusted basis in the property, but no loss if the amount realized is less than the adjusted basis. n77.12

For purposes of determining the investment in the annuity contract n77.13 the aggregate amount of premiums or other consideration paid for the annuity contract is the portion of the amount realized on the exchange that is attributable to the annuity contract (which is the fair market value of the annuity contract at the time of the exchange). n77.14 This rule is intended to ensure that no portion of the gain or loss on the exchange is duplicated or omitted by the application of *IRC Section 72* in the years after the exchange. The annuitant's investment in the contract would be reduced in subsequent years under *IRC Section 72(c)(1)(B)* for amounts already received under the contract subsequent to the

exchange and excluded from gross income when received as a return of the annuitant's investment in the contract.

The proposed effective date for Proposed *Treasury Regulation Section 1.1001-1(j)* is generally for exchanges of property for an annuity contract after October 18, 2006. Thus, the regulations would not apply to amounts received after October 18, 2006, under annuity contracts that were received in exchange for property before that date. n77.15 The proposed effective date for Proposed *Treasury Regulation Section 1.72-6(e)* is generally for annuity contracts received in exchanges after October 18, 2006. n77.16 For both regulations, the effective date is April 18, 2007 for transactions in which the following conditions are met: n77.17

- The issuer of the annuity contract is an individual;
- The obligations under the annuity contract are not secured, either directly or indirectly; and
- The property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

Treasury and the IRS also propose to declare *Revenue Ruling 69-74* obsolete effective contemporaneously with the effective date of these regulations. Thus, the obsolescence would be effective April 18, 2007, for exchanges described in Proposed *Treasury Regulations Sections 1.1001-1(j)(2)(ii)* and *1.72-6(e)(2)(ii)*, and effective October 18, 2006, for all other exchanges of property for an annuity contract.

NOTE:

The proposed regulations do not distinguish between secured and unsecured annuity contracts, or between annuity contracts issued by an insurance company and those issued by individual taxpayers. Instead, the proposed regulations provide a single set of rules that leave the transferor and transferee in the same position before tax as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract. The same rules would apply whether the exchange produces a gain or loss. The regulations do not, however, prevent the application of other provisions, such as *IRC Section 267*, to limit deductible losses in the case of some exchanges. The proposed regulations apply to exchanges of property for an annuity contract, regardless of whether the property is exchanged for a newly issued annuity contract or whether the property is exchanged for an already existing annuity contract. n77.18

Treasury and the IRS are aware that property is sometimes exchanged for an annuity contract, including a private annuity contract, for valid, non-tax reasons related to estate planning and succession planning for closely held businesses. The proposed regulations are not intended to frustrate these transactions, but only to ensure that income from the transactions is accounted for in the appropriate periods. Installment sales provisions are still available for qualifying transactions to extend gain recognition over a period of years. n77.19 Indeed, the Treasury Department and IRS have requested comments as to the circumstances, if any, in which an exchange of property for an annuity contract should be treated as an installment sale, and as to any changes to the regulations under *IRC Section 453* that might be advisable with regard to those circumstances.

The advantage of a private annuity is that the members of the older generation have assurances (although unsecured) that they will receive income for as long as they might live. Under installment purchases, the payments stop after a predetermined period, and the seller no longer benefits from income that the property produces. The other advantages are similar to those associated with self-canceling installment notes (see discussion at § 18.02[3], above)--at the seller's death, the value of the property is not included in his estate. Death before the expiration of the seller's life expectancy should *not* trigger the recognition of the deferred gain. The proposed regulations do not change these advantages. n78

Because of the immediate recognition of the gain in a private annuity arrangement under the proposed regulations, n78.1 however, an installment sale is likely to be a more attractive option, since recognition of gain can be extended over the period during which installment payments are made. Annuity arrangements can offer payments for life of the annuitant, however, which some parties may prefer. Under annuity arrangements, as with installment sales or self-canceling installment notes, the value of the property transferred for the annuity is not includable in the estate of the annuitant.

A disadvantage of an unsecured annuity is, of course, the possibility that the seller may not get paid. In addition, the buyer is not allowed an interest deduction for the interest element implicit in the annuity payment. n79 Finally, having payments continue once the annuitant's life expectancy has been reached may be an economic disadvantage, from the perspective of the payor of the annuity, particularly when no current deduction for the interest element is allowed. The annuitant, on the other hand, is forced to recognize ordinary income on the entire payment, less the exclusion amount. If this is an intrafamily sale, this aspect of private annuities may be particularly problematic.

[6] "Partnership Freeze"

In previous years, the so-called "partnership freeze" was another way to get the appreciation from one's property out of one's estate. A partnership freeze is an extremely sophisticated and complex technique, and a series of amendments to the Code have sharply curtailed the benefits obtainable through the use of this planning technique. The goals of a partnership freeze would generally be to create a partnership between the older and younger generations, with the older generations being entitled to a fixed and preferred income stream and a fixed liquidation preference, and with the younger generations being entitled to all or substantially all of any growth in the income of the partnership, and to all or substantially all of any increase in the value of the assets of the partnership. The members of the older generation are economically in essentially the same position as preferred shareholders in a corporation, although it will normally also be the goal of the members of the older generation to retain a significant degree of control over the operations of the partnership.

The value of the preference serves to limit the value of the partnership interest that can be included in the decedent's estate. This liquidation preference should be equal at least to the value of the partner's original contribution.

The goals of this planning technique are to allow the members of the older generation to maintain control over the partnership and its assets, minimize any current gift taxes (or use of the unified credit), shift future appreciation and income growth to the members of the younger generation, and minimize the value of the interests in the partnership to be included in the estates of the members of the older generation. Because the assets are in a partnership, an *IRC Section 754* election following the deaths of the members of the older generation may allow a basis step-up with respect to the shares of assets attributable to the partnership interests included in the estate of the members of the older generation. (See Chapter 14).

The tax pitfalls in a transaction of this type are numerous, and include a challenge by the Service that the property was not transferred to the partnership in the first place, and a challenge by the Service to the valuation of the property. In addition, if this type of partnership is created through a restructuring of an existing partnership, a reduction in the share of partnership liabilities allocated to a current partner will be treated as a distribution of money. n80 If this is greater than the partner's basis in the partnership, he will recognize gain. n81

The effectiveness of the partnership freeze technique has all but been destroyed by the special valuation rules, n82 and many of the benefits formerly attributable are no longer available.

[7] Charitable Giving

The charitable deduction is a feature of the income, gift and estate tax systems. Charitable contributions made during

the donor's lifetime qualify for both the gift and income tax deductions. n83 This benefit of the income tax deduction makes a lifetime gifting program attractive.

The various techniques for making charitable gifts are too numerous to mention. n84 A donor can make an outright gift, a gift of a partial interest, or a deferred gift (i.e., split interest). A deferred (split interest) gift can be achieved through a gift to a "charitable remainder trust" (a trust which distributes income currently to a designated beneficiary, possibly the donor, with the remainder going to a charitable organization) or a "charitable lead trust" (a charitable organization receives the income from the trust and the remainder goes to a designated beneficiary). In addition, "private foundations" can be set up by individuals who wish to have more control over the ultimate disposition of their donations. These techniques, and a myriad of others, can all be tailored for gifts of real property. (See Chapter 6 for further discussion of gifts of real property generally, and Chapter 11 for a discussion of gifts by developers.)

[8] Impact of Sections 2701-2704

The Revenue Act of 1987 n85 added Section 2036(c) to reduce the tax benefits of "estate freezes." The provision, which has since been repealed, applied to persons who transferred a disproportionately large share of the potential appreciation in an interest in an enterprise but retained a disproportionately large share of income, voting, or other rights in the enterprise. This provision applied only if the transferor held a substantial interest in the enterprise. A substantial interest was considered to be 10 percent or more of the voting power or income stream in the enterprise. Interests owned by any member of the transferor's family were treated as owned by the transferor for purposes of making this determination.

IRC Section 2036(c) was retroactively repealed in 1990. n86 In place of that section was added a series of special valuation rules. n87 These rules were intended to assure a more accurate valuation of transferred property when an older generation member retained a preferred interest in transferred property. In essence, the value of the retained interest is subtracted from the entity's value to yield the value of the transferred interest. The transferred interest may be discounted to reflect a minority interest, if applicable. To value the retained interest, the law mandates a zero value for certain retained "discretionary" rights. The result generally is a decreased value for the retained interest and an increased value and gift tax burden at the time of an affected transfer. These rules, effective generally for transfers after October 8, 1990, apply to the valuation of corporate and partnership equity interests transferred to family members. n88 They also affect the valuation of certain gifts in trust and other life-estate/remainder-interest transactions. n89 Buy-sell agreements and stock options also are restricted in their impact on estate and gift valuation.

[a] Valuation Rules on Transfers of Certain Interests in Corporations or Partnerships

For purposes of determining whether the transfer of an interest in a corporation or partnership to (or for the benefit of) a "member of the transferor's family" is a gift, and the value of such a gift, the value of certain rights to receive distributions that are not qualified payment rights, and certain put, call, liquidation or conversion rights retained by the transferor or "applicable family member" is generally deemed to be zero. n90 In general, this has the impact of increasing the value of the gift.

A transfer for the purpose of these rules includes a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership if the transferor, or an "applicable family member," receives an "applicable retained interest" as a result of the transactions. n91 The regulations set forth additional circumstances in which changes in the capital structure of an entity are considered transfers, including transactions in which the transferor or "applicable family member" holding the "applicable retained interest" prior to the transaction receives property other than the "applicable retained interest" or the "applicable retained interest" increases in value. n92

Furthermore, the termination of an indirect holding in an entity can also constitute a transfer n93 if (1) the property is

held in a trust that the indirect holder is treated as owning, or (2) if the value of the holding would have been includable in the holder's gross estate if the holder had died immediately before the transfer. n94 The rules of *IRC Section 2701* do not apply when there are readily available market quotations on an established securities market for the value of either the transferred interest or the "applicable retained interest," n95 or if a retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportionally the same as the class of the transferred interest. This determination is made without regard to non-lapsing differences in voting rights (or, for a partnership, nonlapsing differences with respect to management and limitations on liability). An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or an "applicable family member," acting individually or in concert, has the right to alter the liability of the transferee. n96 These rules do not apply to a transfer of equity interests that results in a proportionate reduction of each class of equity interest held by the transferor and all "applicable family members" in the aggregate, immediately before the transfer. n97

Similarly, a transfer is not subject to these rules if the transferor, each "applicable family member," and each "member of the transferor's family" holds substantially the same interest after the transaction as they held before the transaction. For this purpose, common stock with non-lapsing voting rights and nonvoting stock are interests that are substantially the same. n98

Furthermore, a transfer does not include a qualified disclaimer or a shift of rights occurring upon the exercise of a power of appointment except to the extent that the exercise reduces the powerholder's interest in appointed property. n99

In general, if a transaction is not subject to these rules, any retained interest is valued at fair market value for gift tax purposes, rather than pursuant to the special valuation rules of *IRC Section 2701*.

The "members of the family" are the transferor's spouse, any lineal descendant of the transferor or the transferor's spouse, and the spouse of any such lineal descendant. An "applicable family member" may be the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and any spouse of such ancestor. n100 An individual is considered to hold any interest held indirectly through a corporation, partnership, trust, or other entity. n101

An "applicable retained interest" includes certain distribution rights if the transferor and applicable family members "control" the corporation or partnership immediately before the transfer. n102 In general, a distribution right is the right to dividends or partnership distributions. n103 The term does not, however, include the following: n104 (1) a right to distributions with respect to any interest that is junior to the rights of the transferred interest; (2) any liquidation, put, call, or conversion right; or (3) any right to receive any guaranteed payment. An entity is "controlled" if the transferor, applicable family members, or any lineal descendants of the parents of the transferor or the transferor's spouse hold, either individually or in concert, (1) at least 50 percent (by vote or value) of the stock of a corporation, (2) at least 50 percent of the capital or profits interests in a partnership, or (3) any interest as a general partner in a limited partnership. n105

Planning Tip:

For purposes of determining whether an entity is controlled with respect to an applicable retained interest, an "applicable family member" includes any lineal descendant of any parent of the transferor or the transferor's spouse. n106 This definition of "applicable family member" is broader than the term "applicable family member" that applies for other rules in *IRC Section 2701*, n107 and includes siblings and nieces and nephews of the transferor and the transferor's spouse. n108

An "applicable retained interest" also includes extraordinary payment rights, including liquidation, put, call, or conversion rights, the exercise or nonexercise of which affects the value of the transferred interest. n109 However, a right that must be exercised at a specific time and at a specific amount is not an extraordinary payment right, and therefore is not an applicable retained interest. n110 Similarly, a nonlapsing right to convert into a fixed number (or a

fixed percentage) of shares of the same class of stock as the transferred stock (or which would be the same class but for nonlapsing differences in voting power) that is subject to adjustments for splits, other changes in capital stock, and accumulated but unpaid distributions is not an extraordinary payment right. (A similar provision applies to partnership interests). n111

An exception is provided from the valuation rules set forth above, for retained rights to "qualified payments." n112 As such, "qualified payments" are valued under general valuation principles. "Qualified payments" are dividends payable on a periodic basis under cumulative preferred stock (or comparable payments under a partnership interest) to the extent that such dividends (or comparable partnership payments) are determined at a fixed rate. n113 A variable rate payment is treated as having a fixed rate if it is determined at a rate that bears a fixed relationship to a specified market interest rate. n114

Payments under any interest held by a transferor that are otherwise qualified payments are treated as qualified payments unless the transferor elects not to treat them as qualified payments. In contrast, such payments held by an applicable family member are treated as qualified payments only if the member elects to treat them as such. n115 A transferor or applicable family member that holds a distribution right that is not a qualified payment may elect to treat that right as a qualified payment. The election may specify the amount of the payment and time it is to be made, provided that those terms are not inconsistent with the underlying legal instrument giving rise to the right. n116 Any of these elections, once made, is irrevocable. n117

If qualified payments are not made at the times and in the amounts used in valuing the retained right, the taxable estate or taxable gifts of the holder of the retained rights will be increased to reflect the value of the retained interest based on the actual distributions made. Any payment made within four years of its due date will be considered to have been made on its due date. This increase or adjustment is made upon (1) the irrevocable lapse or other termination of the holder's right to the qualified payments (including the sale or transfer of the retained interest and the death of the holder), or (2) upon the holder's election. n118

When a qualified payment right is held in conjunction with one or more extraordinary payment rights (i.e., liquidation, call, put, or conversion rights), the value of all such rights is determined as if each extraordinary payment right were exercised in the manner resulting in the lowest value being determined for all such rights. n119 If an applicable retained interest confers a right to receive a qualified payment that has no extraordinary payment rights, the value of the distribution right is determined without regard to *IRC Section 2701*. n120

To ensure that at least some minimum value will be assigned to an equity interest transferred to a family member, there is a minimum value rule. In general, if these rules apply to a transfer, all junior equity interests may not be valued, in aggregate, at less than 10 percent of the sum of the total value of all equity interests in the entity and the total amount of any indebtedness of the entity owed to the transferor or applicable family member. n121 A junior equity interest is common stock or a partnership interest under which the rights to income and capital (or, to the extent provided in regulations, the rights as to either income or capital) are junior to the rights of all other classes of partnership interests. n122 Short-term indebtedness incurred with respect to the current conduct of trade or business is not considered indebtedness of the entity for purposes of this rule. Furthermore, a lease is not considered indebtedness if the lease payments are made on a current basis and represent full and adequate consideration for use of the property. n123

[b] Valuation Rules for Certain Transfers of Interests in Trusts and Joint Purchases by Family Members

As a general rule, when an individual sets up a trust in which he or an "applicable family member" retains a partial interest, the valuation for gift tax purposes of any interest given to a "member of the family" is computed by subtracting the value of any trust interest that the transferor or any "applicable family member" has retained from the full value of the trust. n124 The same calculation is necessary when an individual transfers an interest in property to a "member of the family," in which the individual or an "applicable family member" retains a "term interest." n125 If the retained

interest does not constitute a "qualified interest," its value is considered to be zero. However, the retained interest constitutes a "qualified interest," its value is determined under the ordinary valuation rules. n126

A retained interest is considered a qualified interest if it:

- (1) consists of the right to receive fixed amounts payable not less frequently than annually (a grantor retained annuity trusts interest or GRANT);
- (2) consists of the right to receive amounts that are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust determined annually (a grantor retained unitrust interest or GRUNT); or
- (3) is a noncontingent remainder interest and all of the other interests in the trust consist of interests described in (1) and (2) above, GRANTS and GRUNTS. n127

A "member of the family" includes the transferor's spouse, any ancestor or lineal descendant of the transferor or the transferor's spouse, any spouse of such ancestor or lineal descendant, any brother or sister of the transferor, and any spouse of such brother or sister. n128 An "applicable family member" may be the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and any spouse of such ancestor. n129

These rules apply to the following transactions:

- (1) A transfer of an interest if there are one or more term interests in the property, n130 including a transfer to a new or existing trust or the assignment of an interest in an existing trust.
- (2) Split or joint purchases occurring when members of the same family acquire interests in the same property, and at least one of these interests is a term interest. The individual who acquired the term interest is treated as if he acquired all of the interests in the property (those belonging to family members or the individual himself) and then transferred the nonterm or remainder interest to the other family members involved in exchange for consideration paid (the amounts these individuals actual paid for their interests). n131

The special valuation rules of *IRC Section 2702* for transfers to trusts do not apply to the following: n132 (1) any transfer that is an incomplete gift; (2) any transfer involving the transfer of an interest in certain trusts containing a personal residence; or (3) any transfer to the extent that regulations provide that the transfer is not inconsistent with statutory purposes.

As noted above, certain transfers involving "personal residences" are specifically excepted from these rules and are governed by the general valuation rules if the trust meets the requirements of *Regulations Section 25.2702-5*. n133 These trusts are referred to as qualified personal residence trusts, and are discussed in § 18.04[1][b]. n133.1 For this purpose, a personal residence is the principal residence of the term holder or one other residence (a vacation home) of the term holder, or an undivided fractional interest in either. n134 The "term holder" is the former owner of the residence, generally the member of the older generation. However, an individual may not be the term holder in more than two personal residence trusts at any one time. n135 The trusts may not contain any personal property (such as household furnishings), but they may hold cash up to the amount required:

- (1) for payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be incurred within the next six months;
- (2) for improvements to the residence to be paid for within six months; and

(3) on creation of the trust, for purchase of the initial personal residence within the next three months, and at any other time, for the purchase of a replacement personal residence within the next three months provided the trustee has previously entered into a contract to purchase the personal residence. n136

The trustee may sell the residence and hold the sales proceeds (and any income thereon) in the trust if there is an intention to replace the residence within two years with another qualifying residence. A similar rule applies to insurance proceeds received by the trust due to damage or destruction of the residence. n137 If the residence ceases to qualify as a personal residence of the term holder, the trust corpus must be distributed to the term holder or the trust must convert to a qualified annuity trust (GRANT). n138

The special valuation rules do not apply to a transfer in trust of tangible property that would not qualify for depreciation depletion deductions if used in a trade or business and whose value to the remainderman would not be enhanced if the term holder failed to exercise any rights under their term interest. n139 Improvements that do not increase the fair market value of the property by more than 5 percent are ignored for purposes of the nondepreciable requirement mentioned above. n140 The value of a term interest in property meeting these requirements is what an unrelated third party would pay for such interest in an arm's-length transaction. n141

[c] Buy-Sell Agreements and Other Rights and Restrictions

Buy-sell agreements are used by closely held businesses to achieve various business objectives, such as controlling the transfer of ownership interests in a business, or allowing a small group of shareholders or a partnership to be assured that no "new" or "outside" entity will enter or participate in the business. Perhaps more importantly, buy-sell agreements provide a means by which control of a family business can be retained within the family.

However, buy-sell agreements were also often used to freeze the value of a business interest for estate tax purposes. Accordingly, Congress enacted rules to prevent abuses in this area. n142 These rules provide that any option, agreement, right to acquire or use property at a price below fair market value, or a restriction on the right to sell or use property will be disregarded when valuing such property for estate, gift, or generation-skipping transfer tax purposes unless each of the following requirements is satisfied:

- (1) It is a bona fide business arrangement.
- (2) It is not a device to transfer property to the decedent's family for less than full and adequate consideration.
- (3) Its terms are comparable to similar arrangements entered into by parties in an arm's-length transaction.

The regulations provide a safe harbor pursuant to which any option, agreement, right, etc., is deemed to satisfy these requirements if more than 50 percent by value of the property subject to the right or restriction is owned by parties who are not the natural objects of each other's bounty. n143

[d] Lapsing Rights and Restrictions

Prior to the enactment of the Revenue Reconciliation Act of 1990, a parent could transfer an interest in a partnership or corporation to his or her child but retain certain lapsing voting and/or liquidation rights to decrease the value of the taxable gift. If the retained right lapsed prior to or upon the parent's death, any interest in the business that they owned at the date of death might have a reduced value for estate tax purposes, as this interest no longer had voting and/or liquidation rights attached to it.

To combat perceived abuses in the use of this technique, Congress enacted rules that provide that the lapse of a voting or liquidation right pertaining to a family "controlled" partnership or corporation constitutes a transfer subject to either the gift or estate tax provisions. n144 This provision applies if the deemed transferor and the transferor's "family" hold a "controlling" interest in the partnership or corporation immediately before and after the deemed transfer. n145

A "member of the family" includes the transferor's spouse, any ancestor or lineal descendant of the transferor or the transferor's spouse, any spouse of such ancestor or lineal descendant, any brother or sister of the transferor, and any spouse of such brother or sister. n146

"Control" is defined by cross reference to *IRC Section 2701(b)(2)* as the holding of at least 50 percent (by vote or value) of the stock of a corporation, at least 50 percent of the capital or profits interests in a partnership, or any interest as a general partner in a limited partnership. n147 An individual is considered to hold any interest held indirectly through a corporation, partnership, trust, or other entity. n148

The value of the deemed transfer is equivalent to the decrease in value of all the interests in the partnership or corporation held by the deemed transferor due to the lapse. n149

Furthermore, when an individual transfers an interest in a partnership or corporation to a member of the family, any "applicable restriction" that limits the ability of the entity to liquidate is ignored for estate and gift tax purposes if:

- (1) the transferor and members of the transferor's family hold control of the entity immediately before the transfer; and
- (2) the restriction lapses after the transfer; or
- (3) the transferor or any family member, either alone or collectively, has the power to remove such restriction after the transfer. n150

There is an exception provided for any commercially reasonable restrictions that arise as part of a financing agreement with an unrelated third party. n151 An "applicable restriction" is defined as any limitation on the ability to liquidate the entity that is more restrictive than restrictions under state law. n152 For example, if a partnership agreement requires the consent of all interests to liquidate, but under state law only 70 percent is required, the requirement that all interests must consent is an applicable restriction and will not be considered in valuing an interest. Also, an applicable restriction with respect to preferred stock, such as a right to liquidate the corporation at some later date, will be disregarded in determining the amount of a transfer of common stock under *IRC Section 2701*. n153

FOOTNOTES:

(n1)Footnote 32. *IRC § 2035*.

(n2)Footnote 32.1. See *IRC §§ 2001, 2010(c), 2210, 2505(a)(1)*; see Pub Law 107-16, § 901.

(n3)Footnote 32.2. *IRC § 1015(a)*.

(n4)Footnote 32.3-. [Reserved].

(n5)Footnote 32.4. See *IRC § 2503(b)*.

(n6)Footnote 32.5. *Estate of Kohlsaat v Commr, TC Memo 1997-212* ; see *Estate of Cristofani v Commr, 97 TC 74 (1991)* .

(n7)Footnote 32.6. *Id.*

(n8)Footnote 32.7. See *IRC §§ 1022, 2010(c), 2210.*

(n9)Footnote 33. *IRC § 2501.*

(n10)Footnote 34. *IRC § 2510.*

(n11)Footnote 35. *IRC §§ 1015(a); 1015(d).* However, if the carryover basis is greater than fair market value, then the transferee's basis for purposes of determining loss is limited to fair market value.

(n12)Footnote 36. *IRC § 1001(a).*

(n13)Footnote 37. *IRC § 1014(a).*

(n14)Footnote 38. *IRC § 2035(b), (c).*

(n15)Footnote 39. *IRC §§ 2033, 2036, 2037, 2041.*

(n16)Footnote 39.1. *IRC § 2036(a).*

(n17)Footnote 39.2. *Estate of Trotter v Commr, TC Memo 2001-250* (residence the decedent transferred to an irrevocable trust was includable her estate because her rent-free occupancy of the home until her death was a retained interest under *IRC § 2036*); *Reichardt v Commr, 114 TC 144 (2000)* (properties transferred to family limited partnership were included in decedent's estate); *Schauerhamer v Commr, TC Memo 1997-242*; *Estate of Stewart v Commr, TC Memo 2006-225* (interest in property transferred 6 months before death included in decedent's estate because decedent retained rents received from property after the transfer).

(n18)Footnote 39.3. See *IRC §§ 1015(d)(1), (6), 2001(c), 2501, 2502.*

(n19)Footnote 40. Compare *PW Carroll, TC Memo 1978-173* with *Unger v Campbell, 61-1 USTC P 9163 (ND Tex 1960).*

(n20)Footnote 41. *Treas Reg § 1.1031-1(c).*

(n21)Footnote 41.1. See *Estate of Cullison v Commr, TC Memo 1998-216 .*

(n22)Footnote 42. *IRC § 2036(a); Pittman v US, 878 F Supp 833 (EDNC 1995) .*

(n23)Footnote 43. *IRC § 2035* (inclusion in gross estate of property transferred within three years of death); *IRC § 2036* (inclusion in gross estate of property as to which decedent has made a transfer constituting in whole or in part a gift, and has retained various interests including an interest that does not in fact end before death).

(n24)Footnote 44. *IRC § 453.*

(n25)Footnote 45. *IRC § 453(e).*

(n26)Footnote 46. *IRC § 483.*

(n27)Footnote 47. *IRC § 163(d).*

(n28)Footnote 48. *IRC § 453A(c).*

(n29)Footnote 49. *IRC § 453(e).*

(n30)Footnote 50. *IRC § 2031(a)*.

(n31)Footnote 51. *74 TC 1239*, *acq in result 1981-1 CB 2*. See Note: *Are Self-Canceling Installment Notes Finished as a Tool for Estate Planning? Estate of France v. Commissioner*, 46 Tax Law 595 (1993).

(n32)Footnote 52. *1986-1 CB 243*.

(n33)Footnote 53. May 7, 1986.

(n34)Footnote 54. *IRC §§ 453B(f); 691(a)*.

(n35)Footnote 55. *998 F2d 567 (8th Cir 1993)*.

(n36)Footnote 56. *Treas Reg § 25.2512-5*.

(n37)Footnote 56.1. See *Estate of Costanza v Commr*, *TC Memo 2001-128*, *revd and remanded 320 F3d 599 (6th Cir 2003)*.

(n38)Footnote 57. See *IRC § 2036*.

(n39)Footnote 58. *Estate of Maxwell v Commr*, *3 F3d 591 (2d Cir 1995)*, *affg 98 TC 598 (1992)*.

(n40)Footnote 59. *Id.*

(n41)Footnote 60. See *IRC § 2702(a)(3); Treas Reg § 25.2702-5(c)*; see § 18.04[1] for a discussion.

(n42)Footnote 61. *63 TC 321 (1974)*, *acq and non acq 1977-2 CB 1, 2*.

(n43)Footnote 62. *Rev Rul 77-299, 1977-2 CB 343*.

(n44)Footnote 62.1. *IRC § 2503(b)*; the \$10,000 statutory exclusion amount is subject to inflation adjustments after 1998; under the inflation adjustments, the annual gift tax exclusion for 2002, 2003, 2004 and 2005 is \$11,000 (*Rev Proc 2001-59*, § 3.19, *2001-2 CB 632*; *Rev Proc 2002-70*, § 3.24, *2002-2 CB 845*; *Rev Proc 2003-85*, § 3.26, *2003-2 CB 1184*; *Rev Proc 2004-71*, § 3.28, *2004-2 CB 970*). For 2006 (*Rev Proc 2005-70, 2005-2 CB 979*) and 2007 (*Rev Proc 2006-53, 2006-2 CB 996*), and 2008 (*Rev Proc 2007-66, 2007-45 IRB 970*), the amount is \$12,000. For 2009 and 2010, the amount is \$13,000 (*Rev Proc 2008-66*, § 3.30, *2008-45 IRB 1107*); *Rev Proc 2009-50, 2009-45 IRB 617*.

(n45)Footnote 63. *IRC § 721*.

(n46)Footnote 64. *Estate of Jones v Commr*, *116 TC 121 (2001)* (discounts given on transfers of interests in family real estate partnerships); *Rev Rul 93-12, 1993-1 CB 202* (dealing with minority discount with respect to a minority interest in stock of a closely held corporation).

(n47)Footnote 64.1. *IRC §§ 2001(c)(2), 2010(c), 2505(a)*.

(n48)Footnote 65. *Rev Proc 2008-3*, § 3.01(53), *2008-1 IRB 110*.

(n49)Footnote 65.1. *Reichardt v Commr*, *114 TC 144 (2000)* (properties transferred to family limited partnership were included in decedent's estate); *Schauerhamer v Commr*, *TC Memo 1997-242*.

(n50)Footnote 65.2. *Estate of Hillgren, et al v Commr*, *TC Memo 2004-46*.

(n51)Footnote 66. *IRC § 2036(a)*.

(n52)Footnote 67. *Treas Reg* § 25.2512-5.

(n53)Footnote 68. Whether an individual is a "related person" is determined by *IRC* § 267(b) or (e).

(n54)Footnote 69. *IRC* § 267(b)(1) and (c)(4).

(n55)Footnote 70. See *IRC* § 2036(a).

(n56)Footnote 70.1. See *IRC* §§ 2701-2704.

(n57)Footnote 71. See *Estate of Maxwell v Commr*, 3 F3d 591 (2nd Cir 1995) , affg 98 TC 598 (1992) .

(n58)Footnote 72. *Wheeler v US*, 116 F3d 749 (5th Cir 1997) (remainder interest sold for its actuarial value under treasury regulations).

(n59)Footnote 73. *Treas Reg* §§ 25.2512-5; 20.7520-1; *IRC* § 2031.

(n60)Footnote 74. *Treas Reg* § 1.1014-5(a)(3).

(n61)Footnote 74.1. *IRC* § 167(e)(1).

(n62)Footnote 74.2. *IRC* § 167(e)(3).

(n63)Footnote 74.3. See *IRC* §§ 167(e), 1001, 2036.

(n64)Footnote 75. *IRC* § 2503(b).

(n65)Footnote 76. *IRC* § 2031(a).

(n66)Footnote 77. *Rev Rul* 69-74, 1969-1 CB 43 .

(n67)Footnote 77.1. See *Lloyd v Commr*, 33 BTA 903 (1936) , *nonacq* XV-2 CB 39 (1936), *nonacq withdrawn and acq* 1950-2 CB 3 (private annuity contract for sale of property had no fair market value because of the uncertainty of payment; therefore any gain would be recognized only when annuity payments exceeded annuitant's basis in the property).

(n68)Footnote 77.2. See *Burnet v Logan*, 283 US 404 (1931) .

(n69)Footnote 77.3. *Estate of Bell v Commr*, 60 TC 469 (1973) , *acq in part and nonacq in part* 1974 AOD LEXIS 303 (Jan 8, 1974) , *acq* AOD No 1979-184 (Aug 15, 1979).

(n70)Footnote 77.4. *212 Corp v Commr*, 70 TC 788 (1978) .

(n71)Footnote 77.5. *Prop Treas Reg* §§ 1.72-6(e)(1), 1.1001-1(j)(1).

(n72)Footnote 77.6. See *Treas Reg* § 1.1011-2. Gain from a bargain sale to a charitable organization (including an exchange of property for a charitable gift annuity) is reported ratably, rather than entirely in the year of the exchange [*Treas Reg* § 1.1011-2(c), Ex 8].

(n73)Footnote 77.7. See *Lloyd v Commr*, 33 BTA 903 (1936) , *nonacq* XV-2 CB 39 (1936), *nonacq withdrawn and acq* 1950-2 CB 3.

(n74)Footnote 77.8. See *Rev Rul* 69-74, 1969-1 CB 43 .

(n75)Footnote 77.9. See *IRC § 7520* (requiring the use of tables to value any annuity contract for federal income tax purposes, except for purposes of any provision specified in regulations); see also *Treas Reg § 1.1001-1(a)*.

(n76)Footnote 77.10. *Prop Treas Reg §§ 1.72-6(e)(1), 1.1001-1(j)(1)*.

(n77)Footnote 77.11. See *IRC § 72(c)(1)*.

(n78)Footnote 77.12. *Treas Reg § 1.1001-1(e)*.

(n79)Footnote 77.13. See *IRC § 72(c)(1)*.

(n80)Footnote 77.14. *Prop Treas Reg § 1.72-1(e)(1)*.

(n81)Footnote 77.15. *Prop Treas Reg § 1.1001-1(j)(2)(i)*.

(n82)Footnote 77.16. *Prop Treas Reg § 1.72-6(e)(2)(i)*.

(n83)Footnote 77.17. *Prop Treas Reg §§ 1.72-6(e)(2)(ii), 1.1001-1(j)(2)(ii)*.

(n84)Footnote 77.18. *Prop Treas Reg §§ 1.1001-1(j), 1.72-6(e)*.

(n85)Footnote 77.19. See *IRC § 453*.

(n86)Footnote 78. See *Prop Treas Reg §§ 1.1001-1(j), 1.72-6(e)*.

(n87)Footnote 78.1. *Prop Treas Reg §§ 1.72-6(e)(1), 1.1001-1(j)(1)*.

(n88)Footnote 79. *Bell v Commr, 76 TC 232 (1981)*, *aff'd per curiam 668 F2d 448 (8th Cir 1982)*.

(n89)Footnote 80. *IRC § 752(b)*.

(n90)Footnote 81. *IRC § 731(a)*.

(n91)Footnote 82. *IRC § 2702(c)(2)*, treating certain joint purchases as an acquisition by one family member and then a transfer to other family members subject to the rules of *IRC §§ 2701-2704*. See § 18.02[8], below, for a discussion.

(n92)Footnote 83. *IRC §§ 170, 2522*.

(n93)Footnote 84. See Arthur Andersen & Co, *Tax Economics of Charitable Giving*, for a detailed analysis of this topic.

(n94)Footnote 85. Pub L No 100-203, 100th Cong, 1st Sess (1987).

(n95)Footnote 86. The Revenue Reconciliation Act of 1990, Pub L No 101-508, 101st Cong, 2d Sess (1990).

(n96)Footnote 87. *IRC §§ 2701 through 2704*.

(n97)Footnote 88. *IRC § 2701*; see § 18.02[8][a], below, for a discussion.

(n98)Footnote 89. *IRC § 2702*; see § 18.02[8][b], below, for a discussion.

(n99)Footnote 90. *IRC § 2701(a)(3)(A)*; *Treas Reg § 25.2701-1(a)(2)*.

(n100)Footnote 91. *IRC § 2701(e)(5)*; *Treas Reg § 25.2701-1(b)(2)*.

(n101)Footnote 92. *Treas Reg* § 25.2701-1(b).

(n102)Footnote 93. *Treas Reg* §§ 25.2701-1(b)(2)(i)(C); -6.

(n103)Footnote 94. *Id.*

(n104)Footnote 95. *IRC* § 2701(a)(2); *Treas Reg* § 25.2701-1(c).

(n105)Footnote 96. *Id.*

(n106)Footnote 97. *Treas Reg* § 25.2701-1(c)(4).

(n107)Footnote 98. *IRC* § 2701(e)(5); *Treas Reg* § 25.2701-1(b)(3). See *IRC* § 2701(e)(1), (2).

(n108)Footnote 99. *Treas Reg* § 25.2701-1(b)(3).

(n109)Footnote 100. *IRC* §§ 2701(e)(1), (2); *Treas Reg* § 25.2701-1(d).

(n110)Footnote 101. *IRC* § 2701(e)(3).

(n111)Footnote 102. *IRC* § 2701(b)(1)(A); *Treas Reg* § 25.2701-2(b).

(n112)Footnote 103. *IRC* § 2701(c)(1)(A).

(n113)Footnote 104. *IRC* § 2701(c)(1)(B); *Treas Reg* § 25.2701-2(b)(4).

(n114)Footnote 105. *IRC* § 2701(b)(2); *Treas Reg* § 25.2701-2(b)(5).

(n115)Footnote 106. *IRC* § 2701(b)(2)(C).

(n116)Footnote 107. See *IRC* § 2701(e)(2).

(n117)Footnote 108. *IRC* § 2701(b)(1), (2)(C).

(n118)Footnote 109. *IRC* §§ 2701(b)(1)(B), (c)(2)(A); *Treas Reg* §§ 25.2701-2(b)(1), (2).

(n119)Footnote 110. *IRC* § 2701(c)(2)(B); *Treas Reg* § 25.2701-2(b)(4)(i).

(n120)Footnote 111. *IRC* § 2701(c)(2)(C); *Treas Reg* § 25.2701-2(b)(4)(iv).

(n121)Footnote 112. *IRC* § 2701(a)(3)(A); *Treas Reg* § 25.2701-2(b)(6).

(n122)Footnote 113. *IRC* § 2701(c)(3)(A); *Treas Reg* § 25.2701-2(c).

(n123)Footnote 114. *IRC* § 2701(c)(3)(B).

(n124)Footnote 115. *IRC* § 2701(c)(3)(C)(i).

(n125)Footnote 116. *IRC* § 2701(c)(3)(C)(ii).

(n126)Footnote 117. *IRC* § 2701(c)(3)(C)(iii).

(n127)Footnote 118. *IRC* § 2701(d); *Treas Reg* § 25.2701-4.

(n128)Footnote 119. *IRC* § 2701(a)(3)(B).

(n129)Footnote 120. *IRC § 2701(a)(3)(C).*

(n130)Footnote 121. *IRC § 2701(a)(4)(A).*

(n131)Footnote 122. *IRC § 2701(a)(4)(B)(i); Treas Reg § 25.2701-3(c).*

(n132)Footnote 123. *Treas Reg § 25.2701-3(c)(3).*

(n133)Footnote 124. *Treas Reg § 25.2702-1(b).*

(n134)Footnote 125. *Id.*

(n135)Footnote 126. *IRC § 2702(a)(2).* The rules of *IRC § 2702* also do not apply to transfers in trust to charitable remainder trusts or charitable lead trusts that qualify for a deduction under *IRC § 2522*, transfers in trust pursuant to a property settlement described in *IRC § 2516*, and transfers or assignments to a qualified domestic trust under the circumstances described in *Treas Reg § 20.2056A-4(b).*

(n136)Footnote 127. *IRC § 2702(b).*

(n137)Footnote 128. *IRC §§ 2702(e), 2704(c)(2).*

(n138)Footnote 129. *IRC §§ 2702(a)(1), 2701(e)(2).*

(n139)Footnote 130. *IRC § 2702(c)(1).*

(n140)Footnote 131. *IRC § 2702(c)(2).*

(n141)Footnote 132. *IRC § 2702(a)(3)(A).*

(n142)Footnote 133. *IRC § 2702(a)(3)(A)(ii); Treas Reg § 25.2702-5.*

(n143)Footnote 133.1. See *IRC § 2702(a)(3)(A)(ii).*

(n144)Footnote 134. *Treas Reg § 25.2702-5(c)(1).*

(n145)Footnote 135. *Treas Reg § 25.2702-5(a)(1), (b).*

(n146)Footnote 136. *Treas Reg § 25.2702-5(c)(5)(ii).*

(n147)Footnote 137. *Treas Reg §§ 25.2702-5(c)(7)(ii); -5(c)(7)(iii).*

(n148)Footnote 138. *Treas Reg § 25.2702-5(c)(8);* see *Ltr Rul 200220014* (IRS ruled that a qualified personal residence trust contained necessary provisions with respect to qualified annuity interest, and that payments of the computed annuity amount were a qualified annuity interest and would not result in additional gift tax).

(n149)Footnote 139. *Treas Reg §§ 25.2702-2(c)(1), (2).*

(n150)Footnote 140. *Treas Reg § 25.2702-2(c)(2)(ii).*

(n151)Footnote 141. *Treas Reg § 25.2701-2(c)(1).*

(n152)Footnote 142. *Treas Reg § 83-6(b).*

(n153)Footnote 143. *Treas Reg § 25.2703-1(b)(3).*

(n154)Footnote 144. *IRC § 2704(a)(1); Treas Reg § 25.2704-1.*

(n155)Footnote 145. *IRC § 2704(a)(1)(B).*

(n156)Footnote 146. *IRC § 2704(c)(2).*

(n157)Footnote 147. *IRC §§ 2704(c)(1), 2701(b)(2).*

(n158)Footnote 148. *IRC §§ 2704(c)(3), 2701(e)(3).*

(n159)Footnote 149. *IRC § 2704(a)(2).*

(n160)Footnote 150. *IRC §§ 2704(b)(1), (2).*

(n161)Footnote 151. *IRC § 2704(b)(3).*

(n162)Footnote 152. *Treas Reg § 25.2704-2(b).*

(n163)Footnote 153. *Treas Reg § 25.2704-2(c).*

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Federal Taxes Affecting Real Estate

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CHAPTER 18 Estate Planning for Real Estate *

2-18 Federal Taxes Affecting Real Estate § 18.03

§ 18.03 Valuation of Real Estate for Estate Tax Purposes

[1] In General

The estate tax is levied on the decedent's "gross estate" using the "value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." n154 Thus, it is crucial to properly determine the value of the property. The general rule is that real property is valued at its highest and best use as of the date of death. Alternatively, at the election of the executor, the highest and best use can be determined at a time six months following the date of death n155-167 (see § 18.05[3][c], below). There are also other methods of valuation whereby the estate can actually value certain specific types of property at less than its full or best use value. This section will briefly examine the special-use valuation methods that can be used to reduce the estate's value and the related estate tax. Valuation of real property in general, as well as minority interest discounts, market absorption discounts, and other discounts that may come into play for valuing real property in an estate, are discussed in detail in Chapter 20, "Valuation of Real Property."

[2] Special-Use Valuation for Family Farms and Closely Held Businesses

IRC Section 2032A provides an election that may be used to value farms and real estate used in closely held businesses at their current operating values, rather than their "highest and best use" value. Thus, the estate can include the value of these properties as used in the family business, rather than their highest and best use. For example, real property may be worth only \$400,000 if used in the family bakery business, but \$1 million if converted to a condominium development. This provision is designed to prevent forcing families to sell their closely held businesses and farms to pay the associated estate taxes. The special-use valuation can reduce the estate tax value of the property by a maximum of \$750,000, n168 subject to an inflation adjustment for decedents dying after 1998. n169 For decedents dying in 1999, the figure is \$760,000. n169.1 For decedents dying in 2000, the figure is \$770,000. n169.2 For decedents dying in 2001, the figure is \$800,000. n169.3 For decedents dying in 2002, the figure is \$820,000. n169.4 For decedents dying in 2003, the figure is \$840,000. n169.5 For decedents dying in 2004, the figure is \$850,000. n169.6 For decedents dying in 2005, the figure is \$870,000. n169.7 For decedents dying in 2006, the figure is \$900,000. n169.8 For decedents dying in 2007, the figure is \$940,000. n169.9 For decedents dying in 2008, the amount is \$960,000. n169.9.1 For decedents dying in 2009 and 2010, the amount is \$1 million. n169.10

This special-use valuation provision contains certain limitations. First, the special rule applies only to estates of decedents who were, at the time of their death, citizens or residents of the United States. Second, the qualified real property must be used by the decedent or by a member of his family on the date of the decedent's death. If ownership is

in partnership form, 20 percent or more of the partnership's capital interest must be included in the decedent's gross estate or the partnership must have fewer than 15 partners. n170 Third, the property must have been used by the decedent or his family for at least five of the last eight years ending on the date of the decedent's death. n171 This usage must constitute "material participation." Fourth, the value of the business or farm must be worth 50 percent or more of the entire value of the estate, and the business real property must be worth at least 25 percent of the value of the entire estate. n172 Finally, the business or farm must pass to a "qualified heir," that is, another member of the family. n173 If these requirements are all met, the estate may elect to have the property valued so that it reflects the value as it is *used* in the family business. n173.1 Farms may be valued under a formula method or a five-factor valuation method. n173.2 Closely-held businesses and farms for which the formula method is not used must be valued using the five-factor valuation method. n173.3

As with almost all tax-savings devices, however, there are certain disadvantages associated with this election. The basis step-up is limited to the special-use value of the property reflected in the decedent's estate tax return. This is particularly detrimental if there would be no actual estate tax liability because of the use of the unified credit or the unlimited marital deduction. In an estate with little or no estate tax, it is better to include the property at its best-use value to get the full step-up in basis. Then, if the property is sold, the gain on the property would be substantially lower. n174 Furthermore, requirements for making the election are extremely technical and complex, and although statutory procedures for correcting defective special use valuation elections have been liberalized, n175 the IRS has generally taken a restrictive view, disallowing elections with even minor defects. n175.1 The IRS has granted extensions of time for making a special use valuation election, however. n175.2

Another drawback to using special-use valuation is the potential for recapture of the avoided estate tax if the property is sold. If the property is sold or otherwise disposed of (or if a qualified heir ceases to materially participate in its operation) at any time within 10 years from the date of death, there is a recapture of the estate tax savings. n176 Therefore, if a sale is likely to occur subsequent to death, or if no family members are willing to materially participate in the operation of the farm or business for the 10-year period, it may not be wise to elect Section 2032A.

Finally, it should be noted that a special estate tax lien comes into play for additional estate tax attributable to special use valuation. n176.1 The special lien applies for the pending additional estate tax attributable to the estate's election to use a "special use value" for certain qualified property for estate tax purposes. The lien attaches to certain farm real property and real property used in family businesses. The amount of the lien is generally equal to the difference between the estate tax calculated using the fair market value of the property and the estate tax calculated using the special use value of the property. n176.2 The special lien continues with respect to any interest in qualified real property until: n176.3

- the liability for tax under *IRC Section 2032A(c)* with respect to that interest has been satisfied;
- the liability for tax has become unenforceable by reason of lapse of time; or
- it is established that no further tax liability may arise under *IRC Section 2032A(c)* with respect to that interest.

Under *IRC Section 2032A(c)*, the liability for a recapture tax arises if the qualified heir disposes of any interest in the property or fails to use the property for a qualified purpose within 10 years from the decedent's date of death. n176.4 The recapture period also ceases if the qualified heir dies, and thus, can be less than 10 years. n176.5

Note:

Not every disposition related to specially valued property will trigger the recapture tax. For example, the development of subsurface oil and gas interests in farm property that is subject to a special use valuation election does not trigger the recapture tax because oil and gas interests are not includible as part of the

farmland that may be specially valued under *IRC § 2032A*. To the extent, however, that the specially valued farmland is subsequently used for well drilling and extraction, there is a cessation of use of specially valued farmland for purposes of the recapture provision in *IRC § 2032A(c)(1)(B)*. n176.6 Similarly, a conveyance of water rights and the granting of an easement on property that is specially valued to develop and remove the groundwater will not constitute a disposition or cessation of qualified use under *IRC § 2032A(c)(1)*, where the groundwater rights were not part of the property that was specially valued. Only to the extent the property is specifically used for removing the groundwater will there be a disposition or cessation of use of the properties that triggers the recapture tax. This result ensues because property specifically used for removing the groundwater cannot be used for the *IRC § 2032A* qualified purpose. n176.7

The IRS has ruled that the lien need not automatically be released after 10 years following the decedent's death. Rather, the 10-year period merely provides a measure of time during which the event triggering the recapture tax had to occur. n176.8

The IRS ruled that the "liability" for the tax may continue beyond that period. n176.9 The IRS noted that the due date for the recapture tax is 6 months after the triggering recapture event, n176.10 and that the statute of limitations for assessment of the recapture tax is generally three years from the date the IRS is notified of the disposition/cessation. n176.11

Thus, while the event that triggers the liability for the recapture tax must occur within 10 years of the decedent's death, collection of that liability may clearly continue beyond that 10-year period. The IRS has ruled that when this circumstance occurs the *IRC Section 6324B* special lien should not be released, as the recapture liability is still enforceable. n176.12

[3] Estate Tax Deduction for Family-Owned Business

[a] In General

Effective for estates of decedents dying after 1997 and before 2004, n176.13 an estate may deduct the adjusted value of the qualified family-owned business interests of the decedent for estate tax purposes if those interests comprise more than 50 percent of the decedent's estate and certain other requirements are met. n177 The maximum deduction that may be taken is \$675,000. n178 Taking the deduction will significantly reduce the decedent's gross estate, and, hence, her estate taxes. If the deduction is taken, however, the exclusion amount with respect to the unified credit is \$625,000, subject to an increase if the deduction taken is less than \$675,000. n179

Note:

The deduction is available only for estate tax purposes. It is not available under the generation-skipping transfer tax. n180

A "qualified family-owned business" is any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States, if ownership is held at least 50 percent by the decedent and members of the decedent's family, 70 percent by two families, or 90 percent by three families. The decedent's family must also own at least 30 percent of the trade or business. n181 For this purpose, a decedent is treated as engaged in a trade or business if any member of the decedent's family is engaged in that trade or business. n182

Specific rules apply for determining the percentage ownership of corporations, partnerships and tiered entities. n183 An interest in a trade or business does not qualify if the business's stock or securities were readily tradable on an established securities market or secondary market within three years of the decedent's death. n184 An interest in a trade or business

also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death would qualify as personal holding company income if the business were a corporation. n185

The value of the qualifying trade or business does not include any passive assets (i.e., those producing certain dividends, rents, royalties, interest and similar income), or cash or marketable securities in excess of the working capital needs of the company. n186 Conference reports indicate that working capital needs are to be determined on a historical average, using an analysis set forth in the *Bardahl* case. n187 Certain property that was leased by the decedent on a net cash basis to a member of the decedent's family may be included as part of a qualified family-owned business interest. n188

[b] Qualifying Estates

The family-owned business estate tax deduction is available only if the decedent was a United States citizen or resident at the time of death and the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50 percent of the decedent's adjusted gross estate (the "50 percent liquidity test"). n189 The 50-percent liquidity test is applied by adding all transfers of qualified family-owned business interests made by the decedent to qualified heirs at the time of the decedent's death, plus certain lifetime gifts of qualified family-owned business interests made to members of the decedent's family, and comparing this total to the decedent's adjusted gross estate. n190 To the extent that a decedent held qualified family-owned business interests in more than one trade or business, all those interests are aggregated for purposes of applying the 50-percent liquidity test. n191 The deduction is available only for the estates of decedents dying before January 1, 2004. n191.1

[c] Participation Requirements

To be eligible for the deduction, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's death. n192 In addition, each qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least five years of any eight-year period within 10 years following the decedent's death. n193

[d] Recapture Provisions

The benefit of the deduction is subject to recapture through the imposition of an additional estate tax if, within 10 years of the decedent's death and before the qualified heir's death, one of the following recapture events occurs: n194

- the qualified heir ceases to meet the material participation requirements;
- the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a conservation contribution;
- the principal place of business of the trade or business ceases to be located in the United States; or
- the qualified heir loses United States citizenship (unless the business assets are placed in a qualifying trust or other security arrangement).

[e] Manner of Making Election

The election to use *IRC Section 2057* is made by the executor on the decedent's estate tax return. n195 In addition to making the election, the executor must file a written recapture agreement signed by each person who has an interest in any property designated in the agreement. In the agreement, each person must consent to the application of additional estate tax if a recapture event occurs. n196 The IRS may grant an extension of time for making an election. n196.1 The IRS may also allow a taxpayer to correct simple errors and imperfect elections under *IRC Section 2057*, as where all required information or signatures are not included. n196.2

[4] Estate Tax Exclusion for Land Subject to Qualified Conservation Easement

An executor of an estate may elect to exclude from the taxable estate of a decedent 40 percent of the value of any land subject to a qualified conservation easement that meets the statutory requirements. n197 The conservation easement may be claimed with respect to any land that is located in the United States or its possessions. n197.1 The election must be made on or before the due date (including extensions) for filing the estate tax return. The election is made on the return. n198 The election is also available with respect to interests in a partnership, corporation or trust if at least 30 percent of the entity is owned (directly or indirectly) by the decedent. n199

The maximum exclusion for land subject to a qualified conservation easement is limited to \$100,000 in 1998, \$200,000 in 1999, \$300,000 in 2000, \$400,000 in 2001, and \$500,000 in 2002 and thereafter. n200 If the value of the conservation easement is less than 30 percent of the value of the land without the easement (reduced by the value of any retained development rights), n201 then the 40 percent exclusion percentage is reduced. The reduction in the exclusion percentage is equal to two percentage points for each point that the value of the conservation easement is less than 30 percent of the land's value. Thus, if the value of an easement is 25 percent of the value of the land before the easement less the value of the retained development rights, the exclusion percentage is 30 percent (40 percent less twice the difference between 30 percent and 25 percent). Under this calculation, if the value of the easement is 10 percent or less of the value of the land before the easement less the value of the retained development rights, the exclusion percentage is equal to zero. n202 The date for determining easement compliance is the date on which the donation was made. n202.1

The amount of the exclusion is reduced by the amount of any charitable contribution deduction taken with respect to the land. n203 Debt-financed property is eligible for the exclusion only to the extent of the net equity in the property. For example, if a \$1 million property is subject to an outstanding debt balance of \$100,000, it is treated in the same manner as a \$900,000 property that is not debt-financed. n204

A qualified conservation easement for purposes of the estate tax exclusion generally has the same meaning as for income tax charitable contribution deductions, except that preservation of a historically important land area or a certified historic structure does not qualify as a conservation easement for estate tax purposes. In addition, a *de minimis* commercial recreational activity that is consistent with the conservation purposes, such as the granting of hunting and fishing licenses, will not cause the property to fail to qualify for the estate tax exclusion. n205

It should be noted that the granting of a qualified conservation easement is not treated as a disposition that triggers the recapture provisions under *IRC Section 2032A*. n206 In addition, the existence of a qualified conservation easement does not prevent the property from later qualifying for special-use valuation treatment under *IRC Section 2032A*.

Special rules apply for qualified conservation easements that are granted after the decedent's death. For those post-mortem easements, the estate is allowed a charitable contribution deduction for estate tax purposes with respect to the easement, but only if no charitable deduction is claimed for income tax purposes by the estate or any other person with respect to the easement. n207

A charitable deduction is permitted (for income tax or estate tax purposes) to taxpayers making a contribution of a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible, but so remote as to be negligible. The deduction may be taken regardless of when the mineral interests were separated. n208-210

FOOTNOTES:

(n1)Footnote 154. *IRC § 2031(a)*.

(n2)Footnote 155-167. *IRC § 2032*.

- (n3)Footnote 168. *IRC § 2032A(a)(2)*.
- (n4)Footnote 169. *IRC § 2032A(a)(3)*.
- (n5)Footnote 169.1. *Rev Proc 98-61* , § 3.15, 1998-2 *CB 811* .
- (n6)Footnote 169.2. *Rev Proc 99-42* , § 3.16, 1999-46 *IRB 568* .
- (n7)Footnote 169.3. *Rev Proc 2001-13* , § 3.16, 2001-3 *IRB 337* .
- (n8)Footnote 169.4. *Rev Proc 2001-59* , § 3.18, 2001-52 *IRB 623* .
- (n9)Footnote 169.5. *Rev Proc 2002-70* , § 3.23, 2002-46 *IRB 845* .
- (n10)Footnote 169.6. *Rev Proc 2003-85*, 2003-2 *CB 1184* .
- (n11)Footnote 169.7. *Rev Proc 2004-71*, 2004-2 *CB 974* .
- (n12)Footnote 169.8. *Rev Proc 2005-70*, 2005-2 *CB 979* .
- (n13)Footnote 169.9. *Rev Proc 2006-53*, 2006-2 *CB 996* .
- (n14)Footnote 169.9.1. *Rev Proc 2007-66*, 2007-45 *IRB 970* .
- (n15)Footnote 169.10. *Rev Proc 2008-66* , § 3.29, 2008-45 *IRB 1107* ; *Rev Proc 2009-50* , § 3.29, 2009-45 *IRB 617*.
- (n16)Footnote 170. *Treas Reg § 20.2032A-3(b)(1)*.
- (n17)Footnote 171. *IRC § 2032A(b)(1)*.
- (n18)Footnote 172. *Id.*
- (n19)Footnote 173. *Id*; *IRC § 2032A(e)(1)*.
- (n20)Footnote 173.1. *IRC § 2032A(a)(1)*.
- (n21)Footnote 173.2. *IRC § 2032A(e)(7), (8)*; see *Estate of Rogers v Commr, TC Memo 2000-133* .
- (n22)Footnote 173.3. *Treas Reg §§ 1.856*.
- (n23)Footnote 174. See *IRC § 1014(a)*.
- (n24)Footnote 175. See *IRC § 2032A(d)(3)*.
- (n25)Footnote 175.1. See *Est of Thompson et al v Commr, TC Memo 1998-325* .
- (n26)Footnote 175.2. *Ltr Ruls 200602007, 199911030* ; see *Treas Reg §§ 301.9100-1, 301.9100-3*.
- (n27)Footnote 176. *IRC § 2032A(c)*; *Estate of Gibbs v US, 161 F3d 242 (3d Cir 1998)* .
- (n28)Footnote 176.1. See *IRC § 6324B*.
- (n29)Footnote 176.2. See *IRC § 6324B(c)(2)*.

- (n30)Footnote 176.3. *IRC § 6324B(b)*.
- (n31)Footnote 176.4. *IRC § 2032A(c)(1)*.
- (n32)Footnote 176.5. *IRC § 2032A(c)(1)*.
- (n33)Footnote 176.6. *Rev Rul 88-78, 1988-2 CB 330* .
- (n34)Footnote 176.7. *Ltr Rul 200608012* .
- (n35)Footnote 176.8. *Ltr Rul 200127046*.
- (n36)Footnote 176.9. See *IRC § 2032A(c)(4), (f)*.
- (n37)Footnote 176.10. *IRC § 2032A(c)(4)*.
- (n38)Footnote 176.11. *IRC § 2032A(f)*.
- (n39)Footnote 176.12. *Ltr Rul 200127046*.
- (n40)Footnote 176.13. *IRC § 2057(j)*.
- (n41)Footnote 177. *IRC § 2057(a)(1), (b)*.
- (n42)Footnote 178. *IRC § 2057(a)(2)*.
- (n43)Footnote 179. *IRC § 2057(a)(3); see IRC § 2010*.
- (n44)Footnote 180. See *IRC § 2057(a)*.
- (n45)Footnote 181. *IRC § 2057(e)(1)*.
- (n46)Footnote 182. *IRC § 2057(e)(1)*.
- (n47)Footnote 183. *IRC § 2057(e)(3)*.
- (n48)Footnote 184. *IRC § 2057(e)(2)(B)*.
- (n49)Footnote 185. *IRC § 2057(e)(2)(C); see IRC § 543(a)*.
- (n50)Footnote 186. *IRC § 2057(e)(2)(D)*.
- (n51)Footnote 187. See *Bardahl Mfg Corp v Commr, 24 TCM 1030, TC Memo 1965-200 (1965)* .
- (n52)Footnote 188. *IRC § 2057(e)(2)*.
- (n53)Footnote 189. *IRC § 2057(b)*.
- (n54)Footnote 190. *IRC § 2057(b), (c), (d)*.
- (n55)Footnote 191. *IRC § 2057(b), (c), (d)*.
- (n56)Footnote 191.1. *IRC § 2057(j)*.
- (n57)Footnote 192. *IRC § 2057(b)(1)(D)*.

(n58)Footnote 193. *IRC § 2057(f)(1)(A)*; see *IRC § 2032A(c)(6)(B)*.

(n59)Footnote 194. *IRC § 2057(f), (g)*.

(n60)Footnote 195. See *IRC § 2057(b)(1)(B)*.

(n61)Footnote 196. *IRC § 2057(b)(1)(B), (h)*.

(n62)Footnote 196.1. See Ltr Ruls 200602007, 200143014 .

(n63)Footnote 196.2. *IRC §§ 2057(i)(3)(H), 2032A(d)(1),(3)*; Chief Counsel Memo 200234055.

(n64)Footnote 197. *IRC § 2031(c)(2), (6)*, effective for decedents dying after 1997.

(n65)Footnote 197.1. *IRC § 2031(c)(8)(A)(i)*, eff for decedents dying after 12/31/00; prior to this, easements could be claimed only on land located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture).

(n66)Footnote 198. *IRC § 2001(c)(6)*.

(n67)Footnote 199. *IRC § 2031(c)(10)*.

(n68)Footnote 200. *IRC § 2031(c)(3)*.

(n69)Footnote 201. See Treas Reg §§ 1.1275.

(n70)Footnote 202. *IRC § 2031(c)(2)*.

(n71)Footnote 202.1. *IRC § 2031(c)(2)*,

(n72)Footnote 203. *IRC § 2031(c)(1)(A)*; see *IRC § 2055(f)*.

(n73)Footnote 204. *IRC § 2031(c)(4)*.

(n74)Footnote 205. *IRC §§ 170(h), 2031(c)(8)(B)*.

(n75)Footnote 206. *IRC § 2032A(c)(8)*.

(n76)Footnote 207. *IRC § 2031(c)(9)*.

(n77)Footnote 208-210. See *IRC §§ 170(h)(5)(B)(ii), 2055*, effective for easements granted after 1997.

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Federal Taxes Affecting Real Estate

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CHAPTER 18 Estate Planning for Real Estate *

2-18 Federal Taxes Affecting Real Estate § 18.04

§ 18.04 Estate Planning for Specific Types of Real Property

[1] The Family Home

[a] In General

In some ways, the family home is no different from any other type of real property; in other ways, substantial nontax and non-economic factors make decisions with respect to the family home singularly difficult and completely different than decisions with respect to any other type of real property. For example, a number of the estate planning techniques discussed in this chapter involve selling the property. Individuals, however, may be more than just a little hesitant to part with the family home, especially if they have lived there for most of their lives.

[b] Qualified Personal Residence Trust

The most efficient way to accomplish a transfer of the family home while retaining use is to transfer a home to a qualified personal residence trust. n211 As noted above, n212 under *IRC Section 2702*, special valuation rules apply in the case of transfers of property in trust for the benefit of family members. The general rule is that any interest retained by the transferor is valued at zero. n213 This rule has the effect of causing gift tax to be imposed on the full market value of the property at the time of the transfer. The zero valuation of the retained interest, however, does not apply if the transfer involves the transfer of an interest in trust, all the property in which is a residence to be used as a personal residence by persons holding term interests in the trust. n214 By falling within this personal residence trust exception, the remainder interest of the transferor remaining after the trust term can be valued under actuarial tables under *IRC Section 7520*. This has the effect of reducing the value of the gift on which gift tax is imposed.

The IRS has provided in a revenue procedure a sample declaration of trust for a qualified personal residence trust with one transferor for a term equal to the lesser of the life of the term holder or a term of years. The procedure also provides additional guidance in the form of annotations to the provisions of the sample trust, alternative provisions concerning additions to the trust to purchase a personal residence, and disposition of trust assets on cessation of its qualification as a qualified personal residence trust. n214.1

The IRS also has issued a substantial number of letter rulings, each with different trust terms, under which personal residences, vacation homes, and even interests in cooperative apartments can be transferred to a qualified personal residence trust. The issue is almost always whether the property transferred qualifies as a personal residence. n215

Community interests in residences may also be transferred to a qualified personal residence trust. n215.1 The main risk in establishing a qualified personal residence trust is that the grantor of the property to the trust will not outlive the term of the trust. The grantor may lease the property from the trust during the trust term, and also at the end of the trust term at a fair market rate without the property being included in the grantor's estate. n216 The IRS has ruled that in the case of a transfer of qualifying property to a qualified personal residence trust by a lawful permanent US resident who had obtained a green card, the later surrender of the green card (likely during the term of the trust), and return to their home country would not affect the trust's status as a qualified personal residence trust. n216.1 Another risk of establishing a QPRT, of course, is the possibility that the donor(s) may come to regret giving up control of the family home, and the possibility of family discord. n216.2

Several rulings have addressed modifications of an initial QPRT that upon the expiration of the trust term, and upon a direction of a majority of the remainder beneficiaries, allow the trustee to liquidate the trust or provide a gift to anyone the majority of the current remainder beneficiaries choose of a term interest in real property in the trust estate. The modification also requires the term interest holder(s) to occupy the property as their principal residence. The remaindermen of the initial QPRT--typically the initial grantor's children--create a new irrevocable trust, transfer the residence to it, and have the second trust convey a term of years interest to possess and occupy the residence to the initial grantor. In each ruling, the IRS has ruled that if specified conditions are met, the second trust will also be treated as a QPRT. This allows the remainder interest in the second trust to be valued under actuarial tables rather than being given a zero valuation. To qualify for this treatment, the second trust must contain specified trust provisions, n216.3 must be operated consistent with the terms of the trust instrument, and must be valid trust under local law. The residence in the trust must also qualify as a personal residence. n216.4

[c] Sale and Leaseback of Family Home

Another way to alleviate this problem is to combine the sale with a leaseback (see § 18.02[1][b][i], above). Typically, the present owners will sell their home to their children and then lease it back from them. The lease arrangement must be set at fair rental value, or the anticipated tax benefits may be lost. The leaseback transaction may provide the younger generation with depreciation and other income tax benefits, although the passive loss limitations may limit the usefulness of these income tax benefits. n217 In addition, the lease arrangement must be for a fair rental value, or these tax benefits may be permanently lost. Even with a fair rental, a court may still find an implied agreement among the parties that the parent actually retained a life estate in the home. n218 This finding will cause the fair market value of the home at the time of the parent's death to be included in his or her estate, including any increase in the fair market value of the property between the date of the gift and the date of the decedent's death. n219

[d] Gift of Family Home with Retention of Use

Another method that can be used is a gift with the retention of use. Typically, this arrangement involves a parent giving the residence to his children, but continuing to live in the home. This results in a rather large gift tax currently, *and* the Service will almost certainly attempt to include the home in the decedent's estate under *IRC Section 2036(a)* (retention of a life estate). n220 The courts are likely to uphold the Service on this issue. n221 To avoid inclusion in the parent's estate, the parent must be able to prove that an outright transfer occurred and that no agreement, express or implied, existed conditioning the transfer upon a right to continued use.

In one case in which the taxpayer prevailed, a mother gifted her home to her daughter who lived in the residence and assumed all the benefits and burdens of ownership, including the payment of property taxes. Although the mother was allowed to live with her daughter after the transfer, she scrupulously treated her daughter as sole owner, even asking her permission before inviting friends over. These facts allowed the taxpayer to overcome the presumption that the transfer was made subject to an implicit retained right to continued residence. n222

If this type of transfer is treated as a completed transfer, then, like all gifts of present interests, it will qualify for the

annual exclusion, n223 and there will be no step-up in basis. n224 One drawback to this type of transaction is that the gift leaves the transferee with a basis equal to the transferor's (presumably) low basis, and with no basis step-up at the death of the transferor, whereas the transferor might have been able to avoid, or defer and ultimately avoid at death, any tax on any gain on the sale of the residence pursuant to *IRC Section 121*. Up to \$250,000 (\$500,000 for married taxpayers filing a joint return) of the gain from the sale of a principal residence may be excluded from gross income. n225

[2] Vacation Homes

The restrictions on the deductibility of interest expense and passive activity losses affect the tax treatment of vacation homes. Individuals will have to determine whether it is in their best interest to personally use a second home to such an extent that it will be treated as a "residence" under *IRC Section 280A*. If treated as a residence, interest expense may be entirely deductible as "qualified residence interest" n226 (see Chapter 9). However, other losses generally will not be allowed if they exceed the income generated from the property. On the other hand, if the vacation home is treated as an "active" rental activity, up to \$25,000 of losses may be allowed currently (providing that the individual's income level does not exceed certain amounts) n227 (see Chapter 13).

For purposes of estate planning, the above evaluation may affect the desirability of potential transfers of such vacation home property to younger family members. For example, if a family vacation home qualifies as rental property, but the losses are deferred because of the adjusted gross income limitation, the transfer of the property to younger family members who can use the tax benefits may have positive estate and income tax results.

Most individuals would find it emotionally easier to transfer their interest in a vacation home, than to transfer their principal residence. The most efficient way to accomplish this is to transfer a home to a qualified personal residence trust in the same manner as discussed for family homes in § 18.04[1], above. n228 Another method of excluding this vacation property from an estate is to transfer the *entire* vacation home to children, retaining, however, the right to use the home for vacations. The transfer can be structured as either a gift or a sale. (See the discussion of the various advantages and disadvantages in § 18.02, above. See § 18.02[8], above, for a discussion on the implications that *IRC Section 2702* may have upon the valuation of the retained interest.)

A Word of Caution: As discussed in Chapter 13, losses related to passive activity property may only be used against passive activity income. n229 Unused passive activity losses may be accumulated and carried forward indefinitely. n230 Upon the sale of an entire interest in a passive activity (i.e., rental property or limited partnership), suspended passive activity losses can be deducted without limitation. n231 If the property is transferred via gift, the basis in the hands of the donee is increased by suspended losses accumulated before the transfer. n232 If passive activity property with accumulated suspended losses is transferred upon death, however, suspended losses can be used as a deduction for income tax purposes on the decedent's final tax return, but only to the extent that the suspended loss carryforward exceeds the normal step-up afforded the decedent's property for estate tax purposes. The balance of the unused suspended losses are permanently lost. n233

It is possible, therefore, that passive activity investments with suspended losses that are transferred through the gross estate may generate no benefit from the suspended passive activity losses. n234 Individuals holding passive investments with accumulating suspended passive activity losses may want to consider *inter vivos* sales and transfers to ensure maximum use of these tax benefits. If the passive activity is sold in a taxable transaction to a family member, the property is treated as if it were not disposed of for suspended-loss purposes. The passive losses remain with the acquiring individual and may be offset against his passive activity income. The suspended losses are triggered when the family member disposes of the property in a taxable transaction to an unrelated party. n235

[3] Limited Partnership Interests

Recently, real estate limited partnerships have assumed a larger share of real property ownership (see Chapter 14). It is important not to overlook these holdings. The tremendous variance between one limited partnership and another, however, makes it difficult to provide any general guidelines about planning. However, it is important to point out some of the major considerations in estate planning for limited partnership interests.

Upon death, the value of limited partnership interests owned by the decedent will be included in his or her estate. n236 The value of the interest may be reduced because of the concept of "minority discount." (See § 18.03[1].) Limited partnerships are, by definition, passive activity investments. n237 If the partnership is generating passive activity losses, the partner must have other passive activity gains to use those losses for income tax purposes. n238 As previously mentioned (§ 18.04[2], above), there are potential negative results when unused deferred losses from such investments have accumulated before death. n239 Individuals should reassess their limited partnership investment holdings in relationship to their estate planning goals, to maximize the use of associated tax benefits while minimizing the estate transfer taxes.

It should be noted that gifts of limited partnership interests may be treated as gifts of a future interest, especially if donees do not have the right to a substantial present economic benefit of the interest. As such, the donor will not be entitled to an annual gift tax exclusion for the gift. n240 If there are significant restrictions on distributions from the limited partnership to limited partners, the income flow from the limited partnership is likely to be treated as a future interest. Furthermore, if there are significant prohibitions on the transfer or assignment of the limited partnership interest or restrictions on withdrawal from the limited partnership, the limited partnership interests will lack the tangible and immediate economic benefit required for a present interest under *IRC Section 2503(b)*. n241

FOOTNOTES:

(n1)Footnote 211. See *IRC § 2702(a)(3)(A)(ii)*.

(n2)Footnote 212. See § 18.02[8][b], above.

(n3)Footnote 213. *Treas Reg §§ 1.1001*.

(n4)Footnote 214. *IRC § 2702(a)(3)(A)(ii)*.

(n5)Footnote 214.1. *Rev Proc 2003-42, 2003-1 CB 993*.

(n6)Footnote 215. Ltr Ruls 200626043, 200406045, 200241039, 200211036, 200121015, 200126026, 200117021, 200109017, 200111018, 200039031, 200023020, 200010013, 200004037, 9931028; 9918049, 9918042; 199916030, 199906004, 9841017, 9841015, 9829026, 9829002, 9827037, 9818014, 9817004, 9816003, 9750048, 9741004 (adjoining parcels and home with 21 percent of space rented out as separate rental units), 9739024 (40.17-acre parcel qualifies), 9739010, 9735035, 9735011 (transfer of 75-percent undivided interest in two adjoining parcels), 9735012, 9729027, 9729026, 9725010, 9722009, 9717017, 9714025, 9710046, 9705017, 9645010, 9639064, 9448035, 9442019, 9441039, 9433016, 9425028, 9402011.

(n7)Footnote 215.1. *Ltr Rul 199908032*.

(n8)Footnote 216. Ltr Ruls 199916030, 199906004, 9448035; see *Rev Rul 70-155, 1970-1 CB 189*.

(n9)Footnote 216.1. *Ltr Rul 200118031*.

(n10)Footnote 216.2. See Ltr Rul 200617002 (lawsuit by daughters when donors attempted to transfer interest they had transferred to QPRT).

(n11)Footnote 216.3. See *Rev Proc 2003-42, § 4, 2003-1 C.B. 993*.

(n12)Footnote 216.4. Ltr Ruls 200901019, 200848003, 200848007; 200848008; see *Treas Reg* § 25.2702-5(c).

(n13)Footnote 217. *IRC* § 469.

(n14)Footnote 218. See *IRC* § 2036.

(n15)Footnote 219. *Estate of Maxwell v Commr*, 3 F3d 591 (2d Cir 1995) , affg 98 TC 598 (1992) .

(n16)Footnote 220. *Rev Rul* 70-155, 1970-1 CB 189 .

(n17)Footnote 221. *Estate of Calvert v Commr*, 437 F2d 1148 (4th Cir 1971) ; *Estate of Rapelje v Commr*, 73 TC 82 (1979) .

(n18)Footnote 222. *Roemer v Commr*, 46 TCM 1176 (1983) .

(n19)Footnote 223. *IRC* § 2503(b).

(n20)Footnote 224. See *IRC* § 1014(a).

(n21)Footnote 225. *IRC* § 121, eff generally for sales and exchanges after May 6, 1997. See Chapter 9 for a detailed discussion.

(n22)Footnote 226. *IRC* § 163(h)(2)(D), (h)(3).

(n23)Footnote 227. *IRC* § 469(i).

(n24)Footnote 228. See *IRC* § 2702(a)(3)(A)(ii).

(n25)Footnote 229. *IRC* § 469(a), (d)(1).

(n26)Footnote 230. *IRC* § 469(b).

(n27)Footnote 231. *IRC* § 469(g)(1)(A).

(n28)Footnote 232. *IRC* § 469(j)(6)(A).

(n29)Footnote 233. *IRC* § 469(g)(2).

(n30)Footnote 234. See *Treas Reg* § 1.001-3(f).

(n31)Footnote 235. *IRC* § 469(g)(1)(B).

(n32)Footnote 236. *IRC* § 2031(a).

(n33)Footnote 237. See *IRC* § 469(c).

(n34)Footnote 238. See *IRC* § 469(a), (d)(1).

(n35)Footnote 239. See *IRC* § 469(g)(2).

(n36)Footnote 240. *TAM* 9751003 ; see *IRC* § 2503(b).

(n37)Footnote 241. *TAM* 9751003 .

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Federal Taxes Affecting Real Estate

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CHAPTER 18 Estate Planning for Real Estate *

2-18 Federal Taxes Affecting Real Estate § 18.05

§ 18.05 Other Issues

This chapter has provided a basic overview of the major aspects involved in estate planning for real estate, concentrating on various techniques to reduce the taxable estate. There are, however, a number of other specific areas that deserve brief attention.

[1] Transfers Related to Divorce Settlements

When a couple divorces, they are faced with the challenge of dividing up their property. Under current law, no gain or loss is recognized on a transfer of property to a spouse or to a former spouse if the transfer is incident to a divorce. n242 A transfer of property is treated as incident to divorce if it: (1) occurs within one year after the date on which the marriage ceases; or (2) is related to the cessation of the marriage. n243 A transfer within six years of a divorce is related to the cessation of the marriage if it is "pursuant to a divorce or separation instrument, as defined in *IRC § 71(b)(2)*." n244 Under *IRC Section 71(b)(2)*, a divorce or separation instrument includes a written instrument incident to a divorce decree. n245

The transferee spouse (or former spouse) takes the transferor's adjusted basis in the property. n246 Gain or loss may be recognized on a transfer in trust for the benefit of a spouse or former spouse if the liabilities to which the property is subject exceed the adjusted basis of the transferred property. In that case, the basis of the property to the transferee is also adjusted to take into account any recognized gain. n247 A transfer to a third party on behalf of a spouse or former spouse may also qualify for nonrecognition under *IRC Section 1041* if:

- (1) the transfer is required by a divorce instrument or separation instrument; n248
- (2) the transfer is pursuant to the written request of the other spouse (or former spouse), or
- (3) the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party containing specified information. n249

Though there is no current tax impact for transfers incident to a divorce, careful tax planning is required because of the carryover basis of property transferred pursuant to a divorce. n250 For example, a husband and wife are going to split up two properties. Each is worth \$100,000, yet one has a basis of \$90,000 and the other has a basis of \$20,000. If they

plan to sell these properties in the near future, one property will have a gain of \$10,000 while the other will have a gain of \$80,000. n251 The disparity of the economic burden of this tax should be considered when the marital estate is being divided.

[2] Property That Has Declined in Value

The assumption for most of this chapter is that real estate will appreciate and that efforts to remove this appreciation from the future estate should be made. Sometimes, however, real estate does not appreciate. How should estate planning take into account such property? The general rule is that property that has gone down in value should not be given away. The reason is that if the basis of gifted property is greater than the fair market value at the time of the gift, the donee's basis for determining the loss on sale is only the fair market value on the date of gift. n252 For example, property with a basis of \$100 is gifted when it has a fair market value of \$60. Subsequently, the donee sells the property for \$50. The donee can only take a loss of \$10, the amount of loss attributable to the time when he held the property. n253 On the other hand, if the original owner (donor) had sold the property for \$50, he or she would be able to recognize the full \$50 as loss. n254 As a result of the gift, the tax benefit of the decline in value while the property is held by the donor is lost forever.

If property has been reported on an estate tax return, lower values may not be later substituted for those reported on the return without cogent proof that the reported values were erroneous. n255 The mere selling of the property at a later time for less than the value reported in the estate tax return will not justify a reduction in the value on the return. But that sale, accompanied with evidence that the local market for real property did not decline between the valuation date and the date of sale, and expert testimony that the property was overvalued on the return might be sufficient to show that the initial value reported was erroneous. n254

[3] Postmortem Planning

This section discusses some of the planning techniques that can be used to reduce or mitigate the burden of paying estate taxes.

[a] Deferred Installment Payment of Estate Taxes

IRC Section 6166 allows an estate to pay its estate tax in installments, if a closely held business constitutes more than 35 percent of a decedent's estate. n255 The purpose of this provision is similar to that of *IRC Section 2032A*, in that Congress did not want to force the sale of closely held businesses to enable the estate to pay its taxes.

The deferral provision allows interest-only payments for the first five years; 10 additional years are allowed for the payment of the estate tax itself, plus interest. n256 The deferred estate tax liability attributable to the first \$1 million (adjusted for inflation, for decedents dying after 1998) n257 of value (\$345,800 of tax, reduced by the amount of the unified credit) bears only a 2 percent interest rate, effective for decedents dying after 1997. n258 The rate applied to the balance is determined under *IRC Section 6621*. n259

The 2-percent rate applies on the amount of deferred estate tax attributable to the first \$1 million in taxable value of the closely held business (i.e., the first \$1 million in value in excess of the effective exemption provided by the unified credit and any other exclusions). The interest rate imposed on the amount of the deferred estate tax attributable to the taxable value of the closely held business in excess of \$1 million is reduced to an amount equal to 45 percent of the rate applicable to underpayment of taxes. n260 It should be noted that deferred payments of estate tax on holding companies and non-readily-tradable business interests do not qualify for the 2-percent interest rate. They instead are subject to a rate of 45 percent of the regular deficiency rate. n261 Deferred installment payments on property held through holding companies must include both principal and interest and must be made over five years. n262

Any interest paid on estate taxes that are deferred under *IRC Section 6166* is not deductible for estate or income tax purposes. n263 Statutory provisions clarify the existence of a declaratory judgment remedy in case of a question for eligibility under *IRC Section 6166*. n264

An election to pay the estate tax in installments must be made within the time prescribed for filing an estate tax return, including extensions. n265 An election made on a return that is not timely filed is untimely and therefore invalid. n266-268 Two additional requirements must be met for a taxpayer to be able to pay estate taxes in installments. First, the business must meet an ownership requirement--20 percent of the business must be held by the decedent or his family *or*, depending on the business entity, there must be no more than 45 partners or shareholders, respectively. n269 Second, the business must be an active trade or business. n270 The Service focuses on three factors for this requirement: the level of activity and use of contract labor; whether these activities are in the same entity as the ownership; and the level of disruption that would be caused by a sale of the property. n271 The Service construes the active business requirement narrowly--more narrowly than the statute itself is worded. The District Director having jurisdiction over the estate has the authority to determine if *IRC Section 6166* applies in a particular instance. n272

Although the IRS does have authority to require a taxpayer to provide a bond n273 or a special lien under *IRC Section 6324A* as a condition of qualifying for the extension to pay the estate tax, the Tax Court has ruled that the IRS cannot require a bond or security in every case. Rather, it must exercise reasonable discretion in each case to determine if a bond or lien is necessary. The court remanded the case for further administrative proceedings. n274 In response to the case, the IRS has announced an interim program under which it will determine on a case-by-case basis whether security will be required when a qualifying estate elects under *IRC Section 6166* to pay all or a part of the estate tax in installments. Until final regulations are announced, the IRS will evaluate the following factors and all other relevant facts and circumstances to determine on a case-by-case basis whether a bond or special lien is necessary. The determination may be made at any time and from time to time during the deferral period. The factors include the following: n275

- Duration and stability of the business. This factor considers the nature of the closely held business, the assets of that business, the relevant market factors that will impact the business's future success, its recent financial history, and the experience of its management, in an effort to predict the likelihood of its success and survival through the deferred payment period.
- Ability to pay the installments of tax and interest timely. This factor considers how the estate expects to be able to make the annual payments of tax and interest as due, and the objective likelihood of realizing that expectation.
- Compliance history. This factor addresses the business's history regarding compliance with all federal tax payment and tax filing requirements, in an effort to determine whether the business and its management respect and comply with all tax requirements on a regular basis. This factor also addresses the estate's compliance history with respect to federal tax payment and filing requirements.

With respect to real estate, the Service has taken the position that mere management of real estate assets to obtain rents does not qualify as an interest in a closely-held business so as to qualify for installment payment of estate taxes under *IRC Section 6166*. n276 In one ruling, however, the Service found that the decedent's active day-to-day operation, management and maintenance of ten rental properties until shortly before his death were sufficient to treat his interest in the properties as an active trade or business for purposes of *IRC Section 6166*. n277 The same "active trade or business" finding was made in another ruling in which the decedent was actively involved in more than 100 rental units both as a proprietor and through partnership ownership at the time of his death. n278 In another ruling, a decedent's revocable trust was the sole shareholder of 2 corporations owning six commercial properties. The IRS evaluated the decedent's level of activity (as assisted by the employees of the companies) and ruled that the decedent's interest in five of the properties through his trust's ownership of the corporations constituted a closely held business for which estate taxes

could be paid in installments under *IRC Section 6166*. The IRS found that a sixth property was merely a passive asset within the meaning of *IRC Section 6166(b)(9)(B)(i)*. n279

An estate of a decedent dying after 2001 with an interest in a qualifying lending and financing business n280 is eligible for installment payment of the estate tax. The installment payments, however, must include both principal and interest and must be made over five years. n281

It is critical that installment payments be timely made. If there is likely to be any foreseeable problem in paying an installment, the executor should request an extension of time for paying it under *IRC Section 6161*, discussed in § 18.05[3][b], below. One circuit court has ruled that if an estate has not paid all disputed amounts or is not up to date with its installment payments, the court does not have jurisdiction to permit the estate to challenge any IRS determination of the amount due. n282

[b] Extension of Time to Pay Estate Taxes

Apart from the availability of deferred installment payment of estate taxes when a closely held business is a large part of the estate, n283 an estate may request an extension of time to pay estate taxes for a period not to exceed 10 years. n284 An extension may also be requested for any part of any installment under *IRC Section 6166*. n285 The executor must demonstrate reasonable cause in order to obtain an extension. n286 The regulations give the following circumstances that illustrate reasonable cause: n287

- Inability of the executor to readily marshal liquid assets to pay the estate tax because of their location in several jurisdictions.
- The estate is comprised in substantial part of assets consisting of rights to receive payments in the future (i.e., annuities, copyright royalties, contingent fees, or accounts receivable), but the estate cannot borrow against them except upon terms that would inflict loss upon the estate.
- The estate includes a claim to substantial assets that cannot be collected without litigation.
- Lack of sufficient funds in the estate.

NOTE:

Notably absent from the above list is a situation which would apply to most real estate after 2008, i.e., that the estate tax can only be paid by selling assets in the estate at a sacrifice price or in a depressed market. This circumstance was one that did qualify for an extension under a prior law "undue hardship" provision. n288

[c] Disclaimers

A disclaimer is a useful tool to ensure full use of the unified credit. If the surviving spouse disclaims a bequest, the property generally passes to the residual estate (unless expressly provided otherwise under the terms of the will) and will not qualify for the marital deduction. n289 If a qualified disclaimer is made with respect to the transfer, the Federal estate tax provisions apply with respect to the disclaimed property interest as if the interest had never been transferred to the person making the disclaimer. n290

Example:

Assume a decedent dies in 2002, with a taxable estate valued at \$2 million, consisting of his share of the family home worth \$400,000, other real property worth \$500,000, and marketable securities worth \$1.1 million. The decedent's will leaves his entire estate to his wife. The will provides that disclaimed property will pass to trust for his daughter. If the wife's estate at the death of her husband were \$1

million, she will have an estate worth \$3 million at her death. If she disclaims enough of her residual bequest so that the decedent will make use of his full \$1 million unified credit, the value of his taxable estate (after application of the marital deduction) will be \$1 million, but the unified credit will offset any estate tax due. Upon her death, her estate will be \$2 million rather than \$3 million, assuming no growth in her estate. If she survives until 2006, her estate tax unified credit will offset any estate tax owing on her taxable estate. n291

[d] Alternate Valuation

The executor of an estate has the option of valuing all the estate's property at a date six months after the date of death. n292 This election can be made only if the value of the gross estate *and* the estate tax are reduced. n293 The election applies to all of the estate; it cannot be made on a property-by-property basis. n294 Since the tax basis of the property is determined with reference to its estate tax value, the election may result in a reduction of the estate tax; when the property is sold, however, the income tax may be higher. n295 Therefore, an evaluation of the respective values of the assets and the likelihood that they will be sold, must be made before choosing this alternate valuation election.

The alternate valuation election must be made by the executor on the estate tax return. Once made, the election is irrevocable. n295.1 No election may be made, however, if the estate tax return is filed more than one year after the date it is due, including extensions. n295.2 The IRS may grant extensions of time for making the election, but no extension is granted unless the estate tax return is filed no later than one year after the due date of the return, including extensions. n295.3 If, based on the return of tax as filed, use of the alternate valuation method would not result in a decrease in both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax liability payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate, a protective election may be made to use the alternate valuation method if it is subsequently determined that such a decrease would occur. The protective election is irrevocable as of the due date of the estate tax return, including extensions of time actually granted. The protective election becomes effective on the date on which it is determined that use of the alternate valuation method would result in a decrease in both the value of the gross estate and in the sum (reduced by allowable credits) of the estate tax and generation-skipping transfer tax liability payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate. n295.4

[4] Unified Credit Trusts

One fundamental aspect of estate planning is in ensuring full use of the unified credit, particularly in the estate of the first spouse who dies. n296 A unified credit trust is simply a trust that is drafted in a manner to allow full use of the unified credit.

Example:

Suppose a married couple has an estate worth \$3 million. If the husband were to die in 2002 and leave everything to his wife, his estate would incur no estate tax liabilities. However, if the wife were to die shortly thereafter, she would have a taxable estate of \$3 million. If instead the husband diverts \$1 million of assets to a unified credit trust and away from the marital deduction bequest, his taxable estate (after application of the marital deduction) will be \$1 million, but his unified credit will offset any estate tax due. Upon the death of the wife, her estate will be \$2 million rather than \$3 million, assuming no growth in her estate. If she survives until 2006, her estate tax unified credit will offset any estate tax owing on her taxable estate. Thus, the use of the unified credit trust will allow their entire estate to pass to heirs tax-free. n297

[5] Buy/Sell Agreements

A buy/sell agreement can be used to ensure a smooth transition in ownership of a closely held business and to fix the value of the business interest for estate tax purposes. It is this latter benefit on which this brief section focuses.

The buy/sell agreement can exist either between one owner and the business (redemptive) or between the various owners of a business (cross-purchases). In a typical arrangement, someone in the younger generation has the right to purchase the older generation's interest for a fixed price. When this price is properly fixed, the buy-sell value represents strong evidence in establishing the valuation for estate tax purposes. In addition, the purchase provides cash that the estate can use to pay off its debts.

Further, the agreement must meet certain criteria if it is intended to establish the value of the ownership interest for estate tax purposes. First, the agreement must provide a fixed or determinable price. Second, the estate must be obligated to sell at that price. Third, the obligation must be binding on the decedent *during his lifetime* (as well as binding on his estate at death). If the decedent would, or could, have sold his interest during his life to anyone, at any price, the agreement has no substance for estate valuation purposes. n298 Finally, the agreement must be a result of a bona fide business arrangement and not merely a means to transfer property for less than full consideration. It is well established that maintaining family ownership and ensuring a smooth transition constitute valid business purposes. However, an agreement entered into briefly before the death of an owner might appear to be a device to transfer a decedent's interest for less than full consideration. Further, irrespective of whether these criteria are met, the Service tends to view with skepticism all intrafamily buy-sell arrangements and may seek to challenge them as essentially testamentary schemes for transferring property. In addition, *IRC Section 2703* may limit the effectiveness of buy-sell agreements for gift and estate tax valuation purposes. See § 18.02[8], above, for further discussion.

[6] Certain Transfers to Dependent Children

Certain transfers to dependent children, even in trust, are not an effective income reduction planning tool for two main reasons. First, under a so-called "kiddie tax," the unearned income of children is taxed at their parents' highest marginal rate if: n299

- The child has not attained the age of 19 before the close of the calendar year in which the taxable year of the taxpayer begins, or is a student who has not attained the age of 24 as of the close of that calendar year; and
- The child's earned income n300 for that taxable year does not exceed one-half of the amount of the individual's support. Amounts received as scholarships for study at educational organizations with a regular faculty and student body are not treated as support in making this determination.

The tax is paid on the child's tax return and the parents do *not* get a credit or deduction on their tax return for this payment. In addition, the income from the property cannot be used by the parents in the computation of their passive activity or investment income. This may result in passive loss or investment interest limitations being imposed upon the parents. n301

Second, a grantor is treated as the owner of any trust in which the trust property may revert back to the grantor. n302 This rule applies even if the property is to revert to the grantor's spouse (spousal remainder trust). If a parent were to transfer property to a trust for a period of 15 years with his daughter as the beneficiary, the income from the property would be taxed to the parent.

The estate tax advantages from transferring property to younger generation family members still exists if properly structured. However, income tax benefits no longer go hand in hand with the estate tax benefit.

[7] Real Property Taxes Paid by Estate

Real property taxes paid by an estate are deductible only if the taxes are an enforceable obligation of the decedent at the

time of the decedent's death. n303

FOOTNOTES:

(n1)Footnote 242. *IRC § 1041(a)*.

(n2)Footnote 243. *IRC § 1041(c)*.

(n3)Footnote 244. *Temp Treas Reg § 1.1041-1T(b)*, Q&A 7; see *Young v Commr*, 113 TC 152 (1999) , aff'd 2001-1 USTC P 50,244 (4[th] Cir 2001).

(n4)Footnote 245. *IRC § 71(b)(2)*.

(n5)Footnote 246. *IRC § 1041(b)*.

(n6)Footnote 247. *IRC § 1041(e)*.

(n7)Footnote 248. See *Ingham v US*, 97-2 USTC P 50,447 (WD Wa 1997) , aff'd 99-1 USTC P 50,249 (9th Cir 1999) .

(n8)Footnote 249. *Temp Treas Reg § 1.1041-1T(c)*; see *Walker v Commr*, TC Memo 2003-335 (Tax Court refused to characterize husband's quitclaim deed to wife under settlement agreement as a "request" to transfer the property, and held that the wife was taxable on the gain when she sold the property).

(n9)Footnote 250. See *IRC § 1041(b)*.

(n10)Footnote 251. *IRC §§ 1001(a), 1011(a), 1041(b)*.

(n11)Footnote 252. *IRC § 1015(a)*.

(n12)Footnote 253. See *IRC §§ 1001(a), 1011(a), 1015(a)*.

(n13)Footnote 254. See *IRC §§ 1001(a), 1011(a)*.

(n14)Footnote 255. *Estate of Desmond v Commr*, TC Memo 1999-76 ; *Estate of Hall v Commr*, 92 TC 312 (1989) .

(n15)Footnote 254. *Estate of Desmond v Commr*, TC Memo 1999-76 .

(n16)Footnote 255. *IRC § 6166(a)(1)*.

(n17)Footnote 256. *IRC § 6166(a)(3), (f)*.

(n18)Footnote 257. *IRC § 6601(j)(3)*. Under cost of living adjustments, the amount eligible for the 2 percent rate is \$1.2 million for decedents dying in 2006 (*Rev Proc 2005-70*, 2005-2 CB 979), \$1,250,000 for decedents dying in 2007 (*Rev Proc 2006-53*, 2006-2 CB 996), \$1,280,000 for decedents dying in 2008 (*Rev Proc 2007-66*, 2007-45 IRB 970), \$1,300,000 for decedents dying in 2009 (*Rev Proc 2008-66* , § 3.37, 2008-45 IRB 1107), and \$1,340,000 for decedents dying in 2010 (*Rev Proc 2009-50* , § 3.36, 2009-45 IRB 617).

(n19)Footnote 258. *IRC § 6601(j)*

(n20)Footnote 259. *IRC § 6601(a)*.

(n21)Footnote 260. *IRC § 6601(j)(1), (2)*.

(n22)Footnote 261. *IRC §§ 6166(b)(7), (8), 6601(j)(1), (2)*.

(n23)Footnote 262. *IRC § 6166(b)(8)(B)(ii)*, eff for decedents dying after 12/31/01.

(n24)Footnote 263. *IRC §§ 163(k), 2053(c)(1)(D)*.

(n25)Footnote 264. *IRC § 7479*.

(n26)Footnote 265. *IRC § 6166(d)*.

(n27)Footnote 266-268. *Estate of Hinz v Commr, TC Memo 2000-6* .

(n28)Footnote 269. *IRC § 6166(b)(1)*, eff for estates of decedents dying after 12/31/01; prior to this there could be no more than 15 partners or shareholders (*IRC § 6166(b)(1)*, before amendment by Pub Law 107-16).

(n29)Footnote 270. See *IRC § 6166(b)(9)*.

(n30)Footnote 271. *Rev Rul 75-365, 1975-2 CB 471* ; *Rev Rul 75-366, 1975-2 CB 472* ; *Rev Rul 75-367, 1975-2 CB 472* .

(n31)Footnote 272. *Rev Proc 79-55, 1979-2 CB 539* .

(n32)Footnote 273. See *IRC § 6165*.

(n33)Footnote 274. *Roski v Commr, 128 TC 113 (2007)* .

(n34)Footnote 275. *Notice 2007-90, 2007-46 IRB 1003* . The notice also provides additional detail about useful sources of information for each of the factors.

(n35)Footnote 276. *Rev Rul 75-365, 1975-2 CB 471* ; *Rev Rul 75-367, 1975-2 CB 472* .

(n36)Footnote 277. *Ltr Rul 9801009* .

(n37)Footnote 278. *Ltr Rul 200340012* .

(n38)Footnote 279. *Ltr Rul 200339043* .

(n39)Footnote 280. See *IRC § 6166(b)(10)(B)* for a definition.

(n40)Footnote 281. *IRC § 6166(b)(10)(A)*.

(n41)Footnote 282. *Hansen v US, 248 F3d 761 (8th Cir 2001)* .

(n42)Footnote 283. *IRC § 6166*, discussed in § 18.05[3][a], above.

(n43)Footnote 284. *IRC § 6161(a)(2)*. The extension may only be for 4 years in the case of a deficiency [*IRC § 6161(b)(2)*].

(n44)Footnote 285. *IRC § 6166(a)(2)(B)*.

(n45)Footnote 286. *IRC § 6161(a)(2)*.

(n46)Footnote 287. *Treas Reg § 20.6161-1(a)*.

(n47)Footnote 288. See *IRC § 6166(a)(1)*, before amendment by Pub Law No 94-455; 111-5; *Treas Reg § 20.6161-1(a)(2)*.

(n48)Footnote 289. *IRC §§ 2046, 2518.*

(n49)Footnote 290. *Treas Reg § 20.2046-1(a).*

(n50)Footnote 291. *IRC § 2001, 2010(c), 2046, 2056, 2518.*

(n51)Footnote 292. *IRC § 2032.*

(n52)Footnote 293. *IRC § 2032(c).*

(n53)Footnote 294. *IRC § 2032(a).*

(n54)Footnote 295. *IRC § 1014(a).*

(n55)Footnote 295.1. *IRC § 2032(d)(1).*

(n56)Footnote 295.2. *IRC § 2032(d)(2).*

(n57)Footnote 295.3. See Ltr Rul 201016006; *Treas Reg § 20.2032-1(b)(3).*

(n58)Footnote 295.4. *Treas Reg § 20.2032-1(b)(2).*

(n59)Footnote 296. See *IRC § 2010.*

(n60)Footnote 297. *IRC § 2001, 2010(c), 2056.*

(n61)Footnote 298. *Rev Rul 59-60, 1959-1 CB 237 .*

(n62)Footnote 299. *IRC § 1(g)(1), (2)(A).*

(n63)Footnote 300. See *IRC § 911(d)(2).*

(n64)Footnote 301. See *IRC § 469.*

(n65)Footnote 302. *IRC § 673.*

(n66)Footnote 303. *IRC § 2053(c)(1)(B); Treas Reg § 20.2053-6(b)* (mere accrual of property taxes in accounting sense does not support deduction); *Estate of Stewart v Commr, TC Memo 2006-225* (payment of property taxes by estate were not deductible because there was no outstanding obligation for them at the time of decedent's death).

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CHAPTER 18 Estate Planning for Real Estate *

2-18 Federal Taxes Affecting Real Estate § 18.06

§ 18.06 Summary

This chapter demonstrates the importance of estate tax planning when an individual has real estate holdings. Real estate is simply a part of the entire estate planning process, albeit an important part. The form of ownership, transfers made during one's lifetime, and the testamentary dispositions, all need to be considered when putting together an estate plan.

There are many factors to consider in planning for real estate: the value of the property, whether it qualifies for certain special valuation methods, the expected appreciation of the property, the degree of control that the current owners seek to maintain, and the income or loss produced by the property, to name just a few. An estate plan needs to consider all those factors and be flexible enough to meet the objectives under today's law, as well as the law as it may be tomorrow.

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CHAPTER 19 Financing Commercial Real Estate Transactions *

2-19 Federal Taxes Affecting Real Estate 19.syn

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CHAPTER 19 Financing Commercial Real Estate Transactions *

2-19 Federal Taxes Affecting Real Estate § 19.01

§ 19.01 Introduction

Anyone who is involved with a commercial real estate project quickly realizes that completing the project will require vision, creativity, tenacity and compliance with a complex set of rules and regulations. This is clearly true with respect to the physical aspect of the project, since the developer must identify a suitable site and project market demand, design an attractive building, and comply with a bewildering array of zoning and environmental regulations. However, it is also true with respect to the financial aspect of a real estate project.

Few if any real estate developers will be interested in financing a commercial real estate project with their own funds--to do so would limit the scope of their activity, greatly reduce the potential profitability of a project and increase their own personal economic risk. For these reasons, commercial real estate ventures have historically been financed with a combination of equity from the developer (including "sweat equity"), equity from partners of the developer, various levels of debt financing and various types of government subsidies.

The tax advisor involved in commercial real estate transactions must therefore be familiar with the tax issues applicable to the developer's own sweat equity, third-party equity, debt financing (including financing provided by domestic and foreign lenders and tax-exempt financing) and governmental subsidies (including low-income housing and historic tax credits). Advisors will also have to consider the sources of available funds since, for example, equity provided by funds, including tax-exempt investors, may be subject to unrelated business taxable incomeⁿ¹ and ERISA rules; equity available from exempt organizations and real estate investment trusts may require that a commercial rental project forego receiving additional rents based on its lessees' net income from the property,ⁿ² and providers of mortgage debt financing may be planning to securitize the loan in a REMIC.ⁿ³ This Chapter 19 provides a survey of the tax issues present in the types of real estate financing techniques that will frequently be encountered in the financing of a commercial real estate project. Readers will observe that the movement of real estate finance towards corporate finance requires real estate advisors to be familiar with issues and techniques previously of interest primarily to corporate finance advisors.

FOOTNOTES:

(n1)Footnote 1. *IRC §§ 511-514.*

(n2)Footnote 2. *IRC §§ 512(b)(3)(B)(ii); 856(d)(2)(A).*

(n3)Footnote 3. *IRC § 860A-860G.*

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CHAPTER 19 Financing Commercial Real Estate Transactions *

2-19 Federal Taxes Affecting Real Estate § 19.02

§ 19.02 Equity Investment

[1] Developer's Equity

A commercial real estate project will generally be owned through a limited partnership or, most frequently today, a limited liability company. In either case, the entity will generally choose to be treated as a partnership for Federal income tax purposes pursuant to the entity classification regulations. n4 These ownership vehicles are used because they are flexible, are not taxable entities for Federal income tax purposes and provide a level of protection for the owner's assets from claims of creditors of the entity. n5 Developers will generally use a separate entity for each separate real estate project or property, both to provide liability insulation between its properties and because the originators of first mortgage loans may require that the property owner be a special purpose entity (sometimes referred to as a "SPE") to facilitate a securitization of the mortgage. n6

A real estate developer may wish to finance its real estate activities in part by contributing the land for the project to the partnership, hoping to be able to withdraw from the partnership an amount equal to the fair market value of the land once other partners have contributed capital or the partnership has arranged financing. The contribution of property may be treated as a disguised sale of the property to the partnership if the developer's distribution is funded by capital contributions by other partners. n7 If a cash distribution is funded with loan proceeds, however, the transaction will not necessarily be recast as a disguised sale if the receipt of the loan proceeds is subject to significant uncertainties. n8

The developer and its active partners (i.e., its "co-developers") will want to make sure that the manner in which they acquire their interests in the partnership that owns the project will not be characterized as an income or gain recognition event to them. n9 The principal developer will generally be the person who forms the entity that will own the real estate project, and since he or she will be forming it at a very early stage, and since, at that time, there will generally be no other participant in the transaction from which the principal developer can be viewed as receiving an interest in the owning partnership in connection with the performance of services, the principal developer will generally not be concerned that its acquisition of an interest in the owning partnership is taxable compensation. However, the principal developer will frequently expand the ownership equity to include others who will be active partners and may be viewed as receiving an interest in the partnership as compensation for services, such as architects, land use planners and other key people who will assist in the development of the project. These co-developers *may* have to be concerned about the tax consequences of their acquisition of their interests in the partnership that owns the project.

[2] Co-developer's "Sweat" Equity

[a] Profits Interests

The treasury regulations addressing the tax consequences of the acquisition of a partnership interest provide that the non-recognition rule of *IRC Section 721* does not apply to a partner who receives an interest in capital (as distinguished from a share in partnership profits) as compensation for services. n10 Despite the inference in the parenthetical phrase that the receipt of an interest in partnership profits would not be a taxable event, in a series of cases, the Service was able to establish the principle that the receipt of an interest in partnership profits as compensation for services was a taxable event. However, the practical consequence of this conclusion was frequently insignificant, because the courts concluded that the partnership profits interest had little or no value. n11 The Service has since retreated from its victories, and it announced in *Revenue Procedure 93-27* n12 that, in general,

- (1) it will not treat the receipt of an interest in a partnership as compensation for services to the partnership as a taxable event for the partner or the partnership as long as the interest is merely an interest in future profits or future appreciation;
- (2) the profits interest does not relate to a substantially certain predictable stream of income from partnerships assets (such as income from a high quality debt obligation or a high quality net lease);
- (3) the partner does not dispose of the partnership interest within two years; and
- (4) the partnership interest is not an interest in a publicly-traded limited partnership.

[b] Other Interests

Persons who enter the developer partnership on a subsequent date, after value has been created, may be in a different position than those who acquire their interests at the beginning of the project. The Service distinguishes between the receipt of a profits interest in a partnership (generally not taxable) and the receipt of an interest in partnership capital (generally taxable if received as consideration for the performance of services), by analyzing the new partner's rights to receive any value if the partnership were immediately liquidated, its assets sold at their fair market values, and the proceeds distributed in accordance with the partnership agreement. n13 The application of this standard in determining whether a partner has received a profits interest or a capital interest in a real estate project that is underway but still has many remaining hurdles to negotiate requires a difficult valuation analysis.

Some partnerships have attempted to deal with this issue, as well as with the issue of distinguishing between the rewards to persons who are involved with a venture from start to finish and those whose contribution may be less because they have joined the partnership after some significant milestones have been achieved, by providing partnership interests that are weighted on the basis of the number of days during the existence of the partnership that the partner is a member. Under this approach, a service partner who received a 1 percent profits interest on the first day of a project partnership's existence (and remained a partner until the project is sold) would receive 1 percent of the profits realized by the partnership, whereas a service partner who acquired its 1 percent interest halfway through the life of the partnership (and remained a partner until the partnership is sold) would receive only 1/2 percent of the profits realized by the partnership on the sale of the project. Those structuring these partnerships would analyze *Revenue Procedure 93-27* as providing that a partner receiving this type of interest in a partnership would own a mere profits interest (using the definition provided in the Revenue Procedure), because it would have a "zero" fraction on its first day as a partner.

In other circumstances, the new members of a developer-partnership may receive partnership interests that are not fully vested. *Revenue Procedure 2001-43* provides that the determination of whether an interest granted to a service provider is a profits interest is under certain circumstances tested at the time the interest is granted, even if, at that time, the interest is substantially nonvested. Where a partnership grants a profits interest to a service provider in a transaction meeting the requirements of *Revenue Procedure 93-27*, the IRS will not treat the grant of the interest or the event that

causes the interest to become substantially vested n13.1 as a taxable event for the partner or the partnership. For purposes of *Revenue Procedure 93-27*, where a partnership grants a partnership profits interest that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant provided that: n13.2

- (1) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;
- (2) upon the grant of the interest or at the time the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and
- (3) all other conditions of *Revenue Procedure 93-27* are satisfied.

Assuming the interest is not fully vested, the partnership agreement might provide that the new service partner will forfeit its interest if it does not remain with the partnership until the project has received its certificate of occupancy and achieved a stabilized rent roll. Under such circumstances, the partner will generally want to file an election under *IRC Section 83(b)* to include in gross income (in the year of acquisition) the value of the partnership interest in excess of any amount paid for it, and the partnership may well insist that the partner file such an election. Pursuant to *Revenue Procedure 93-27*, this amount should be zero. A partner who does not make the *IRC Section 83(b)* election will also avoid income recognition on receipt of the partnership interest (both pursuant to *Revenue Procedure 93-27* and pursuant to *IRC Section 83(a)*) but will recognize compensation income, when the forfeiture restrictions lapse, in an amount equal to the fair market value of the partnership interest at that time over the amount, if any, paid for it. n14 The fact that the receipt of the partnership interest would not otherwise have been taxable pursuant to the principles of *Revenue Procedure 93-27* should not change this result. The Service has successfully contended that even a service provider who pays full fair market value for property received subject to forfeiture restrictions is nevertheless taxable--at ordinary income rates--on any increase in fair market value when the forfeiture restrictions lapse, absent an *IRC Section 83(b)* election. n15

The service partner's failure to make an *IRC Section 83(b)* election would also have tax consequences for the partnership and the other partners. The service partner will not be treated as the owner of the partnership interest for Federal income tax purposes during the period before the forfeiture restrictions lapse, and its holding period will not begin until that time. n16 Accordingly, any partnership income or loss allocable to the non-electing service partner's interest cannot be allocated to it and must be allocated to the other partners; any cash flow distributions made to the non-electing service partner must be treated as compensation for services rather than as a distribution of partnership cash flow that might otherwise be partially sheltered by the partnership's depreciation deduction; and the partnership (and thus the other partners) may have a taxable event at the time of vesting, equivalent to the consequences of a sale of an undivided interest in partnership assets (the undivided interest being the portion attributable to the non-electing service partners' percentage interest) for their fair market value. n17 The partnership will not necessarily be entitled to an offsetting compensation deduction at that time, since it may well be that the expenditure must be capitalized because it relates to the construction or acquisition of a capital asset. n18

[c] Allocation Issues

The creation of partnership interests with vesting schedules produces interesting tax complexities even when the recipient makes the *IRC Section 83(b)* election. Under those circumstances, the electing service partner is treated as the owner of the partnership interest for Federal income tax purposes from the commencement of its legal ownership of the

interest, and its holding period begins on that date. n19 Accordingly, the partner will be entitled to receive the allocations of profit and loss properly allocable to its partnership interest, even though that interest is not vested and the amounts allocated may never actually be received by the partner. Under such circumstances, the partnership has several alternative ways in which to draft its allocation provisions:

Profits interest with full income allocation. In this alternative, the service partner would acquire a profits interest in the partnership and would receive an allocation of income equal to its full percentage share, whether or not the full share was vested. The partnership agreement would contain a forfeiture provision pursuant to which a service partner who left before his or her interest fully vested would forfeit the unvested portion, with that amount going to the benefit of the principal developer, or to the other partners, or both. In this scenario, whatever the service partner received in the way of allocations and distributions would have the same character as did the income earned by the partnership, giving the service partner capital gain potential if the partnership's investment activities generated long term capital gains. This could produce some tax inefficiencies, however, because the service partner would have to pay tax on the income or gain allocated to it in respect of the unvested portion of its partnership interest, n20 but might not be entitled to any deduction with respect to the forfeited amount if there was a forfeiture n21 or might not be able to use the loss, since any allowable loss would likely be a capital loss. Furthermore, in the event that there is a forfeiture, the shift of the fair market value of the forfeited capital interest to the other partners whose interests are increased might be taxable to them at that time.

Profits interest with companion phantom partnership interest. In this scenario, the partnership interests acquired by the service partners would entitle them to an allocation of only their *vested* portion of any income received by the partnership; these service partners would also have a non-qualified unfunded deferred compensation arrangement with the principal developer, entitling them to receive an amount equal to the unvested portion of the income attributable to their profits interests, as and when they vested. The partnership income attributable to the unvested portion of the service partner's partnership interest would be allocated to the principal developer, and the partnership agreement would presumably provide a tax distribution for the taxes on that allocation. If and when the unvested portion of a service partner's partnership interest vested, the principal developer would also be obligated to make an in-kind deferred compensation payment of the just-vested partnership interest to that service partner. Any deduction attributable to that payment would be specially allocated by the partnership to the principal developer, although there might not be a current deduction. n22 The principal developer, whose partnership interest is reduced at that time, would probably have a gain recognition event at that time. The proper analysis of a compensatory capital account shift (from the perspective of the partner whose interest is reduced in the shift) is that the partner has disposed of an undivided interest in its share of the assets of the partnership for an amount equal to their fair market value, and if gain is realized on such a disposition, that gain must be recognized. The service partner would clearly have ordinary compensation income with respect to the deferred compensation payments and the transferred interest, and such amounts would be subject to social security taxes and the medicare tax.

[3] Third Party Equity

Third party equity may come from a variety of sources: pension or profit-sharing plans and other tax-exempt investors, other taxable investors, or foreign investors. Third party equity investors will typically seek a market rate cumulative priority return and then a residual share of profits from the venture. Losses from the venture (i.e., the excess of depreciation over principal amortization and free cash flow) must be allocated in accordance with capital accounts for as long as any of the equity owners have positive capital accounts. Accordingly, a developer with no capital investment would generally not be eligible to receive an allocation of losses while third party investors have positive capital account balances. Assuming that the developer partner does not undertake a deficit restoration obligation, n23 it will not be possible to allocate losses to the developer at a time when the co-equity investors have positive capital account balances. n24 Furthermore, if the partnership's lenders are related to one or more of the other equity investors, it will generally not be possible to allocate losses to the developer until the related party partner has received an additional allocation of losses equal to the amount loaned by the related party lender. n25

If the partnership that owns the property includes tax-exempt investors, further constraints will be imposed on the allocation provisions of the partnership agreement, since the agreement will generally have to comply with the "fractions rule" of *IRC Section 514(c)(9)* to allow certain of the exempt investors to avoid unrelated business taxable income.

Foreign investors would generally invest through a domestic corporation, to avoid the application of the branch profits tax. Should a foreign investor invest directly through a foreign entity, or through a single-member domestic LLC that does not elect to be treated as a corporation, the partner will have branch profits tax issues, and the partnership will have withholding responsibilities. n26

FOOTNOTES:

(n1)Footnote 4. *Treas Reg § 301.7701-3*.

(n2)Footnote 5. If there is only a single owner, the owning entity can be organized as a single member limited liability company that will be treated as a division (i.e. as an integral part) of the owner for Federal income tax purposes. *Treas Reg § 301.7701-3(b)(1)(ii)*. This ownership structure will generally provide a liability shield to the owner, but will generally not result in any entity level Federal income taxes. For convenience, this Chapter will generally refer to the typical owning entity as a partnership, even though it may be formed as a limited liability company.

(n3)Footnote 6. See § 19.03[6].

(n4)Footnote 7. *IRC § 707(a)(2)(b)*.

(n5)Footnote 8. *Treas Reg § 1.707-3(f)* (Example 3).

(n6)Footnote 9. *IRC §§ 61(a)(1)* and *83(a)* provide, in effect, that if property is received in connection with the performance of services, the excess of the fair market value of the property over the amount paid for the property must be included in gross income in the first year in which the property is non-forfeitable or transferrable to a third party free of any forfeiture restrictions.

(n7)Footnote 10. *Treas Reg § 1.721-1(b)(1)*.

(n8)Footnote 11. See, e.g., *WG Campbell, 91-2 USTC P 50,420 (8th Cir 1991)* .

(n9)Footnote 12. *1993-2 CB 343* .

(n10)Footnote 13. *Rev Proc 93-27, 1993-2 CB 343* .

(n11)Footnote 13.1. See *Treas Reg § 1.83-3(b)* for when an interest is substantially vested.

(n12)Footnote 13.2. *Rev Proc 2001-43, 2001 -34 IRB191*.

(n13)Footnote 14. *IRC § 83(a)*; *Treas Reg § 1.83-1(a)(1)(i)*.

(n14)Footnote 15. *Alves v Commr, 734 F2d 478 , 84-2 USTC P 9546 (9th Cir 1984)*.

(n15)Footnote 16. *Treas Reg § 1.83-1(a)(1)*; *IRC § 83(f)*; *Treas Reg § 1.83-4(a)*.

(n16)Footnote 17. *Treas Reg § 83-6(b)*.

(n17)Footnote 18. *Treas Reg § 1.83-6(a)(4)*; *IRC § 263A*; *GD Carpenter v Commr, TC Memo 1994-289* .

(n18)Footnote 19. *Treas Reg § 1.83-4(a)*.

(n19)Footnote 20. There would be pressure to allow a distribution from the partnership of an amount that would pay taxes on the unvested income allocated to the service partner.

(n20)Footnote 21. *Cf. IRC § 83(b)(1)*.

(n21)Footnote 22. *Treas Reg § 1.83-6(a)(4); IRC § 263A; GD Carpenter v Commr, TC Memo 1994-289* .

(n22)Footnote 23. Few developer partners are willing to assume this liability.

(n23)Footnote 24. *Treas Reg § 1.704-1(b)(1)*.

(n24)Footnote 25. *Treas Reg § 1.704-2(i)*.

(n25)Footnote 26. See Chapter 17.

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§ 19.03 Debt Financing

[1] Mezzanine Financing

A real estate developer will frequently seek more debt financing than is available on a first mortgage basis for a loan that will have an investment grade rating. For example, during the fourth quarter of 2000, a lender to the developer of a commercial office property might require a loan-to-value ratio for its first mortgage of between 60 and 75 percent, depending on the location of the property. A developer seeking to fill the gap between such a first mortgage and the cost of its project can consider mezzanine financing, a category of financing that includes second mortgages, loans secured by the developer's interest in the partnership that owns the project, and preferred equity interests in the property-owning entity. However, the developer will generally find that if its first mortgage loan is going to be securitized in a REMIC, the loan documents will prohibit second mortgages on the property, thereby leaving the developer with only mezzanine financing secured by interests in the owning entity or preferred equity interests as its sources for filling the gap between the first mortgage and the cost of the project. This will limit the universe of possible lenders. In general, loans secured by interests in partnerships that own real estate may not be "qualifying REIT assets". Accordingly, mortgage REITs, one fairly large category of potential lenders, may be eliminated as possible sources of capital. n27 For the same reasons, REMICS are not likely sources for mezzanine financing collateralized only by interests in the entity that owns the real estate. n28

Another type of mezzanine financing is a preferred equity investment in the entity that owns the real property. This form of financing might be used where the first mortgage loan documents will prevent not only a second mortgage on the property, but also any pledge of the ownership interests in the entity that owns the real property. A preferred equity investment will generally entitle the mezzanine financing party to receive a guaranteed payment or preferred return from the partnership equal to its agreed-upon yield, and to receive a return of its capital investment on a basis senior to that of all other partners in the partnership--generally on a fixed date. The terms of the preferred equity investment will frequently give the investor creditor-like control rights with respect to the owning partnership in the event that the guaranteed payments or preferred return are not made. This type of investment will also have a narrower available pool of capital--it will not constitute a qualified mortgage for REMIC purposes. However, an interest in a partnership that owns real estate can constitute a qualifying REIT asset, n29 unless the substance of the investment is such that it must be characterized as debt for federal income tax purposes, in which case the discussion of *PLRs 8708082 and 8626025* in the preceding paragraph becomes relevant.

In some circumstances, a developer may be able to complete the financing of a commercial real estate project through the use of seller financing. As a business matter, seller financing will probably have to be mezzanine financing, and will be subject to the same constraints discussed above. In addition, developers that are affected by the "at risk rules" will not be able to include seller financing in their amount at risk, because such amount does not constitute qualified non-recourse financing. n30

[2] Loans from Certain Lenders

[a] Participating Loans

A developer will find that the anticipated source of funding for its first mortgage loan will affect the economic terms of the loan. For example, the developer of a speculative project may find that first mortgage funds are available only at such a high rate that the cash flows from the project in its early years may be unable to carry the loan, and it may seek, as an alternative, a loan with a lower interest rate that also entitles the lender to a share of profits from the property or to a percentage of the appreciation in the value of the property. Such a financing proposal will be received more or less warmly by different categories of prospective lenders. For example, if the proposed lender is a foreign entity, a conventional first mortgage loan with a fixed rate of interest will not constitute a United States real property interest for purposes of *IRC Section 897* (imposing a tax on dispositions of investments in United States real property by non-resident alien individuals or foreign corporations). n31 In addition, interest paid on such a mortgage to a foreign, non-bank lender not otherwise engaged in business in the U.S. will generally not be subject to tax pursuant to the portfolio interest rules. n32 Accordingly, the rate charged by the foreign lender on a fixed rate loan will not have to take into account the possibility that the borrower will have to withhold Federal income tax from the interest payments to the lender. n33 However, these same conclusions do not apply to a loan with the lower coupon and a share of profits. A participating loan that entitles a foreign lender to receive a share in the appreciation in the value of real property, or a share of gross or net proceeds or profits derived by the borrower from the property, is not an interest solely as a creditor for purposes of *IRC Section 897*, and thus will constitute a United States real property interest. n34 In addition, any interest paid on a mortgage loan that is determined by reference to receipts, sales or cash flow of the borrower, the income or profits of the borrower, or any change in the value of the underlying property does not constitute "portfolio interest." n35 Accordingly, that interest would be taxable to the foreign lender, and the borrower would be obligated to withhold tax from the payment. Most loan documents proposed by foreign lenders in these circumstances will provide that the borrower is required to "gross up" the interest payments to its lender, in order to offset the impact of withholding.

A borrower who approaches a mortgage real estate investment trust will also find an adverse tax-based reaction to a proposal that a loan be structured with a lower fixed interest coupon but a share of profits from the property. Interest based on the income or profits of the borrower or of the property generally does not qualify as "interest" for purposes of the income qualification tests applicable to real estate investment trusts. n36 A borrower approaching a pension fund will not encounter a negative tax-based reaction to a proposal that a loan carry a lower fixed coupon and a share of the profits from the property. The interest on such a loan will generally not be subject to tax in the hands of the pension fund, because the unrelated business income rules contain no exception (for interest on participating loans) to the general rule that interest does not count as unrelated business taxable income. n37

[b] Registration Requirements

The Code contains several provisions supporting the tax policy bias against bearer debt. Interest on bearer debt may not be deductible. n38-39 Loans from foreign lenders are eligible for the portfolio interest exception to the withholding rules only if, *inter alia*, the obligations are in registered form and the United States person who would be subject to the withholding requirements (if withholding was required) receives a statement that the beneficial owner of the obligation is not a United States person. n40 The person who would otherwise be obligated to withhold if withholding was required would normally be the borrower, unless the transaction is structured with a United States intermediary. An

obligation is in registered form only if either ownership of the obligation can be transferred only pursuant to a book entry system or by means of a surrender of the obligation to the issuer and its issuance or reissuance to the new owner. n41 The Service has the authority to issue regulations, exempting from these requirements obligations of a type which it believes are not used frequently to avoid federal income taxes. n42

NOTE:

For debt obligations issued before March 19, 2012, n42.1 interest paid on bonds that are not issued in registered form but which meet the foreign targeting requirements of *IRC Section 163(f)(2)(B)* also qualifies as portfolio interest. n42.2 The exception allowing the treatment of that interest as portfolio interest is repealed effective for debt obligations issued after March 18, 2012. n42.3

[i] Structure for a Static Pool

It is relatively difficult for individual borrowers or small real estate developers to comply with these complex regulations, which implement statutory provisions that have as their focus much larger commercial transactions. One investment structure that has been used to pool the obligations of multiple small borrowers, such as in a vacation interval development, is to create a grantor trust to hold the borrowers' notes. Such a structure can enable the developer (who is typically pledging the notes received from its customers to the developer's financing source) to comply with the rules applicable to portfolio interest if that financing source is a foreign entity. A trust for each project could be established as a grantor trust to hold an existing portfolio of receivables relating to the project and those generated within up to 90 days after closing. This trust will not have any power to vary the investment of its assets after the end of the 90-day period. The trust agreement for such a trust would provide that it does not have the power to vary the investment of the owner or the power to reinvest any proceeds from the original investment, except on a temporary basis in specified liquid assets. The trust certificates evidencing ownership of a beneficial interest in the trust will be transferable only by means of record entry on the books of the trust, and will therefore qualify as registered obligations for tax purposes. No withholding would be required with respect to payments to foreign holders of the trust certificates, in reliance on the authority of the temporary and final portfolio interest exception withholding regulations. n43

[ii] Structure for a Dynamic Pool

Another trust could be organized as a domestic entity n44 having at least two members, and could agree *not* to elect to be treated as a corporation for Federal income tax purposes. This trust would not be restricted in its ability to accept deposits of additional receivables from the relevant project after its formation period, because it would seek classification as a partnership, not as a grantor trust. *Treas Reg Section 301.7701-3(a)* provides as follows:

"business entity that is not classified as a corporation ... can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under Section 301.7701-2(b)(2)) or a partnership."

In addition, the section provides that elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. n45 The promissory notes to be received by this second type of trust would have to provide that ownership thereof (and the right to receive payments of principal and interest) could be transferred only pursuant to a book entry system. An agent, however, might be able to maintain the book entry system on behalf of the makers of those promissory notes, and the foreign owners of the certificates of beneficial interest in the trust, and any transferee, could provide the trust with Forms W-8 indicating their foreign status. A book entry system maintained by an agent should satisfy the registration requirement of the regulations.

[3] Tax-Exempt Financing

Developers may find in some circumstances that the tax-exempt debt market is an available source of low-cost funding for a real estate project, assuming that the project comes within the statutory list of projects eligible to be financed with state or local bonds, the interest on which is excludable from gross income under *IRC Section 103*.ⁿ⁴⁶ For example, such financing may be available with respect to:

- (1) real estate projects that constitute qualified residential rental projectsⁿ⁴⁷ that provide low-income housing,
- (2) qualified small issue bondsⁿ⁴⁸ used to finance certain small approved commercial real estate projects,
- (3) qualified redevelopment bondsⁿ⁴⁹ used to finance redevelopment in certain designated blighted areas, and
- (4) qualified green building and sustainable design projects that qualify for "qualified green bond" financing.^{n49.1}

The basic tests that a project must satisfy before it can be concluded that it is eligible for financing with state or local bonds are complex, and the bond issuance process is time consuming and expensive. Further, a bond financed project, once successfully financed, must continue to comply with those complex rules lest the tax exempt status of the bonds be compromised. For example, a modification of the terms of tax-exempt financing that constitutes a reissuanceⁿ⁵⁰ may be treated as the issuance of a new municipal bond which, if it fails to comply with the rules applicable to new bond issuances or bond refundings, will no longer be exempt from tax. A common situation in which this issue arises is in the context of a proposed sale of a bond-financed project when it is contemplated that the terms of the bond financing with respect to the project will have to be modified to make the project economically successful. The new developer's dilemma is that, if it acquires the project without any commitment on the part of the issuing authority to modify the terms of the bond financing, it may lose its investment if the negotiations with respect to the modification ultimately fall through. On the other hand, if the issuing authority agrees to the terms of the modification in advance of the transfer, the modified financing may be treated as new acquisition financing rather than as a current refunding of the existing project, and the new acquisition financing may not qualify under the relevant tax rules for acquisition financing with state or local bonds.ⁿ⁵¹ For example, the initial financing of a qualified residential rental project requires an allocation of volume cap, and if the qualified residential rental project is not a new project, a specified amount of rehabilitation must be accomplished with respect to the project.ⁿ⁵² Although these restrictions will not apply to a current refunding of a bond financing project that originally qualified under these rules, a financing that is characterized as acquisition financing will not qualify as a current refunding.

Another situation that may face a developer of a bond financed project is the desire of some of its partners to dispose of their interests in circumstances in which the developer may wish to continue its ownership interest in that partnership. The economics of the project may be quite different for, on the one hand, limited partners who invested in the project at a time when it was generating (or expected to generate) deductible losses or sheltered cash flow, but who now find that it is generating taxable income in excess of distributable cash, as compared to the general partner who may have shelter from its other real estate activities for its share of this "phantom" income and who may be earning significant fees for its management services with respect to the project and the partnership.

If the partnership that owns the project: (a) borrows through a taxable financing and uses the proceeds to redeem the limited partners, and (b) simultaneously refinances its tax-exempt debt, the refinancing should be treated as a current refunding and not recharacterized as acquisition financing pursuant to *Regulations Section 1.150-1(d)(2)(v)*.

For Federal income tax purposes, a partnership generally remains the same legal and tax entity after a redemption of even a majority of the partnership interests, assuming that there has not been a sale or exchange of 50 percent or more of

the other partnership interests within a year before or after the transaction, n53 and assuming that the manner in which the redemption occurs cannot be recharacterized as a disguised purchase of partnership interests. n54 Thus, the partnership that owns the project will remain in existence for Federal income tax purposes and will remain the owner of the project, notwithstanding changes in the beneficial ownership of the partnership.

The regulation applies only to *asset* acquisitions. It should not be interpreted as automatically applying to shifts in the equity ownership of an entity that owns the asset. n55

The Service dealt with the concept of an indirect asset acquisition in a private letter ruling involving an electric utility (referred to herein as Lico). n56 That private letter ruling dealt with a transaction in which a *new issuer* issued tax-exempt bonds to buy the stock of Lico and to provide Lico with funds to pay off its existing debt. In the Lico transaction, it appears that the Lico assets were generally being transferred to new entities, although the exact mechanics of the transfers are not clearly described in the ruling. The Service needed to reach a conclusion that the proposed acquisition fell within the transition rule to the *Tax Reform Act of 1986*, applicable to bonds used directly or indirectly to provide electrical output facilities, and concluded that the stock acquisition was an indirect asset acquisition in order to fit within the transition rule. Having so concluded, the Service also held that bonds issued by the new issuing authority during the six-month period following the closing date and used to refinance outstanding Lico debt would be treated as bonds used to finance an asset acquisition within the meaning of the cited regulation. The facts in this private letter ruling are distinguishable from the hypothetical transaction under discussion--the bonds in the Lico transaction were issued by *the new issuing authority* for the purpose of acquiring the stock; in the hypothetical transaction discussed above, the bonds are being issued by the existing asset owning entity, not for the purpose of acquiring the asset, albeit in connection with a transaction in which there is a redemption of current equity owners.

[4] Original Issue Discount

Complicated commercial real estate projects will frequently result in complicated financing structures. Mortgage loans may be negotiated with interest holidays, provisions requiring payment of interest only when there is cash flow from the project, provisions entitling the lender to receive equity interests in the borrower, etc. Many of these loan structures will require an examination of the original issue discount rules. n57 In general, with numerous exceptions and limitations, these rules provide that the lender and borrower must accrue original issue discount income and expense on a constant interest basis over the term of the debt, even though the interest will be paid on some other schedule.

Observation: A real estate financing is likely to encounter the original issue discount rules when either:

- (a) the mortgage loan is actually issued at a discount, or provides for a higher interest accrual rate than its "pay" rate;
- (b) the loan provides for interest payments that are contingent (such as payments based on cash flow or increases in value of the mortgaged property); or
- (c) a significant modification is made to the terms of an outstanding mortgage loan, resulting in a "reissuance" exchange of a new loan for the old loan.

[a] Overview of Statutory Provisions

IRC Section 1271 provides for the tax treatment of amounts received on retirement or sale or exchange of debt instruments. Amounts received by a holder on the retirement of a debt instrument are generally treated as received "in exchange" for the debt instrument, n58 thus, potentially allowing (or requiring) the holder to report capital gain (or loss) on the transaction. Exceptions are provided for loans issued with an intent to call the loan for redemption before maturity (in which case, an amount of gain realized equal to the unamortized original issue discount is treated as

ordinary income) n59 and certain short-term obligations. n60

Original issue discount must be included in the income of the holder of the loan, calculated on the basis of a constant interest rate. n61 The timing and amount of the interest deductions for the borrower on such a loan are determined by reference to similar principles, subject to numerous exceptions. n62 The *IRC Section 1273* provides the general rules for determining the amount of original issue discount. In general, subject to a *de minimis* rule, n63 original issue discount is defined as the excess of the stated redemption price of a debt instrument at its maturity over its "issue price." n64

Observation: In the case of a debt instrument such as the note and mortgage given by a typical real estate borrower to raise funds to acquire or improve real estate, the "issue price" of the debt instrument will be the proceeds of the loan. Different rules apply with respect to purchase money debt taken back by a seller of the property. The issue price of purchase money debt will generally be equal to either the stated redemption price at maturity (if the debt has an interest rate at least equal to the applicable federal rate (the "AFR") n65 or an imputed amount (if it does not.) n66 The stated redemption price of the debt instrument at maturity means, in general, all amounts payable under the note other than interest based on a fixed rate and unconditionally payable at fixed intervals at least annually during the entire term of the debt. n67 A real estate financing may have a "stated redemption price at maturity" that exceeds the principal amount of the debt if interest accrues but is not required to be paid currently. n68

IRC Section 1275 provides definitions and special rules, including a broad grant of authority to the Service to provide regulations dealing with the tax treatment of debt instruments having varying rates of interest, put and call options, indefinite maturities, contingent payments or other circumstances, and modifying the tax treatment of such debt instruments to the extent necessary to carry out the purposes of the original issue discount provisions. n69

[b] Contingent Interest Regulations

The Treasury Department has recently exercised its regulatory authority with respect to loans providing for contingent interest.

Observation: Such a loan might arise as a mortgage on a commercial property entitling the lender to receive a percentage of the gross rent or cash flow from the property, or a percentage of any increase in the fair market value of the property. n70 Final regulations issued on June 14, 1996 set forth the tax treatment of debt obligations providing for contingent payments. n71 In general, these regulations apply to debt obligations issued on or after August 13, 1996. n72

The Contingent Interest Regulations, in general, abandon the former "wait and see" method of accounting for contingent interest, n73 in which the lender and borrower would not be required or allowed to take account of contingent interest until the amount thereof was reasonably determinable, in favor of a method that requires lenders and borrowers to make a reasonable projection of the contingent interest to be received or paid, and then prepare their tax returns on the basis of that projection. This method of accounting for interest is referred to as the "non-contingent bond" method. Under the non-contingent bond method required by the Contingent Interest Regulations, interest on a debt instrument subject to this rule must be taken into account for tax purposes by the lender and the borrower *whether or not* the amount of any payment is fixed or determinable for the year.

[i] Borrower Must Determine Payment Schedule

For any contingent payment debt instrument subject to the non-contingent bond method, a borrower must first determine the yield on the instrument and then establish a payment schedule to fit the yield. n74 The yield that must be determined by the borrower is the yield at which it would be able to borrow pursuant to a fixed rate debt instrument with terms and conditions otherwise similar to the terms and conditions of the contingent payment debt instrument. n75

This fixed rate yield is intended to be a "comparable" yield. The terms and conditions of a loan with a comparable yield--such as the level of subordination, term, timing of payments and general market conditions--must closely resemble the terms and conditions of the contingent payment loan in question. After determining the comparable yield, a "projected payment schedule" for the contingent interest loan must be determined. n76 The "projected payment schedule" includes the non-contingent payments on the loan and an amount (i.e., a projected amount) for each contingent payment. n77

[iii] Types of Contingent Payments

The regulations describe two different types of contingent payments. Contingent payments that are based on market information, referred to as "market-based payments," must be taken into account in an amount equal to the amount that would be paid on the issue date, between unrelated parties, for the right to receive the contingent payment on the date the contingent payment is required to be made. This amount is referred to as the "forward price" of the contingent payment. Contingent payments that are not based on market information, referred to as "non-market based payments," must be taken into account on the basis of the "expected value" of the payment as of the issue date.

Observation: It seems likely that most real estate loans bearing contingent interest will have "non-market based payments."

[iii] Adjustments to Payment Schedule

After the projected payment schedule has been determined by the borrower, the projected payments (rather than the actual payments) are used to determine the adjusted issue price of the debt instrument, the holder's basis in the debt instrument, and the amount of interest to be included in income by the lender and deducted by the borrower. The regulations provide that if the actual contingent payments differ from the projected contingent payments, adjustments are made to take account of the differences. n78 Lenders take into account only those adjustments that occur during a tax year in which the lender holds the debt; borrowers take into account only those adjustments that occur in a year in which the borrower is primarily liable for the debt. n79 The reference to a period of time during which a borrower is primarily liable for the debt presumably includes, in the case of a non-recourse debt, taxable years in which the borrower owns the property that is the primary security for the debt.

The adjustments are referred to as positive adjustments (for instances in which the actual amount of a contingent payment is more than the projected payment), and negative adjustments (for instances in which the actual amount of a contingent payment is less than the projected payment). In each case, the adjustment occurs on the actual (or scheduled) date of the contingent payment. Adjustments occurring during the year are netted. A net positive adjustment is treated as additional interest paid and received during the year. n80 A net negative adjustment first reduces interest on the debt instrument that the lender and the borrower would otherwise take into account for the year (such as the non-contingent components of the projected payment schedule). Any excess amounts are treated as ordinary loss to the lender and ordinary income to the borrower (but limited to net amounts taken into account by the lender and borrower in prior years); and any remaining net negative adjustment is carried forward to future years. n81 A net negative adjustment is not subject to the limitation imposed by *IRC Section 67* (the 2 percent floor on miscellaneous itemized deductions) for taxpayers otherwise subject to those limitations.

[iv] Determination of Comparable Yield

Responsibility for establishing the comparable yield and the projected payment schedule is initially allocated under the Contingent Interest Regulations to the borrower.

Observation: This seems logical because, in most cases, the borrower will have significantly more information about its own borrowing ability than will the lender, and thus the borrower will be in the best position to determine the "comparable yield" that it would have to pay.

The borrower's calculations must be supported by contemporaneous documentation showing that the amounts determined are reasonable, are based on reliable, complete and accurate data, and are made in good faith. n82 If the borrower maintains this contemporaneous documentation, its determination of the comparable yield and projected payment schedule will be respected, unless one or the other of those determinations is unreasonable. n83

The "comparable yield" for a debt instrument with "non-market-based" contingent payments, such as a right to a percentage of the cash flow or gross revenues from a real estate project, is presumed to be the applicable federal rate, if the issue is marketed or sold in large part to tax-exempt investors (including foreign investors). For example, if a pension fund makes a first mortgage loan for a real estate project and the terms of the loan provide for a fixed coupon plus a percentage of gross rents from the project, the "comparable yield" that the borrower would determine would be presumed to be limited to the applicable federal rate for comparable maturities. n84 This presumption is a rebuttable presumption, but rebutting the presumption requires clear and convincing evidence. For example, if a recent issue of the same borrower, with a comparable maturity, seniority, etc., is trading at a yield above the AFR, this fact should be clear and convincing evidence that a yield above AFR can appropriately be determined as the yield for the debt instrument in question. However, an appraisal of the value of the contingent payments would not be clear and convincing evidence sufficient to rebut the presumption.

[v] Disclosure of Projected Payment Schedule

The projected payment schedule determined by the borrower must be disclosed to the lender and used by the lender to determine its interest income accruals. The borrower must provide this information to the lender in a reasonable manner. For example, the borrower may provide the name or title and the address or telephone number of a representative of the borrower who will make this information available to the lender on request. n85 Alternatively, this information may be set forth in an original issue discount legend on the face of the debt instrument. The securities laws will also require disclosure of this information in any disclosure documents applicable to debt instruments subject to the disclosure requirements of the securities laws.

If the borrower does not comply with these rules, or if its projected payment schedule is unreasonable, the lender must determine the comparable yield and then inform the Service that it has created its own projected payment schedule. This information must be set forth on a statement attached to the lender's timely-filed federal income tax return for the year in which it acquired the debt instrument. n86 Thus, under the revised Contingent Interest Regulations, lenders and borrowers are generally required to take consistent positions with respect to timing of the accrual of contingent interest.

Observation: This is a significant change from prior law. The rules applicable to debt instruments issued prior to August 13, 1996, contain no clear requirement that lenders and borrowers utilize the same method for accounting for contingent interest. n87

[vi] Determination of Whether Contingencies Are Real

An issue raised but not resolved in either the final regulations or prior law is whether a specific debt instrument does, in fact, bear contingent interest. The Contingent Interest Regulations provide that if payments on a debt instrument are subject to a contingency that is either remote or incidental, the contingency is, in effect, ignored. For this purpose, a contingency is "remote" if there is a remote likelihood that the contingency will occur, or will not occur. The determination of remoteness is made at the time of issuance (and at the time of any reissuance) of the debt instrument. n88 In the case of a remote contingency, if there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur; if there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur. n89

A contingency relating to the amount of a payment is "incidental" if, under all reasonably expected market conditions,

the potential amount of the contingent payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. A payment subject to such an incidental contingency is ignored until the payment is made. n90 A contingency relating to the timing of a payment is incidental if, under all reasonably expected market conditions, the potential difference in the timing of the payment in question is insignificant. A payment subject to an incidental timing contingency is assumed to be made at the earliest date that the payment could be made pursuant to the contingency. n91

Example:

If a shopping center is financed with seven-year debt that provides for the payment of additional interest equal to a very small percentage of cash flow in excess of \$1,000,000, and the current cash flow from the fully-occupied, recently leased center is only \$10,000, it may be that the likelihood that the contingent payment would be made would be remote and/or incidental, in which case the possibility that the payment might be made would be ignored unless and until it is made.

[vii] Consequences of Remote Contingencies

A conclusion that a contingency with respect to interest on a debt instrument is remote has a different impact on a debt instrument issued before August 13, 1996 (and not "reissued" thereafter) than it does on a debt instrument issued on or after that date. In the case of pre-August 13, 1996 debt instruments, to which the final Contingent Interest Regulations do not apply, a contingency that is not remote may require the borrower and the lender to defer reporting the entire amount of interest until the contingency is resolved, whereas a conclusion that a contingency is remote may require the lender and the borrower to report the non-contingent interest income and expense with respect to the debt instrument currently, pursuant to the original issue discount rules relating to non-contingent obligations.

Example:

If a pre-August 13, 1996 structured zero coupon borrowing had payment provisions subject to a material non-remote contingency, the "wait and see" approach authorized by the case law would justify a cash basis lender's reporting all of the income only at the maturity of the borrowing, when the contingency would have been resolved. n92 However, if the contingency were determined to be remote, or not material, it is likely that it would be ignored, in which case the interest income should be accrued currently in accordance with the original issue discount rules applicable to non-contingent obligations.

In contrast, in the case of borrowings occurring on or after August 13, 1996, the base interest amount must be reported currently, in any event, in accordance with the original issue discount rules. The determination of whether or not an amount payable is subject to a remote contingency affects only the issue of whether the contingent amount itself must be projected and also taken into account currently, or can be ignored until paid. This change may reduce the frequency with which extremely remote or insubstantial interest contingencies are included in loan term sheets.

[viii] Exceptions to Non-Contingent Bond Method

Under the Contingent Interest Regulations, certain contingent payment obligations are not subject to the non-contingent bond method of calculating interest (i.e., non-publicly traded debt instruments issued in connection with a sale or exchange of non-publicly traded property). n93 These exceptions apply to certain debt instruments issued in exchange for property, such as a real estate buyer's purchase money indebtedness issued to a seller of the property. Debt instruments that are not subject to the non-contingent bond method are generally bifurcated, with the contingent payments being taken into account when paid and the non-contingent payments taken into account under the original issue discount rules applicable to non-contingent debt instruments. n94

[ix] Anti-Abuse Rule

The Contingent Interest Regulations also contain an anti-abuse rule, pursuant to which the Commissioner can apply or

depart from the regulations "as necessary to achieve a reasonable result" if a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result under the regulations that "is unreasonable in light of the applicable statutes." This anti-abuse rule replaces the anti-abuse rule adopted as a temporary regulation in January of 1994. n95 The temporary anti-abuse rule applies to debt instruments issued on or after April 4, 1994, and before August 13, 1996. n96

The anti-abuse rule leaves the Commissioner with a substantial degree of discretion. First, it applies whenever "a" principal purpose of the transaction is to achieve an unreasonable result; it is not limited to transactions in which the unreasonable tax planning is "the" principal purpose of the transaction. Second, it empowers the Commissioner to apply or depart from the regulations, as necessary, to reach a reasonable result--there does not appear to be any need, for example, for there to be a conclusion that the result otherwise reached by the regulations be abusive or unreasonable. Not surprisingly, a significant factor in determining whether the result reached in the transaction is reasonable is whether it has a significant effect on the Federal income tax liability of the borrower or the lender. Another significant factor in the determination is whether the tax result reached in the contingent payment transaction could be reached if the debt instrument (without the contingency) and a contract relating to the contingency were entered into separately. n97 For example, if a debt instrument with original issue discount contained an interest rate formula pursuant to which the amount due at maturity could be reduced or increased if short-term interest rates at that time are outside an expected range, the determination of whether the result of the transaction is reasonable could depend on whether the same tax result would be obtained if the borrower issued the debt instrument without the contingency and entered into the interest rate contract with a third party.

[x] Reissuance and Original Issue Discount

The Contingent Interest Regulations provide that, in certain circumstances, contingent payment debt instruments can be treated as reissued solely for purposes of the original issue discount rules, even if the debt instrument would not otherwise be treated as reissued for purposes of Section 1001. For example, if a scheduled payment of qualified stated interest is not made, there is a deemed reissuance solely for purposes of *IRC Sections 1272 and 1273*. n98

[5] Debt Restructuring

[a] Background of Reissuance Regulations

IRC Section 1001(c) requires that, in general, gain or loss realized on the sale or exchange of property be recognized. *Regulations Section 1.1001-1(a)* provides that, in general, the gain or loss realized from the exchange of property for other property differing materially, either in kind or in extent, is treated as income or loss sustained. In a series of Revenue Rulings in the 1970's and 1980's, the Service began providing guidance, primarily to issuers of tax-exempt obligations, as to the changes that could be made to the terms of a debt instrument without the changes being so significant that the changed debt instrument would be considered to "differ materially, either in kind or in extent." These changes generally were made in the context of a workout, a proposed change in the use of the bond-financed property or a change in tax rates that would affect the interest rate on the tax-exempt bond. n99 Numerous private letter rulings were also issued during this time period, and a consensus emerged that although changes in interest rates (other than extremely small changes) would result in the exchange of a "materially different" new debt instrument for the old one, changes in the identity of the obligor and/or the collateral, as well as changes in the maturity, would not. This consensus is no longer valid.

[b] Cottage Savings Association

This consensus was disturbed in 1991 when the Supreme Court decided *Cottage Savings Association v. Commissioner*, n100 which held that a loss was recognized by a savings and loan association on the exchange of a participation interest in a pool of residential mortgages for a participation interest in another pool of residential mortgages that had "substantially identical" economic terms, although different borrowers. In its opinion allowing loss recognition, the

Court stated that the term "materially different" used in the Regulations in determining whether a disposition of property had occurred referred not to material differences in economic substance but to "legally distinct entitlements."

[c] Administrative Reaction to *Cottage Savings*

The *Cottage Savings* decision led to the December 1992 publication of proposed regulations under *IRC Section 1001*, setting forth rules pursuant to which a significant modification of a debt instrument would be deemed to result in an exchange of the original debt instrument for a modified debt instrument differing materially in kind or extent. These proposed regulations, as revised, were adopted as final regulations on June 26, 1996 (*TD 8675*, 61 *Federal Register* 32926). The final regulations provide a series of "bright line" tests and safe harbors that enable lenders and borrowers engaged in workout discussions to know with certainty whether modifications to the loan terms will be challenged by the Service as constituting an exchange of a new debt instrument for an old debt instrument. n101

[d] Reasons for Avoiding Reissuance

Borrowers and lenders may both be interested in avoiding a taxable exchange when restructuring a debt in a workout. A lender may wish to avoid having a debt restructuring treated as an exchange if its basis for the debt instrument is less than the face amount. n102 The Treasury Regulations establishing the amount of gain recognized when a new debt instrument is exchanged for an old debt instrument provide that the amount realized is either its issue price, or, in some circumstances, its stated principal amount, but not its fair market value. n103 Accordingly, even a cash method lender will realize gain on debt restructuring if its adjusted basis for the debt instrument is less than the recomputed issue price or stated principal amount of the modified debt instrument. n104

A borrower may wish to avoid modifications that are treated as an exchange for a number of reasons, including the possibility that:

- (1) as a result of the application of the original issue discount rules, the modified debt instrument will have a lower issue price than the old debt instrument, which could result in cancellation of indebtedness income under *IRC Section 108*;
- (2) the new debt instrument will be recharacterized as equity for tax purposes, which could result in a taxable disposition of the collateral; or
- (3) the new debt instrument will be subject to different partnership basis allocation rules or no longer constitute qualified non-recourse financing.

[e] Approach Taken in Final Regulations

The final regulations adopt an analytical building block approach, requiring first a determination of whether a change in the terms of a debt instrument rises to the level of being a "modification," and then a determination of whether any modification is a "significant modification." One of the consequences of this methodology is that multiple alterations to different terms of a debt instrument, each of which separately is not a "modification," are not aggregated into a modification; accordingly, such alterations cannot combine to become a significant modification. In contrast, multiple alterations of a term of a debt instrument, each of which does constitute a "modification," can be aggregated to result in a significant modification, even if each of the modifications, on its own, would not be deemed to be significant. A "significant modification" results in a deemed exchange that can be a taxable event.

[i] Scope of the Regulations

The regulations apply to alterations to the terms of a debt instrument rising to the level of a modification, however accomplished. Thus, they apply to an amendment to the terms of an existing debt instrument, changes that the lender

and the borrower accomplish indirectly through one or more transactions with third parties, and the actual issuance of a new debt instrument in exchange for an old debt instrument. They do not, however, apply to exchanges of debt instruments solely involving holders, or to transactions with third parties, such as interest rate swaps. n105

[ii] Definition of Modification

The definitions used in the regulations are a blend of the Supreme Court's language in the *Cottage Savings* case with the position of the Service before the Court in that case. The definition of "modification" follows the Supreme Court--it focuses on changes in legal relationships. A "modification" is defined as any alteration (including any deletion or addition, in whole or in part) of a legal right or obligation of the issuer or of a holder of a debt instrument. n106 Such an alteration is a modification whether it is evidenced by an express agreement between the parties, by the conduct of the parties, or otherwise.

Example:

An alteration that might occur by reason of the conduct of the parties, although not pursuant to any express agreement, would be the forbearance of the lender in a workout situation.

[iii] Alterations May Not Constitute Modifications

The regulations identify certain alterations that will not constitute modifications. First, as a general rule, an alteration of a legal right or obligation is not a modification if it occurs by operation of the terms of a debt instrument. This general rule does not apply to:

- (1) changes in the identity of the obligor, to the addition or deletion of a co-obligor, or to a change of an obligation, in whole or in part, from recourse to non-recourse or from non-recourse to recourse;
- (2) an alteration that changes a debt instrument into something that is not debt for federal income tax purposes (other than pursuant to the exercise of a right to convert the debt into equity of the issuer pursuant to a conversion right existing in the terms of the document); and
- (3) certain alterations resulting from the exercise of an option, unless the option is a unilateral option or, in the case of an option exercisable by the lender, the exercise does not result in a deferral or reduction of any scheduled payment. n107

Example:

An alteration that occurs by operation of the terms of the debt instrument would be changes in the interest rate required to be made to reflect changes in a reference index rate.

An option is unilateral only if:

- (1) under the terms of a debt instrument or under applicable law, the party burdened by the option does not have (at the time the option is exercised), or acquire as a result of the exercise, a right to alter or terminate the instrument or put the instrument to a person related to the issuer;
- (2) the exercise of the option does not require the consent of the other party, a party related to that party, or a court or arbitrator; and
- (3) the exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option) unless, on the issue date of the instrument, the consideration is a *de minimis* amount, a specified amount or an amount that is based on a formula that uses objective financial information.

[iv] Alterations May Constitute Modifications

A change in the recourse nature of the mortgage will constitute a modification even if it occurs pursuant to the terms of the debt instrument. n108

Example:

If a mortgage loan provides that it is recourse to the owner until the property achieves a specified stabilized cash flow level, at which time it ceases to be recourse, a modification of the loan would occur at the time the property achieves the specified stabilized cash flow. Recall, however, that a taxable exchange will not automatically result unless the modification is significant.

Example:

If an obligation of the tenants-in-common of a real estate project provided that one tenant-in-common would be released if it conveyed its interest in the property to a substitute tenant-in-common whose net worth met specified standards, a modification of the debt instrument would occur at the time of such a transfer and substitution.

[v] Debt/Equity Retesting

The regulations resolve what had been a troublesome issue in debt workouts and restructuring; namely, whether, in a restructuring that was a reissuance, it would always be necessary to evaluate the new debt from a traditional debt/equity perspective.

Example:

Assume that a more than *de minimis* change in the interest rate on a mortgage loan was made at a time when a decline in the fair market value of the property had wiped out the equity cushion underlying the lender's position. Assume further that if a new loan secured by the same property were being made at the same time and on the same terms as the restructured loan, the parties' tax advisors would be concerned that the "debt" would be treated as "equity," because it had substantially all of the economic upside and substantially all of the economic downside with respect to the property. Under these circumstances, if the debt restructuring requires a debt/equity retesting, an "equity" conclusion could have undesirable tax effects on the owners of the property, including gain recognition with respect to the property, gain recognition pursuant to the partnership basis rules as a result of a reduction in the partnership's liabilities, etc. However, the regulations provide that, although an alteration resulting in an instrument that is not debt for tax purposes is generally a modification, n109 if the conclusion that the modified debt instrument is not debt for tax purposes is predicated on a decline in the borrower's financial condition from the date of issuance of the old debt instrument to the date of the modification, then the modification is generally not a significant modification. n110

[vi] Forbearance

The regulations provide that as long as there is no written or oral agreement to alter other terms of a debt instrument, a lender's temporary forbearance (i.e., an agreement by the lender to stay collection or temporarily waive an acceleration clause or similar default right) is not a modification unless the forbearance remains in effect for a period that exceeds two years (measured from the date of the issuer's initial failure to perform) plus any additional period during which either the parties conduct good faith negotiations (with respect to the debt) or the issuer is in bankruptcy or receivership, etc. n111 Note that in the event of a payment default, the lender's forbearance allows the deferral of payment during the period of the forbearance and is comparable in some respects to an extension of the maturity date. n112 This comparison is particularly appropriate if the forbearance takes the form of a binding written agreement to forbear for a specified period, as is permitted by the regulations. However, as is discussed below, the regulations also provide rules pursuant to which extensions of maturity will be considered substantial modifications. An agreement by a lender,

following a payment default, to forbear collection remedies for two years (measured from the date of the original default) is not a modification; whereas an agreement by a lender to extend the maturity of a debt obligation for two years is a modification, although it is an insubstantial modification as long as the original maturity of the debt instrument was at least four years.

[vii] Timing of a Modification

In general, if the lender and the borrower enter into an agreement to make changes in the terms of a debt instrument, and if the changes will constitute a modification, the modification occurs at the time the lender and the borrower enter into the agreement, even if the changes in the terms are not immediately effective. There are two exceptions to this rule. First, if the parties provide that the changes in the terms of the debt instrument are conditioned on reasonable closing conditions, the modification occurs on the closing of the agreement, with the result that if the closing does not occur because of the failure to satisfy the conditions, no modification occurs. n113 Second, if the change in a term of a debt instrument occurs pursuant to a plan of reorganization in a bankruptcy or similar case, the modification occurs upon the effective date of the plan. n114

[f] Significant Modifications

After adopting the approach of the Supreme Court in *Cottage Savings* to establish the definition of a modification, the Treasury Regulations generally adopted the position of the Service before the Supreme Court in that case to determine whether a modification is significant. The regulations provide that, as a general rule, a modification is significant only if the legal rights or obligations that are altered, and the degree to which they are altered, are "economically significant." n115 In general, other than modifications relating to changes in yield, timing of payments, identity of obligor or security, the nature of the debt (debt or equity; recourse or non-recourse), and accounting or financial covenants, all modifications to a debt instrument are considered collectively, so that a series of non-significant modifications may be significant when considered together. n116

[i] Changes in Yield

The regulations provide a bright-line test for determining whether a change in the yield of the debt instrument is a significant modification. The test is somewhat more generous than either prior administrative practice or the proposed regulations. The bright-line test applies to

debt instruments that provide only for fixed payments, debt instruments with alternative payment schedules subject to *Regulations Section 1.1272-1(c)*, n117 debt instruments that provide for a fixed yield subject to *Regulations Section 1.1272-1(d)* n118 and variable rate debt instruments.

Whether a change in the yield of other debt instruments is a significant modification (for example, if there is a change in the formula for determining contingent payments on a debt obligation calling for contingent payments of interest) is determined pursuant to the general rule requiring a determination of whether the changes are "economically significant".

The bright-line test for changes in yield is that a change in yield is a significant modification only if the yield of the new debt instrument varies from the yield of the old debt instrument by more than the greater of 25 basis points or 5 percent of the annual yield of the old debt instrument. n119 The 25 basis point test was carried over from the proposed regulations, which were viewed by many as being more generous than existing administrative practice. The new bright-line test based on the interest rate on the old bonds (5 percent of the yield on the old bonds) was intended to allow for *de minimis* modifications of the interest rate on higher yielding bonds where the change in interest rate might be quite small as a percentage of the yield on the bonds even though it is greater than 25 basis points.

Example:

For an obligation with a yield of 5 percent, a permitted 25 basis point increase would produce a yield of 5.25 percent (5 percent higher than the original yield). A smaller percentage increase in the yield of a mortgage loan with a higher yield (for example, a 4 percent increase that would increase the yield on an 8 percent obligation from 8 percent to 8.32 percent) would exceed the 25 basis point threshold, even though the economic significance of the change might be less for the 8 percent obligation than the 25 basis point change would be for the 5 percent obligation.

[ii] Changes in the Timing of Payments

The regulations provide that a modification changing the timing of payments due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. ⁿ¹²⁰ The regulations do not specifically address a change in the timing of payments that results in a material acceleration of scheduled payments; this is a change from the proposed regulations, which stated that a partial prepayment was not a significant modification. ⁿ¹²¹ The background information for the final regulations gives no explanation of the reason for this change.

The regulation also provides a bright-line safe harbor that a deferral of scheduled payments is not a material modification if the deferred payments are unconditionally payable no later than the end of a period beginning on the original due date of the first deferred payment and ending after a period equal to the lesser of five years or 50 percent of the original term of the instrument. ⁿ¹²² This safe harbor may not be a secure anchorage.

Example:

If, in the tenth year of a 20-year partially amortizing mortgage, the lender extended the due date for the balloon payment due at the end of the mortgage, so that it became due in 25 years rather than 20 years, the deferral would come within the safe harbor. However, if the lender, pursuant to the same mortgage, agreed in the 10th year to allow the borrower to skip one year's principal installment and extended the due date for the final principal payment by one year, the extension would not seem to fall within the safe harbor. ⁿ¹²³

[iii] Changes in Obligor

The regulations provide that, as a general rule, a change in the obligor is a significant modification. Several exceptions to this general rule are provided. First, the substitution of a new corporate obligor is not a significant modification if it occurs pursuant to a liquidation under Section 332 (a liquidation of an 80 percent owned subsidiary) or a reorganization described in subparagraphs A, C, D, F or G of Code Section 368(a)(1); if the transaction does not result in a change in the lender's "payment expectations"; and if the transaction does not result in a "significant alteration" (an alteration that would be a significant modification but for the fact that it occurs pursuant to the terms of the loan documents). ⁿ¹²⁴ A lender's payment expectations change if, as a result of the change, there is a substantial increase in the borrower's ability to pay the debt, and the change increases the borrower's ability from primarily speculative to adequate, or if there is a substantial decrease in the borrower's ability to pay the debt and the decrease changes that ability from adequate to primarily speculative. ⁿ¹²⁵

[iv] Certain Asset Acquisitions

The substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, provided that the transaction does not result in a change in payment expectations and does not result in a significant alteration. ⁿ¹²⁶

[v] Significant Alterations

The conclusion that certain of the foregoing changes in obligor do not constitute a significant modification depends in

part upon the conclusion that the transaction does not result in a "significant alteration." The regulations define the term significant alteration to mean an alteration (i.e., a deletion or addition in whole or in part of a legal right or obligation of the issuer or holder of a debt obligation) that would be a significant modification but for the fact that it occurs by operation of the terms of the instrument. n127 Understanding this provision requires a review of the basic structure of the regulations. In general, alterations are examined to determine whether they constitute modifications. Modifications are then examined to determine whether they are significant modifications. Certain alterations occurring pursuant to the terms of a debt instrument are not modifications (for example, a debt instrument might provide for a change in interest rate because of changes in prevailing index rates or in the value of the collateral securing the mortgage). Even though such a change occurring pursuant to the terms of the debt instrument would be an alteration that does not constitute a modification, if it did constitute a modification, the modification might be significant (for example, if the change violated the "change in yield" bright line test). Accordingly, if the debt instrument provided that the interest rate would automatically increase in the event of a corporate acquisition, and if the increase was a change in yield that was outside the change in yield bright-line, the interest rate change would be a significant alteration and would cause the substitution of an obligor to constitute a significant modification.

[vi] Other Rules Relating to Changes in the Obligor

The regulations provide that the substitution of a new obligor on a non-recourse debt instrument is not a significant modification. n128 On initial evaluation, this seems like a reasonable position--the lender on a non-recourse loan is depending on the value of the property and has no right to seek payment from other assets of the borrower, so a change in the identity of the borrower should not be material. However, not all borrowers are created equal. It is not uncommon for loan documents to prohibit the transfer of the property providing collateral security for a non-recourse loan without the consent of the lender. Lenders include such a provision in their loan documents because, even in the case of a non-recourse loan, the lender is relying to some extent on the track record and reputation of the borrower. One borrower ("Borrower A") may have the reputation of having a long-term view and may have the resources to maintain the quality of a rental building even during a slow rental market; another ("Borrower B") may be thinly capitalized and have a reputation for letting properties struggle and suffer during such a period. n129

[vii] Addition or Deletion of a Co-Obligor

The regulations provide that the addition or deletion of a co-obligor on a debt instrument is a significant modification if it results in a change in payment expectations or it is part of a series of transactions that results in a substitution of a new obligor. In the latter case, it is tested under the rules applicable to substitutions of obligors rather than the rules applicable to additions or deletion of co-obligors. n130

[viii] Changes in Security or Credit Enhancement

The regulations provide that a modification that releases, substitutes, adds or otherwise alters the collateral for, or a guarantee on or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations. Here also the distinction between an alteration that is not a modification and one that is a modification is important. For example, if a mortgage loan that is supported by a guarantee from an AA credit enhancer requires that the credit enhancer be replaced by an AAA credit enhancer under certain circumstances, such a change would be an alteration that is not a modification (because it occurs pursuant to the terms of the debt instrument) even if the change in credit enhancer resulted in a change in payment expectations. n131 However, if the change in credit enhancer was not provided for in the terms of the loan document, but instead was negotiated by the parties (thus constituting a modification), it would be a significant modification if it resulted in the change in payment expectations. n132

The regulations provide that a modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, or a guarantee on, or other form of credit enhancement for a non-recourse debt instrument is a

significant modification, except that a substitution of collateral is not a significant modification if the collateral is fungible (e.g., government securities); a substitution of a similar commercially available credit enhancement contract for existing credit enhancement is not a significant modification; n133 and the improvement of the property securing a non-recourse debt does not result in a significant modification. n134

[ix] Changes in Priority

A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations. n135

[x] Changes in Recourse Nature of a Debt Instrument

The regulations provide, in general, that a change in a debt instrument from recourse (or substantially recourse) to non-recourse (or substantially non-recourse) is a significant modification. For example, a legal defeasance of a recourse loan is a significant modification because, after the legal defeasance, the borrower no longer has any legal liability on the debt. There are two exceptions to this rule, one dealing with defeasance of tax exempt bonds, and the second dealing with a modification that changes a recourse debt to a non-recourse debt if (a) the debt continues to be secured only by the original collateral, and (b) the modification does not result in a change in payment expectations.

Example:

This latter exception should apply to a change in a loan from recourse during the construction period to non-recourse after the building receives a Certificate of Occupancy and achieves a stabilized specified revenue level, as long as the change to non-recourse does not result in a change in payment expectations. n136

A loan agreement well drafted by the lender will presumably not permit a change from recourse to non-recourse that results in a change in payment expectations.

[xi] Rules of Application

A transaction that implicates several provisions of the regulations must be tested under each of them. For example, a deferral of the maturity date of a zero coupon bond that changed both the yield and the timing of payments would have to be tested both under the section dealing with changes in yield and under the section dealing with deferrals of payments. If a modification would otherwise be covered by the bright-line tests or safe harbors for significance (i.e., those dealing with changes in yield, changes in timing of payments, changes in the obligor or security and changes in the nature of the debt instrument, such as from recourse to non-recourse), but is effective only upon the occurrence of a substantial contingency, the significance of the modification must be determined pursuant to the general rule of economic significance, rather than the specific bright-line tests and safe harbors. n137

[xii] Cumulative Effect and Aggregating

The regulations provide that modifications of different terms of a debt instrument, none of which separately would be a significant modification under any of the bright-line tests, do not need to be aggregated (except that in evaluating the significance of any particular modification, it is assumed that all of the other simultaneous modifications have already occurred). In contrast, two or more modifications of the same term of a debt instrument over a period of time must be aggregated to determine whether they would constitute a significant modification if they had been made as part of a single change. n138

[g] Substitutions of Debt Instruments Using Election Under Revenue Procedure 2001-21

[i] In General

In Revenue Procedure 2001-21, n138.1 the IRS has provided taxpayers with an optional election to treat certain debt substitutions as realization events, applicable to substitutions occurring on or after March 13, 2001. n138.2 The election is available when a taxpayer substitutes a newly issued debt instrument for an outstanding one. The election is available even though the substitution does not result in a significant modification under the regulations, n138.3 and is therefore not otherwise an exchange. n138.4

[ii] Background

A modification of a debt instrument is generally treated as a taxable exchange of the original instrument for the modified instrument only if the modification is significant. n138.5 The regulations provide rules to determine whether certain modifications, such as a change in the yield or timing of payments, constitute significant modifications. n138.6

A taxpayer may want to refinance and consolidate outstanding debt instruments in a way that increases the liquidity of the issuer's debt by concentrating more of the issuer's outstanding debt in a smaller number of issues. In general, if the terms of the newly issued debt are not materially different from the terms of the outstanding debt, substituting the newly issued debt for the outstanding debt does not result in a significant modification of the outstanding debt. Therefore, the substitution of the newly issued debt for the outstanding debt in the refinancing and consolidation is not a realization event for tax purposes. Some or all of the newly issued debt, however, may have original issue discount in varying amounts, depending upon the terms of the outstanding debt for which the newly issued debt was substituted. n138.7

[iii] Scope of Revenue Procedure 2001-21

The election under this *Revenue Procedure 2001-21* is available only if all of the following conditions are satisfied: n138.8

- Either (a) debt instruments from a single new issue ("new debt") are substituted for debt instruments from two or more outstanding issues of debt ("old debt"), or (b) debt instruments issued in a qualified reopening n138.9 ("new debt") are substituted for debt instruments from one or more outstanding issues of debt ("old debt").

- The substitution does not result in a significant modification of the old debt under the regulations. n138.10

This determination may be made either on the substitution date or on the date that is two business days before the date on which the substitution offer commences, provided that date is no more than 30 business days before the date on which the substitution offer ends.

- The new debt and the old debt are publicly traded.
- The old debt was issued at par, at a premium, or with less than a *de minimis* amount of original issue discount. n138.11
- The new debt is issued at par or with less than a *de minimis* amount of original issue discount or premium. For purposes of this condition, the issue price of the new debt is determined under Treas Reg § 2510.3-101, rather than under 29 CFR § 2510.3-101, and the *de minimis* amount for premium is determined using principles of Treas Reg § 1.1273-1(d).
- Neither the new debt nor the old debt is a contingent payment debt instrument, n138.12 a tax-exempt obligation, n138.13 or a convertible debt instrument. n138.14

- All payments on the old debt and the new debt are denominated in, or determined by reference to, US dollars, and the functional currency of the business unit issuing the new debt is the US dollar.
- The issuer and one or more holders of the old debt make the election provided for in *Revenue Procedure 2001-21*.

[iv] Making the Election

The issuers and holders make the election by agreeing in writing to treat the substitution in the manner specified in §§ 4.02 through 4.04 of *Revenue Procedure 2001-21*. The agreement must be entered into no later than the last day of the month in which the substitution occurs. The procedure gives several sample statements of election. n138.15 The issuer must attach a statement containing specified information about the old and new debt to its return for the taxable year in which the substitution occurs. n138.16

[v] Treatment of Substitution

If the election is made, the issuer and electing holders must report the substitution for tax purposes as a repurchase of the old debt in exchange for the new debt in the taxable year in which the substitution occurs. n138.17 The revenue procedure specifies the manner in which the issuer and electing holders must account for the deemed exchange. n138.18 Unless the new debt is issued in a qualified reopening, the issuer must take into account over the term of the new debt any difference between the adjusted issue prices of the old debt at the time of the substitution and the issue price of the new debt. If the aggregate issue price of the new debt that is transferred to electing holders as a substitute for the old debt is greater than the aggregate adjusted issue prices of the old debt for which it is substituted, the issuer treats the difference as a reduction in the aggregate issue price of the new debt. As a result, the difference is taken into account by the issuer over the term of the new debt as increased original issue discount or as reduced bond issuance premium. If the aggregate issue price of the new debt that is transferred to electing holders as a substitute for the old debt is less than the aggregate adjusted issue prices of the old debt for which it is substituted, the issuer treats the difference as an increase in the aggregate issue price of the new debt. As a result, the difference is taken into account by the issuer over the term of the new debt as reduced original issue discount or increased bond issuance premium. n138.19 If the new debt is issued in a qualified reopening, the issuer applies the above rules by using the remaining term of the new debt instead of the term of the new debt, and by using the adjusted issue price of the new debt immediately after the substitution instead of the issue price of the new debt. n138.20 Notwithstanding any other Code provisions that would otherwise apply (including *IRC* §§ 356(a) and 1276(a)), an electing holder does not recognize any gain or loss as a result of the deemed exchange. Instead, the holder's basis immediately after the substitution in the new debt is the same as the holder's adjusted basis (determined as of the date of the substitution) in the debt instruments for which the new debt was substituted. In addition, the holder's holding period for the new debt includes the holder's holding period for the old debt. n138.21

If the stated redemption price at maturity of the new debt n138.22 is greater than the holder's basis (immediately after the substitution) in the new debt, the holder treats the difference as market discount on the new debt and the new debt as a market discount bond, unless the discount is *de minimis*. n138.23 The treatment of market discount is governed under *IRC Sections 1276 and 1278*. n138.24 A different rule applies if, as of the date of the substitution, there is any accrued market discount on the old debt that has not been taken into account by the holder as ordinary income. If there is no market discount on the new debt or the amount of any market discount on the new debt is *de minimis*, the amount of accrued market discount on the new debt is zero, and the accrued market discount on the old debt is ignored. If the amount of market discount on the new debt is more than *de minimis*, the lesser of this market discount and the accrued market discount on the old debt is treated by the holder, as of the date of the substitution, as accrued market discount of the new debt. In addition, solely for purposes of determining the accruals of any additional market discount on the new

debt, the holder's basis is increased by the amount of the accrued market discount on the old debt that is treated as accrued market discount on the new debt. n138.25 If the holder's basis in the new debt (immediately after the substitution) is greater than the stated redemption price at maturity of the new debt n138.26 the holder treats the difference as bond premium on the new debt. n138.27

[h] Election to Defer Cancellation of Indebtedness Income from Reacquisition of a Debt Instrument

In response to the economic downturn and tight lending market in 2008 and 2009, Congress enacted a temporary provision that allows taxpayers to elect to defer cancellation of indebtedness income arising from a reacquisition of certain debt instruments after December 31, 2008, and before January 1, 2011. Income so deferred must be included in gross income of the taxpayer ratably over five years beginning four or five years after the reacquisition. n138.28 A taxpayer who makes the election must defer any otherwise allowable original discount deduction with respect to the newly issued instrument. n138.29 See Chapter 12 for a detailed discussion of the provision.

[6] Debt Securitizations--Flexibility Constraints

[a] Overview

A Real Estate Mortgage Investment Conduit, or "REMIC" is an entity created under *IRC Sections 860A-860G* to provide a tax structure within which real estate mortgages can be securitized. A REMIC is generally not subject to any federal income tax; instead, the income from the mortgages it holds is taxed to the holders of interests in the REMIC. n139 It may be necessary or desirable for the developer of a commercial real estate project to seek financing that would be eligible for inclusion in a REMIC. The securitization of a real estate mortgage results in a lower effective interest rate for the borrower than would be obtainable through a non-securitized financing, because the securitization process repackages the underlying real estate mortgages into separate securities with differing maturities and priorities. Because of their attractiveness to different categories of investors, the separate securities will have a lower aggregate interest cost than would a single conventional loan. However, a principal issue that must be faced by a borrower is whether the structural rigidity of the REMIC rules will outweigh the interest rate advantages of the use of a REMIC as a real estate financing technique.

This chapter will limit its analysis of the REMIC rules to some of the operational constraints a REMIC financing will impose on the owner of a commercial real estate project. n140 In greatly simplified form, the essential structural elements for a REMIC, and the essential characteristics of a mortgage loan to be securitized through a REMIC, are the following:

The interests in the REMIC must consist only of regular interests (which, in general, are taxed like debt instruments) and a single class of residual interest (which, in general, is taxed like an equity investment). n141 The regular interests in the REMIC must have fixed terms, be issued at the inception of the REMIC, and must not be materially modified at any time thereafter. n142 The assets held by the REMIC must be limited to: qualified real estate mortgages, permitted liquid investments as reserves or as temporary investments of cash flow, and property acquired in the event of foreclosure, default or imminent default on a qualified mortgage. n143 The qualified mortgages held by the REMIC generally must be acquired at the inception of the REMIC, or within a brief period thereafter, or as replacements for defective mortgages within a limited time after the formation of the REMIC. n144 In general, the qualified mortgages may not be materially modified at any time after their acquisition by the REMIC. n144.0.1 As will be seen, this last requirement may prove to be a significant restriction on the borrower. It should be noted, however, that regulations provide a number of exceptions under which changes in the terms of a mortgage are not treated as modifications. n144.0.2 In addition, the IRS has issued several revenue procedure "safe harbors", under which it will allow modifications of certain loans without challenging the tax status of the REMIC. n144.0.3 These procedures are discussed in detail in Chapter 16. It should also be noted that qualified mortgage obligations represent an increase in the principal amount under the original terms of an obligation, provided that increase: (1) is attributable to an advance made

to the obligor pursuant to the original terms of the obligation; (2) occurs after the REMIC startup day; and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. n144.1 The term also includes reverse mortgage loans and the periodic advances made to obligors on them. n144.2

[b] Limitations on Borrower

The REMIC qualification requirement that substantially all the assets of the REMIC must consist of "qualified mortgages" and "permitted investments" can limit the flexibility of the borrower under a REMIC-securitized mortgage to manage its real estate, by limiting the times and circumstances in which it can obtain the release of collateral in connection with a sale or other transaction with respect to the property, and will generally eliminate the ability of a borrower to renegotiate the terms of its mortgage if economic conditions change.

[i] Definition of Qualified Mortgage

A "qualified mortgage" is, generally, any obligation (including any participation or certificate of beneficial ownership therein) that is principally secured by an interest in real property and is transferred to the REMIC on the start-up date in exchange for regular or residual interests therein, or is transferred to the REMIC within three months after the start-up date in exchange for another obligation, or is transferred to the REMIC within two years after the start-up date in exchange for a defective obligation. Accordingly, a real estate mortgage otherwise constituting a "qualified mortgage" will not be a "qualified mortgage" if (with limited exceptions not applicable here) it is acquired by the REMIC after its start-up day. A substantial modification of a mortgage loan can cause a REMIC to be treated as acquiring a new mortgage loan on the date of the substantial modification.

Observation: This requirement can limit the flexibility of a borrower whose mortgage loan is securitized in a REMIC, for example, by preventing a borrower from obtaining the release of some real estate collateral by posting substitute real estate collateral.

[ii] Release of Collateral-Defeasance

A borrower in a multiple property real estate financing may need to be able to obtain the release of one or more of the properties in the collateral package (for example, because the collateral consists of a large number of properties and the borrower's normal business operations result in periodic property dispositions and acquisitions), while keeping the original financing in place secured by replacement collateral. The borrower will generally find that its financing costs will be higher for a loan that is prepayable than they will be for a loan that is not prepayable, but it may need to preserve its flexibility with respect to the collateral and have the ability to obtain a release of a portion of the original collateral. In a conventional multi-property loan, if the collateral properties are sufficiently homogenous, a borrower may be able to negotiate with the lender for the right to obtain the release of a portion of the original collateral by pledging substitute property as collateral, provided that the substitute property meets pre-specified underwriting criteria. With a non-securitized conventional loan, a borrower's ability to obtain these rights is limited primarily by the strength of its negotiating position, by its ability to develop with the lender satisfactory underwriting criteria for the replacement collateral, and by the parties' general desire to avoid causing a reissuance of the mortgage loan because of potential gain recognition and original issue discount/ cancellation of indebtedness income consequences. n145 In the context of a loan intended to be securitized in a REMIC, however, the borrower's flexibility is also constrained by the REMIC rules.

[iii] Restrictions Imposed in REMIC Documentation

The loan documents relating to a loan to be securitized through a REMIC will generally provide that the borrower will be entitled to defease the loan, in whole or in part, at any time after the later of (a) a negotiated number of years after the loan closing or (b) two years from the lender's securitizing the loan, if it delivers to the trustee sufficient secure liquid collateral such that the scheduled payments of principal and interest on the defeasance collateral will provide timely payment of all the remaining scheduled payments of principal and interest on the defeased portion of the loan. n146 If

the loan is a multi-property cross collateralized loan, the defeasance provisions will probably require that the defeasance collateral be a percentage (higher than 100%) of the portion of the outstanding loan principal allocated to the property being defeased.

Observation: Such a right to defease a portion of the loan will give the borrower the right to manage its property portfolio within the permitted time frame, but at a potentially significant cost if the opportunity to sell one of the properties occurs at a time when interest rates have declined, because of the increased cost of obtaining the defeasance collateral.

[iv] Required Legal Opinions

It can be expected that the loan documents will provide that, in connection with any such defeasance, the borrower will have to provide an opinion of counsel that the defeasance (i) will not adversely affect the federal income tax status of the REMIC pool in which the loan has been included (the "Non-disqualification Opinion") and (ii) will neither result in any "deemed" exchange pursuant to *IRC Section 1001* nor adversely affect the loan's status as indebtedness for federal income tax purposes. The first two of these concepts are specifically addressed in the Treasury Regulations and the third requires the application of reasonably well-established common law principles. It should be possible for a borrower to negotiate a defeasance right that is neither a reissuance of the underlying mortgage loan, nor a conversion of the mortgage loan into something other than true debt, and does not have an adverse impact on the status of the REMIC.

[v] Criteria for Defeasible Loans

First, the right to defease must be contained in the terms of the loan documents. Second, either the loan must not be a recourse loan, or the defeasance must not constitute a legal defeasance. n147 As is discussed in greater detail in § 19.03[5] above, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is generally not a modification, and if it is not a modification, it cannot be a significant modification that causes a "deemed" exchange. A legal conclusion that there has been no reissuance (and that the defeasance does not otherwise cause the loan to be treated as other than true debt for federal income tax purposes) will justify the giving of the tax opinions referred to above.

[vi] Exceptions

The rule that alterations occurring by operation of the terms of a debt instrument cannot constitute modifications contains exceptions potentially applicable to a defeasance. One exception is for an alteration that results in the substitution of a new obligor, or a change, in whole or in part, in the recourse nature of the instrument. The reissuance regulations provide that a legal defeasance of a recourse debt instrument (i.e., a defeasance transaction in which a recourse borrower is released from all liability to make payments on the debt instrument, including any obligation to contribute additional securities if necessary to provide sufficient funds to meet all scheduled payments on the instrument) is a change in the nature of a recourse debt instrument to a non-recourse debt instrument and constitutes a significant modification. n148 Accordingly, it is important for tax purposes that a multi-property loan as to which defeasance flexibility is required not be a recourse loan, or that the permitted defeasance not be a legal defeasance as described above. Rating agencies involved with a securitized mortgage may insist that the defeasance collateral be owned by a new special purpose entity, a step that may cause the defeasance to be treated as a legal defeasance.

Observation: There may be a conflict between a recourse borrower's business goals for a defeasance (which would lean towards a legal defeasance) and its tax goals (which may require that the defeasance not be a legal defeasance).

A second exception is for alterations resulting from the exercise of an option that is not unilateral, provided to an issuer or holder, to change a term in a debt instrument (and, in the case of options exercisable by a holder, only if the exercise of the option does not result in deferral of, or a reduction in, any scheduled payment of interest or principal). This

provision should not apply to a defeasance right as long as the exercise of the right does not give the lender any right to alter the debt; to require it to be paid; to "put" the debt to an affiliate of the borrower; a right to consent; or a right to a payment that is not fixed in the terms of the debt instrument and would make the borrower's right to defease something other than unilateral.

Observation: A borrower under a multi-property loan destined for securitization will, for both business and tax reasons, generally resist any requirement that consent be obtained for a defeasance, or that a fee be payable, unless the fee is *de minimis*, or fixed in or calculable from the terms of the loan documents.

[vii] REMIC Disqualification Analysis

The REMIC regulations specify the circumstances in which a defeasance will not have an adverse impact on the status of the REMIC. The release of a lien on real property securing a qualified mortgage will not cause the mortgage to cease to be a qualified mortgage on the date the lien is released if the mortgagor pledges substitute collateral consisting solely of government securities (as defined in Section (2)(a)(16) of the *Investment Company Act of 1940*); the mortgage documents allow such a substitution; the lien is released to facilitate the disposition of the property or any other customary commercial transaction and is not part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and the release does not occur within two years of the start-up date of the REMIC.

n149

[c] Partial Prepayment Alternative

The requirements set forth in the preceding paragraph should not be applicable to transactions in which a loan is prepaid or partially prepaid. Accordingly, an alternative strategy for a borrower who wishes to sell a portion of the mortgaged collateral would be to prepay a sufficient portion of the loan to obtain a release of the property. As is noted above, however, a borrower will generally pay an increased interest cost on a prepayable loan to compensate the lender for the reinvestment interest rate risk that would arise in the event of a prepayment. The REMIC statutory provisions and regulations do not address the consequences of the release of a lien by a REMIC as a result of the partial payoff of a mortgage loan. However, a partial or complete payoff of a mortgage loan is a transaction that will occur frequently in the ordinary course of business of a mortgage pool, and a partial or complete payoff of a mortgage loan will frequently be caused by a desire to obtain the release of the mortgage lien on all or a portion of the collateral. Accordingly, *Regulations Section 1.860G-2(a)(8)* should not be interpreted as applying to a release of collateral attributable to a partial prepayment, but should be viewed merely as a test for determining whether an obligation continues to be principally secured by real property if the lien on the original real estate collateral is released, and other collateral is pledged as substitute security. *Regulations Section 1.860G-2(a)(8)* imposes limits on the release of real property collateral securing a qualified mortgage at a time when the mortgage and the regular interests are not being prepaid, because the regulation limits the type of substitute collateral that may be pledged by the mortgagor without violating the "primarily secured by real property" requirement. In a partial or complete payoff of a qualified mortgage, the mortgagor will not need to pledge substitute collateral. A mortgage that has been paid off is no longer an asset of the REMIC. Under the final regulations, a prepayment should not be viewed as a significant modification because it does not generally have an economically significant effect on the remaining portion of the loan.

[7] Debt to Equity Conversions

[a] Background

The ultimate debt restructuring is a conversion of the debt into an equity interest in the collateral property or in the borrower. There remains some controversy concerning the issue of whether or not a conversion by a partnership creditor of its debt of the partnership into an equity interest in the partnership is an income recognition event. *IRC Sections 61(a)(12)* and *108* provide that, except as otherwise provided in subtitle A, gross income includes income from

discharge of indebtedness. The exclusions provided in *IRC Section 108* do not address the conversion of partnership indebtedness into partnership equity, although they do contain specific rules addressing the tax consequences of a contribution of corporate debt to the capital of a corporation or the satisfaction of corporate debt through the issuance of corporate stock to the creditor. n151 On the other hand, *IRC Section 721(a)* provides, without any exceptions, other than an exception for transactions involving partnership investment companies, that no gain or loss shall be recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

The foregoing analysis supports the conclusion that a partnership should not recognize cancellation of indebtedness income if a creditor transfers all or a portion n152 of the partnership's debt to the partnership in exchange for an equity interest in the partnership, n153 and receives a capital account interest in the partnership equal to the outstanding amount of the debt. The conversion may be an occasion on which the other partners may wish to have the partnership adjust their capital accounts to reflect the fair market value of the partnership's assets. n154 There may be a different result if the creditor receives a capital account that is *smaller* than the outstanding amount of the debt--under those circumstances, the argument against debt relief income may be weaker. n155

[b] Internal Revenue Service Position

The Service has been of two minds on this issue. *Compare* notice of proposed rule making CO-90-90, which states:

The Treasury Department intends to issue regulations designed to prevent the elimination of income from discharge of indebtedness in certain non-recognition transactions... . [T]he regulations to be issued will provide for recognition of income from discharge of indebtedness in these cases. Some of the non-recognition transactions to which the regulation will apply will include transactions described in Sections ... 721 The regulations to be issued will be effective for any transaction on or after March 21, 1991; n156

with *Notice 91-15* , which states:

Except to the extent described above [describing certain transactions not related to the subject under discussion] the preamble to proposed Section 1.108-2 and this notice do not affect the treatment of transactions in which debtor and creditor interests are combined. Until further guidance is issued, such transactions will be treated in accordance with current law. Thus, in general, the transfer of partnership debt to a partnership in exchange for a partnership interest is not within the scope of the preamble. n157

It should be noted that Service officials have stated publicly that the Service does not believe that there is a partnership equity for debt exception to the cancellation of indebtedness income rules. n158

[c] Analysis of Convertible Partnership Debt

At times when the available pool of funds for financing commercial real estate projects is in short supply, a developer may find that institutional lenders will lend only if they also receive a right to convert their debt into an equity interest in the borrower-partnership. The more speculative the project, the more likely it is that the lender will take this position. The borrower-partnership will have an additional basis to contend that the conversion of debt into partnership equity is not a taxable event under these circumstances. This non-recognition theory is based on the analysis contained in authorities dealing with convertible corporate debt, which hold that no gain is realized on conversion, without regard to whether the transaction would stand up as a recapitalization, on the theory that the equity interest into which the debt is converted was an element always existing in the debt. n159 The authorities in this area also provide that the holding period of stock acquired on conversion of convertible debt will include the holding period of the debt that was converted. n160 This "tacked on" holding period conclusion is based either on *IRC Section 1223(1)*, which provides that in determining the holding period for property received in an exchange, the period for which the exchanged property

was held shall be included if the property received has the same basis, in whole or in part, as the property exchanged, or on the theory that the equity is simply the continuation of the original investment, albeit in a different form.

FOOTNOTES:

(n1)Footnote 27. *PLR's 8708082 and 8626025* hold that a REIT can treat a loan secured by the borrower's interest in a partnership or joint venture as if it was secured by an allocable portion of the assets of the partnership or joint venture. Accordingly, under the theory of these private letter rulings, a loan secured by interests in a partnership that owns only real estate would be a qualified mortgage. However, the Service is reportedly reconsidering its position on this issue and has stopped issuing rulings. See Fass, Shaff and Zief, *Real Estate Investment Trust Handbook* at § 4.11[2][b] (West Group, 1999).

(n2)Footnote 28. The REMIC regulations define the terms "interests in real property" and "real property" for REMIC purposes by reference to the definitions of those terms in the REIT rules. *Treas Reg § 1.860G-2(a)(4)*, cross referencing *Treas Reg §§ 1.856-3(c)* and *-3(d)*. Both of these definitions are used for purposes of the definition of "qualified mortgage" within the meaning of *IRC § 860G(a)(3)* and "real estate assets" in *IRC § 856(c)(5)*.

(n3)Footnote 29. *Treas Reg § 1.856-3(g)*.

(n4)Footnote 30. *IRC §§ 465(b)(6)(d)(i); 49(a)(1)(D)(iv)(ii)*. See § 13.02.

(n5)Footnote 31. *IRC § 897(c)(1)(a)(ii)*.

(n6)Footnote 32. *IRC §§ 871(h); 881(c)*.

(n7)Footnote 33. *IRC §§ 1441; 1442*.

(n8)Footnote 34. *Treas Reg § 1.897-1(d)(3)*.

(n9)Footnote 35. *IRC § 871(h)(4)(A)(i)*.

(n10)Footnote 36. *IRC §§ 856(c)(2)* and *(3)* (income tests); *IRC § 856(f)(1)* (general rule excluding from the term "interest" amounts that depend in whole or in part on the income or profits of any person).

(n11)Footnote 37. Compare *IRC § 512(b)(1)* (excluding interest from gross income for purposes of determining unrelated business taxable income) with *IRC § 512(b)(3)(b)* (excluding rent from gross income for purposes of determining unrelated business taxable income only if the determination of rent does not depend in whole or in part on the income or profits from the property).

(n12)Footnote 38-39. *IRC § 163(f)*.

(n13)Footnote 40. *IRC § 871(h)(2)(B)*. See *IRC § 163(f)(1), (2)*; the Secretary may determine that the statement is not necessary in order to carry out the purposes of *IRC § 871(h)*.

(n14)Footnote 41. *Temp Treas Reg § 5f-1.103-1(c)* provides as follows:

"(1) General Rule. An obligation ... is in registered form if--(i) the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, [or] (ii) the right to the principal of and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) (as described in paragraph (c)(2) of this section)."

The cross referenced paragraph (c)(2) reads as follows:

"(2) Special rule for registration of a book entry obligation. An obligation should be considered transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. The book entry is a record of ownership that identifies the owner of an interest in the obligation."

(n15)Footnote 42. *IRC § 163(f)(2)(B)*.

(n16)Footnote 42.1. Pub Law No 111-147, § 502(f).

(n17)Footnote 42.2. *IRC §§ 163(f)(2)(B), 871(h)(2)(a), before repeal by Pub Law No 111-147, § 502*.

(n18)Footnote 42.3. Pub Law No 111-147, § 502(f).

(n19)Footnote 43. As to payments before January 1, 2001, see *Temp Treas Reg §§ 35A.9999-5(e)(A-21); (A-1) (A-8)*; and *Temp Treas Reg § 1.163-5 T(b)*; as to payments after December 31, 2000, see *Treas Reg § 1.871-14(d)*; see also *Notice 99-25, 1999-20 IRB 75 and TD 8856*.

(n20)Footnote 44. *Treas Reg § 301.7701-1(d)* defines a domestic entity as one "created or organized in the United States or under the law of the United States or of any state."

(n21)Footnote 45. *Treas Reg § 301.7701-3(a)*.

(n22)Footnote 46. *IRC §§ 141-150*.

(n23)Footnote 47. *IRC § 142(d)*.

(n24)Footnote 48. *IRC § 144(a)*.

(n25)Footnote 49. *IRC § 144(c)*. For a thorough discussion of the federal tax rules applicable to municipal bonds, see *National Association of Bond Lawyers, Federal Taxation of Municipal Bonds*.

(n26)Footnote 49.1. See *IRC § 142(a)(14)*.

(n27)Footnote 50. See *§ 19.03[5]*.

(n28)Footnote 51. *Treas Reg § 1.150-1(d)(2)(v)*. This regulation provides that if, within six months before or after a person assumes (or takes subject to) obligations of an unrelated party in connection with an asset acquisition, the assumed issue is refinanced, the refinancing issue is not treated as a refunding issue.

(n29)Footnote 52. *IRC §§ 146; 147(d)*.

(n30)Footnote 53. *IRC §§ 708(a); 708(b)(1)(B)*.

(n31)Footnote 54. Such a recharacterization might be possible if the funding for the redemption is contributed to the partnership or loaned to the partnership by the remaining partners, guaranteed by the remaining partners, etc. *IRC § 707(a)(2)(B)*.

(n32)Footnote 55. This conclusion follows from the fact that although there is an exception in the regulations for certain tax-free reorganizations, the reorganizations referred to in the exception include only corporate *asset* acquisitions (liquidations of subsidiaries, mergers, tax-free asset acquisitions, etc.)—the exception does not cover the tax-free acquisition of all of the stock of a corporation. If the regulation applied to a transaction in which the equity interests in

the owning entity are sold and the owning entity simultaneously refinances its tax-exempt bonds, there would be no exception for a tax-free stock acquisition, even though there clearly is an exception for all of the variations of tax-free asset acquisitions. This would not make any sense.

(n33)Footnote 56. *PLR 9823008* .

(n34)Footnote 57. *IRC §§ 1271-1275*.

(n35)Footnote 58. *IRC § 1271(a)(1)*.

(n36)Footnote 59. *IRC § 1271(a)(2)(A)*.

(n37)Footnote 60. Short-term obligations are obligations with an original maturity of not more than one year from date of issue obligations, on which an amount of gain realized equal to the ratable share of "acquisition discount" is treated as ordinary income. Because these rules apply only to short-term obligations, and primarily affect the holder of the indebtedness, not the issuer, they are not likely to be relevant in real estate finance transactions.

(n38)Footnote 61. *IRC § 1272*.

(n39)Footnote 62. *IRC § 163(e)(1)*. The exceptions include a deferral [*IRC § 163(e)(3)*] of the original issue discount deduction for obligations held by related foreign persons and limitations on the deduction of original issue discount on certain high yield obligations [*IRC § 163(e)(5)*]. Note that the restrictions related to certain high yield obligations are suspended for qualifying obligations issued from Sept 1, 2008 through Dec 31, 2010 [*IRC § 163(e)(5)(F)(i), (iii); Notice 2010-11, 2010-4 IRB 326*].

(n40)Footnote 63. Original issue discount of less than an amount equal to 1/4 of 1 percent of the stated redemption price at maturity times the number of complete years to maturity is de minimis. *IRC § 1273(a)(3)*.

(n41)Footnote 64. *IRC § 1273(a)(1)*.

(n42)Footnote 65. *IRC § 1274(d)*.

(n43)Footnote 66. *IRC §§ 1273(b)(4) and 1274(a)*.

(n44)Footnote 67. *IRC § 1273(a)(2); Treas Reg § 1.1273-1(c)*. The contingent interest regulations discussed below change the definition of "qualified stated interest" as a result of the establishment of the rules relating to remote and incidental contingencies, and the rules providing for alternative but fixed payment schedules. Accordingly, the former definition of qualified stated interest contained in former *Treas Reg § 1.1273-1(c)* "stated interest that is unconditionally payable... at least annually at a single fixed rate ..." is modified to provide that interest is only treated as unconditionally payable if reasonable legal remedies exist to compel payment, or the debt instrument otherwise contains terms and conditions that make the likelihood of late payments or non-payment remote. See Rev Rul 95-70, 1995-2 CB 124 , for an analysis of a loan that bears a penalty rate of interest on delinquent interest, and holding that such amounts are not unconditionally payable.

(n45)Footnote 68. *IRC § 1274A* provides special rules for certain smaller transactions, which would generally not be of any benefit to a real estate financing of any significant size.

(n46)Footnote 69. *IRC § 1275(d)*.

(n47)Footnote 70. For a discussion of a loan bearing contingent interest that was held to constitute equity, not debt, see, *Farley Realty Corp v. Commr*, TC Memo Dec 1959-93 (1959), *aff'd* 279 F2d 701 (2d Cir 1960) .

(n48)Footnote 71. Treasury Decision 8674 , published at 61 *Fed Reg* 30133 (June 14, 1996) , sometimes referred

to herein as the "Contingent Interest Regulations."

(n49)Footnote 72. See, e.g., *Treas Reg* § 1.1275-4(f).

(n50)Footnote 73. See *Utility Trailer Mfg Co v US*, 212 F Supp 773, (SD Ca 1962) (Accrual method taxpayer could not accrue and deduct inflation protection amounts that might be due at maturity of its notes as long as such amounts were still contingent).

(n51)Footnote 74. *Treas Reg* § 1.1275-4(b)(3).

(n52)Footnote 75. *Treas Reg* §§ 1.1275-4(b)(3)(i);-4(b)(4)(i).

(n53)Footnote 76. *Treas Reg* § 1.1275-4(b)(3)(ii).

(n54)Footnote 77. *Treas Reg* § 1.1275-4(b)(4)(ii).

(n55)Footnote 78. *Treas Reg* § 1.1275-4(b)(3)(iv).

(n56)Footnote 79. *Treas Reg* § 1.1275-4(b)(6).

(n57)Footnote 80. *Treas Reg* § 1.1275-4(b)(6)(ii).

(n58)Footnote 81. *Treas Reg* § 1.1275-4(b)(6)(iii).

(n59)Footnote 82. *Treas Reg* § 1.1275-4(b)(4).

(n60)Footnote 83. *Treas Reg* § 1.1275-4(b)(4)(v).

(n61)Footnote 84. *Treas Reg* § 1.1275-4(b)(4)(i)(B).

(n62)Footnote 85. *Treas Reg* § 1.1275-2(e).

(n63)Footnote 86. *Treas Reg* § 1.1275-4(b)(4)(iv).

(n64)Footnote 87. The preamble to the final Contingent Interest Regulations provides that, in general, taxpayers may use "any reasonable method" to account for contingent payments on debt instruments issued before August 13, 1996.

(n65)Footnote 88. *Treas Reg* § 1.1275-2(h)(1).

(n66)Footnote 89. *Treas Reg* § 1.1275-2(h)(2).

(n67)Footnote 90. *Treas Reg* § 1.1275-2(h)(3)(i).

(n68)Footnote 91. *Treas Reg* § 1.1275-2(h)(3)(ii).

(n69)Footnote 92. See, e.g., *Pierce Estates, Inc v Commr*, 195 F2d 475 (3d Cir 1952) ; *Utility Trailer Mfg Co v US*, 212 F Supp 773 (SD Ca 1962) .

(n70)Footnote 93. *Treas Reg* § 1.1275-4(c).

(n71)Footnote 94. *Treas Reg* § 1.1274-2(c)(2).

(n72)Footnote 95. *Temp Treas Reg* § 1.1275-2T(g).

(n73)Footnote 96. *Treas Reg* § 1.1275-2(g).

(n74)Footnote 97. *Treas Reg* § 1.1275-2(g)(2).

(n75)Footnote 98. *Treas Reg* § 1.1275-2(j).

(n76)Footnote 99. See, e.g., *Rev Rul* 79-262, 1979-2 CB 33 (change in obligor); *Rev Rul* 77-416, 1977-2 CB 34 (addition of substitute collateral); and *Rev Rul* 81-281, 1981-2 CB 18 (reduction in principal amount, increase in interest rate and change in maturity date).

(n77)Footnote 100. 499 US 554 (1991) .

(n78)Footnote 101. *Treas Reg* § 1.1001-3. The final regulations apply to modifications to debt instruments on or after Sept 24, 1996, although taxpayers could rely on them for modifications occurring after Dec 2, 1992 [*Treas Reg* § 1.1001-3(h)]. December 2, 1992 was the date on which the reissuance regulations were first proposed. It isn't clear why the Service chose not to allow taxpayers to rely on the final regulations for prior transactions, whenever occurring. One reason might have been the recognition that this would be a one-way street; it would not be appropriate for the Service to require taxpayers to follow the regulations for periods before their proposal, because there was more favorable prior administrative authority, and the language used by the Supreme Court in the *Cottage Savings* case created substantial confusion. Alternatively, in view of the fact that the statute of limitations on 1992 restructurings for calendar year taxpayers would generally be expiring during 1996 (unless consents extending those statutes of limitations have been executed by the taxpayer and the government), it may be that this statement has as its background a decision by the Service that it will not pursue pre-1993 cases and that it does not expect or want to facilitate any refund claims for pre-1993 cases. In any event, this issue is one that has an audit focus, not a planning focus.

(n79)Footnote 102. This could result either because the lender has taken a charge-off with respect to the debt, based on partial worthlessness, or because the lender acquired the debt in the secondary market, at a discount. Regulations address the problems of the lender who has taken a partial bad debt writeoff, but not the problems of a holder who purchased at a discount. *Treas Reg* § 1.166-3(a)(3).

(n80)Footnote 103. *Treas Reg* § 1.1001-1(g)(1).

(n81)Footnote 104. *Treas Reg* § 1.1001-1(g)(1) appears, in the context of cash method taxpayers, to be in conflict with the statute. *IRC* § 1001(b) states that "the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." This inconsistency exists only in the case of lenders on the cash method of accounting, because it is well established that the accrual concepts of the accrual method of accounting override this provision. *Rev Rul* 89-122, 1989-2 CB 200 , clarifying *Rev Rul* 79-292, 1979-2 CB 287 .

(n82)Footnote 105. *Treas Reg* § 1.1001-3(a)(1).

(n83)Footnote 106. *Treas Reg* § 1.1001-3(c)(1)(i).

(n84)Footnote 107. *Treas Reg* § 1.1001-3(c)(2).

(n85)Footnote 108. *Treas Reg* § 1.1001-3(c)(2)(i).

(n86)Footnote 109. This conclusion does not apply to the holder's exercise of a conversion right in the debt instrument.

(n87)Footnote 110. *Treas Reg* §§ 1.1001-3(c)(2)(ii); -3(e)(5). This general rule does not apply if the modification is or includes the substitution of a new obligor or the addition or deletion of a co-obligor.

(n88)Footnote 111. *Treas Reg § 1.1001-3(c)(4)*.

(n89)Footnote 112. It is not clear whether a waiver of the imposition of a default interest rate is part of a permitted forbearance, or a potentially prohibited change in yield. In view of the fact that the imposition of a default interest rate is a common financing term, but is probably not normally factored into the yield analysis of a proposed transaction, and that the purpose of the forbearance rule seems to be to facilitate workouts, the waiver of a default rate of interest should not be viewed as a change in yield. This interpretation is consistent with the conclusion in *Treas Reg § 1.1001-3(e)(2)(iii)(B)* that the payment of a commercially reasonable prepayment penalty is not taken into account in determining yield.

(n90)Footnote 113. *Treas Reg § 1.1001-3(c)(6)(ii)*. Query--if the closing conditions are all satisfied in advance of the closing, does the modification occur at the time the last condition is satisfied or is it delayed until closing? The Treasury Regulation seems to contemplate the latter. Additional query--Since an agreement between a lender and a borrower to extend the term of a debt obligation is a modification occurring at the time of the agreement, is there a different result if the lender agrees at some time prior to maturity to refinance a loan at its maturity? Does the mere agreement to refinance constitute a modification of the old debt at the time the commitment is entered into? If the lender's obligation to refinance is subject to reasonable closing conditions, such as the requirement that the borrower's financial condition satisfy certain ratios, is the problem eliminated?

(n91)Footnote 114. Query--if a prepackaged bankruptcy [a bankruptcy in which the agreement of a majority of the creditors is obtained prior to the filing of the bankruptcy petition and the reorganization plan] changes the terms of a debt obligation, does the modification occur on the date the agreement with the majority of the creditors is obtained, or only on the date of the subsequent approval of the plan by the bankruptcy court? It would seem that the effective date of the modification should be the date of the confirmation of the plan even in the context of a "prepackaged" bankruptcy, because of the bankruptcy court's obligation to confirm that the disclosure of the terms of the plan was adequate, that the plan satisfies the requirements of the Bankruptcy Code, and otherwise prevent the plan from becoming final at an earlier date.

(n92)Footnote 115. *Treas Reg § 1.1001-3(e)(1)*.

(n93)Footnote 116. *Id.*

(n94)Footnote 117. This section applies to debt instruments providing for alternative schedules applicable on the occurrence of contingencies, but only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date.

(n95)Footnote 118. This section applies to debt instruments that provide for principal payments fixed in amount but uncertain as to time.

(n96)Footnote 119. *Treas Reg § 1.1001-3(e)(2)(ii)*.

(n97)Footnote 120. *Treas Reg § 1.1001-3(e)(3)(i)*.

(n98)Footnote 121. *Prop. Treas Reg § 1.1001-3(e)(2)(iii)*.

(n99)Footnote 122. *Treas Reg § 1.1001-3(e)(3)(ii)*.

(n100)Footnote 123. If the annual principal installments were due on the last day of the year, the five-year safe harbor period would begin on the last day of the tenth year and end on the last day of the fifteenth year. The deferred payments would not be unconditionally payable within this safe harbor period whether the transaction was viewed as deferring the due date for the tenth year's payment and each annual payment thereafter by one year (because under that analysis the payments scheduled to be made in years 15 through 20 would not be made within the safe harbor period

even though each of them was deferred for only one year) or whether the transaction is analyzed as the deferral of the year ten payment to year 21.

(n101)Footnote 124. *Treas Reg § 1.1001-3(e)(4)*.

(n102)Footnote 125. *Treas Reg § 1.1001-3(e)(4)(vi)*.

(n103)Footnote 126. *Treas Reg § 1.1001-3(e)(4)(i)(C)*. The regulations also provide rules specifying when the substitution of a new obligor on a tax-exempt bond will not be treated as a significant modification; rules dealing with elections under *IRC § 338* to treat stock purchases as asset purchases; and rules dealing with bankruptcy proceedings, namely, that the filing of a petition in itself does not result in the substitution of a new obligor.

(n104)Footnote 127. *Treas Reg § 1.1001-3(e)(4)(i)(E)*.

(n105)Footnote 128. *Treas Reg § 1.1001-3(e)(4)(ii)*.

(n106)Footnote 129. Query--would a lender who had failed to include a transfer restriction in the mortgage documents for its loan to Borrower A feel that there had been no "economically significant" alteration in its position as a result of a transfer of the property from Borrower A to Borrower B?

(n107)Footnote 130. *Treas Reg § 1.1001-3(e)(4)(iii)*.

(n108)Footnote 131. *Treas Reg § 1.1001-3(c)(1)(ii)*.

(n109)Footnote 132. *Treas Reg § 1.1001-3(e)(4)(iv)*.

(n110)Footnote 133. Query whether there would be a significant modification if the AA rated credit enhancement on a non-recourse loan was replaced by a guarantee from the borrower's AA rated affiliate, if the affiliate was not in the business of extending credit enhancement so that its guarantee might not be considered to be "commercially available".

(n111)Footnote 134. *Treas Reg § 1.1001-3(e)(4)(iv)(B)*. For example, a construction loan is not substantially modified with each day's progress during the construction period.

(n112)Footnote 135. *Treas Reg § 1.1001-3(e)(5)(ii)*.

(n113)Footnote 136. *Id.*

(n114)Footnote 137. *Treas Reg § 1.001-3(f)*.

(n115)Footnote 138. Compare *Treas Reg § 1.1001-3(f)(3)* with *Treas Reg § 1.1001-3(f)(4)*.

(n116)Footnote 138.1. *Rev Proc 2001-21, 2001-9 IRB 742*.

(n117)Footnote 138.2. For substitutions occurring on prior dates, see *Rev Proc 99-18, 1999-1 CB 736*.

(n118)Footnote 138.3. See *Treas Reg § 1.1001-3*.

(n119)Footnote 138.4. See *Treas Reg § 1.1001-1(a)*.

(n120)Footnote 138.5. *Treas Reg § 1.1001-3(b)*.

(n121)Footnote 138.6. *Treas Reg § 1.1001-3(e)*.

(n122)Footnote 138.7. *Treas Reg § 1.1275-2(j)*; see [f], above, for a general discussion of significant modifications

in debt restructurings.

(n123)Footnote 138.8. *Rev Proc 2001-21* , § 3, 2001-9 IRB 742

(n124)Footnote 138.9. See *Treas Reg* § 1.1275-2.

(n125)Footnote 138.10. See *Treas Reg* § 1.1001-3.

(n126)Footnote 138.11. See *Treas Reg* § 1.1273-1(d).

(n127)Footnote 138.12. See *Treas Reg* § 1.1275-4.

(n128)Footnote 138.13. See *IRC* § 1275(a)(3).

(n129)Footnote 138.14. See *Treas Reg* § 1.1272-1(e).

(n130)Footnote 138.15. *Rev Proc 2001-21* , § 4.01, 2001-9 IRB 742 .

(n131)Footnote 138.16. *Rev Proc 2001-21* , § 4.01(2), 2001-9 IRB 742 .

(n132)Footnote 138.17. *Rev Proc 2001-21* , § 4.02, 2001-9 IRB 742 .

(n133)Footnote 138.18. *Rev Proc 2001-21* , §§ 4.03, 4.04, 2001-9 IRB 742 .

(n134)Footnote 138.19. *Rev Proc 2001-21* , § 4.03(1), 2001-9 IRB 742 .

(n135)Footnote 138.20. *Rev Proc 2001-21* , § 4.03(2), 2001-9 IRB 742 .

(n136)Footnote 138.21. *Rev Proc 2001-21* , § 4.04(1), 2001-9 IRB 742 .

(n137)Footnote 138.22. See *Treas Reg* § 1.1273-1(b).

(n138)Footnote 138.23. See *IRC* § 1278(a)(2)(C).

(n139)Footnote 138.24. *Rev Proc 2001-21* , § 4.04(2)(a), 2001-9 IRB 742 .

(n140)Footnote 138.25. *Rev Proc 2001-21* , § 4.04(2)(b), 2001-9 IRB 742 .

(n141)Footnote 138.26. See *Treas Reg* § 1.1273-1(b).

(n142)Footnote 138.27. *Rev Proc 2001-21* , § 4.04(3), 2001-9 IRB 742 ; see *Treas Reg* §§ 1.171-1 through 1.171-5 for treatment of bond premium.

(n143)Footnote 138.28. *IRC* § 108(i).

(n144)Footnote 138.29. *IRC* § 108(i)(2).

(n145)Footnote 139. *IRC* § 860A; but see *IRC* § 860F(a), which imposes a tax on certain prohibited transactions.

(n146)Footnote 140. For a thorough discussion of the taxation of REMICs, see J. Peaslee and D. Nirenberg, *The Federal Income Taxation of Mortgage-Backed Securities* (1994).

(n147)Footnote 141. *IRC* § 860A(a).

(n148)Footnote 142. *IRC* § 860G(a).

(n149)Footnote 143. *IRC § 860D(a)(4)*.

(n150)Footnote 144. *IRC § 860G(a)(3)*.

(n151)Footnote 144.0.1. *Treas Reg § 1.860G-2(b)(1)*.

(n152)Footnote 144.0.2. *Treas Reg § 1.860G-2(b)(3)*.

(n153)Footnote 144.0.3. *Rev Proc 2009-45, 2009-40 IRB 471 ; Rev Proc 2007-72, 2007-52 IRB 1257 ; Rev Proc 2008-47, 2008-31 IB 272; Rev Proc 2008-28, 2008-23 IRB 1054 .*

(n154)Footnote 144.1. *IRC § 860G(a)(3)(A)(iii)*, effective Jan 1, 2005.

(n155)Footnote 144.2. *IRC § 860G(a)(3)*. See Chapter 16 for a detailed discussion of REMICs.

(n156)Footnote 145. If the terms of a debt instrument are changed, and if the change results in a "significant modification", the lender may recognize gain or loss, and the borrower may recognize cancellation of indebtedness income coupled with ultimately offsetting original issue discount. See § 19.03[5][d], above.

(n157)Footnote 146. These requirements have their origin in *Treas Reg § 1.860G-2(a)(8)*.

(n158)Footnote 147. Note that with a *de facto* defeasance, the borrower will remain legally liable on the defeased debt, and must include the earnings on the defeasance fund in its income and will generally be able to deduct the interest paid on the defeased debt. A borrower that legally defeases a loan may be able to claim a deduction for a debt prepayment premium with respect to any excess of the cost of the defeasance collateral over the outstanding balance of the loan, and will no longer have to account for either the earnings on the defeasance collateral or the interest on the defeased debt.

(n159)Footnote 148. *Treas Reg § 1.1001-3(e)(5)*.

(n160)Footnote 149. *Treas Reg § 1.860G-2(a)(8)*. There are also certain exceptions in the REMIC regulations under which events that would otherwise constitute a significant modification under *IRC § 1001* are not treated as a reissuance under the REMIC rules (*Reg § 1.860G-2(b)(3)*). These events are (i) changes in the terms of the obligation occasioned by a default (or a reasonably foreseeable default); (ii) the assumption of the obligation; (iii) the waiver of a due-on-sale clause or a due-on-encumbrance clause; and (iv) the conversion of the interest rate by a mortgage pursuant to the terms of a convertible mortgage. These exceptions are not particularly relevant to a defeasance.

(n161)Footnote 150. Partial prepayments are not modifications under other Code provisions. Under the original issue discount rules, a partial prepayment does not result in the creation of a new instrument. *Treas Reg § 1.1275-2(f)* provides that "pro rata prepayments" (payments which are not made pursuant to the instrument's payment schedule and which result in a substantially pro rata reduction of each payment remaining to be paid on the instrument) are treated as payments in retirement of a portion of a debt instrument, which may result in gain or loss to the holder. However, this gain or loss is determined by assuming that the original debt instrument consisted of two instruments--one that is retired and one that remains outstanding. If a portion of the instrument is treated as remaining outstanding, it should not be treated as a new instrument resulting from a modification. This approach was also adopted in *Treas Reg § 1.446-2(e)(4)*, which provides rules for allocating interest to prepayments.

(n162)Footnote 151. *IRC §§ 108(e)(6); 108(e)(8)*.

(n163)Footnote 152. The lender and the partners of the borrower may wish to keep a portion of the debt alive. In many instances a conversion of partnership debt into equity is under consideration at a time when the partnership is in economic difficulty and the partners' capital accounts in the partnership are negative. From the lender's position, keeping a portion of the debt alive may preserve its priority *vis-a-vis* other creditors of the partnership. From the

perspective of the partners of the borrower, it may be necessary to preserve a portion of the indebtedness as debt in order to avoid income under *IRC* § 752 as a result of a reduction in the partnership's liabilities.

(n164)Footnote 153. There may be an exception to this conclusion if the initial consideration creating the obligation would not have qualified for non-recognition treatment if it had been contributed directly to the partnership in exchange for a partnership interest, for example, if the debt was issued for services rendered.

(n165)Footnote 154. *Treas Reg* § 1.704-1(b)(2)(iv)(f).

(n166)Footnote 155. See *Treas Reg* § 1.721-1(b)(1), which provides that the non-recognition provisions of *IRC* § 721 do not always apply when a partner gives up a part of its capital account in favor of another partner. This provision could apply by analogy, if the creditor receives a capital account that is smaller than the outstanding amount of the debt.

(n167)Footnote 156. *1991-1 CB* 774, 777 .

(n168)Footnote 157. *1991-1 CB* 319 . The tax consequences of converting partnership debt to equity have not been the subject of administrative interpretation by the Internal Revenue Service. The Service has refused to rule on whether the statutory provisions applicable to corporations in this area also apply to partnerships. *PLR 8444069* and *PLR 8117210* . Any future regulations addressing this area will apply only on a prospective basis. *Notice 91-15* .

(n169)Footnote 158. Remarks of James Sowell, attorney-advisor, Treasury Office of Tax Legislation Counsel, reported in *Tax Notes*, Oct 25, 1999, at p.428.

(n170)Footnote 159. *Rev Rul* 72-265, *1972-1 CB* 222 .

(n171)Footnote 160. *Rev Rul* 62-140, *1962-2 CB* 181 ; amplified by *Rev Rul* 85-164, *1985-2 CB* 117 .

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Federal Taxes Affecting Real Estate

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CHAPTER 19 Financing Commercial Real Estate Transactions *

2-19 Federal Taxes Affecting Real Estate § 19.04

§ 19.04 Governmental Subsidies

[1] In General

Many real estate developers will be designing projects for tenants who have a significant degree of locational flexibility, and who are thus able to use the prospect of the new jobs and other community economic benefits that will result from the project as a carrot when negotiating for various types of governmental subsidies for their project. For example, a tenant looking for a major block of office space in the New York Metropolitan area can realistically consider Manhattan, certain other New York City boroughs, Westchester or Nassau Counties in New York, Fairfield County, Connecticut, and New Jersey. Since real estate developers are generally competing for key tenants in the same way that municipalities may be competing for those same tenants, the real estate developer must explore the possibility of qualifying a project for the maximum amount of government subsidies in order to be able to present a project to a tenant at the lowest cost to the tenant. A developer could work with economic development authorities and other municipal entities to piece together the available public contributions to the project. These would include grants, low-rental-cost land, low-cost energy, reduction or abatement of various city and state taxes, and federally tax-exempt or federally taxable but state tax-exempt financing. For example, financing is available through the New York Industrial Development Agency for projects that would not qualify for federally tax-exempt financing, but would offer a state and city income tax exemption, and exemption from mortgage recording tax, state sales tax and real property tax. In addition, a Business Improvement District may be formed to issue bonds exempt from federal, state and city income taxes to finance certain infrastructure costs to be repaid from the proceeds of a district charge on the property owners in the district.

As regards several of the most visible recent large scale publicly-supported projects (or proposed projects in the New York metropolitan area), the basic public financing packages included (or would include) as follows:

Yankee Stadium. The New York City proposal would use commercial Rent and Occupancy Tax revenues to pay the City's portion of the construction cost. This tax is in a phase-out stage in 1999; the New York City proposal would delay the phase-out and use the tax revenues to pay the City's contribution to the stadium construction.

USTA National Tennis Center. This project was financed with a \$150 million insured civic facility revenue bond issued by the New York City IDA in 1994. The Tennis Center bonds may have been Section 501(c)(3) bonds (the USTA National Tennis Center, Inc., is a Section 501(c)(3) organization) and the facility financed by the bond issue is a public

recreational facility for most of the year.

Times Square/Disney. A package of public assistance was put together for this project, including tax abatements, city grants, low-interest city loans, municipal acquisition of sites made available to the projects, sales tax savings on sales taxes payable on tangible personal property going into the project, etc.

Other projects may be eligible for government subsidies because the project fulfills a governmental purpose, such as low-income housing. As an example of such specifically targeted governmental subsidies, New York City provides Section 421-A "negotiable certificates" to developers of low income housing in certain parts of the City. The negotiable certificates can be transferred to other market rate residential projects, resulting in a real estate tax abatement for the transferee project. Partnerships that construct low income housing and receive negotiable certificates generally have not treated the award of the negotiable certificates as an income recognition event and also have not allocated any portion of the cost of the building to the negotiable certificates. This conclusion is not mandated by any explicit Code provision, and the Code does provide that gross income means "all income from whatever source derived", unless otherwise excluded by law.ⁿ¹⁶¹ However, the conclusion that the subsidy is not income has firm policy foundations and is supported by a substantial body of case law. As noted below in more detail, however, the IRS takes a contrary position.ⁿ¹⁶²

Municipal subsidies that are a reimbursement for capital expenditures should not be income to the recipient but instead should be treated as capital contributions.ⁿ¹⁶³ The gross income exclusion under the *Cuba Railroad* theory requires that the subsidy become a permanent part of the transferee's capital structure; that the subsidy not be compensation for a specific service provided by the transferee to the transferor; that the contribution must be bargained for (presumably it is the "bargaining for" that restricts the grant to capital uses); that the contribution must be expected to benefit the recipient in an amount that approximates its value (perhaps to buttress the requirement that the grant is not compensation for specific services); and that the grant must ordinarily be used to generate additional income (buttressing the dedication of the grant to capital and presumably prohibiting use of the grant as a source for distributions to owners).

Government subsidies given to replace lost income, permitted to be used to subsidize operating expenses (or distributed to the owners of the enterprise), are *currently taxable*.ⁿ¹⁶⁴ However, the taxpayer does not receive any basis in the government subsidy, and therefore cannot, for example, depreciate it.ⁿ¹⁶⁵

Governmental incentives for businesses to relocate, or for investors to develop real estate in particular locations, have increased in popularity and proliferated in many state and local jurisdictions in recent years. Incentive programs range from direct subsidy payments to financing assistance, infrastructure development, and site development and relocation subsidies. These programs generally have the goal of providing assistance to businesses for the purpose of promoting economic development in the community. In the case of real estate projects, "soft subsidies" in the form of job training programs are generally of less benefit than programs oriented toward reducing the cost for the business of locating or remaining in the community. Incentive payments for the owners and developers of real estate can take many forms. These payments have evolved from simple contributions of cash or property, to low-interest or no-interest long-term subordinated indebtedness, to "tax increment financing" (TIF).

As the incentive programs have evolved, the case law and Internal Revenue Code on the tax treatment of payments under them have likewise evolved, but in a slower and more reactive fashion. As with other areas, the response has generally been limited by the need to address the income tax issues within the framework of case law and Code provisions that developed without regard to the underlying purpose of the incentive programs. In some cases, the amounts received can be excluded from gross income by a specific Code provision, e.g., *IRC Section 118*, if the payment qualifies as a contribution to the capital of a corporation. In other cases, the taxpayer must rely on case law developed to address other issues. The details of government incentives differ dramatically, so the tax effect of any particular program cannot be predicted with absolute certainty. This is especially true for non-corporate taxpayers such

as partnerships and LLCs. n165.1

[2] Statutory Framework for Treatment of Governmental Incentives

The core statutes affecting taxation of governmental incentives for corporations are *IRC Sections 118* and *362(c)*. *IRC Section 118(a)* excludes from gross income of a corporation any contribution to the corporation's capital. Regulations clarify that Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of the land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for the goods and services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. n165.2

To prevent a corporation from gaining a basis in assets acquired from a tax-free contribution, any property other than money that is acquired as a contribution to capital (other than property contributed by a shareholder as a contribution to capital) is given a zero basis. n165.3 A separate rule applies to money received by a corporation as a contribution to capital (other than money contributed by a shareholder as a contribution to capital). The basis of any property acquired with that money during the 12-month period beginning on the date the contribution is received must be reduced by the amount of the contribution. The excess of any money so contributed over the amount of that reduction must be applied to reduce the basis of other property held by the taxpayer, n165.4

It is not always clear whether a particular item is a contribution to capital. An early case dealing with whether a payment should be excluded from basis (and not whether the payment was gross income) is routinely cited and used to determine whether a payment is a "capital contribution" under *IRC Section 118*. n165.5 The case sets forth five factors (looking at the contributor's motive) to determine if a payment is a capital contribution: n165.6

- (1) the payment must become a permanent part of the transferee's working capital;
- (2) the payment must not constitute compensation for a specific service provided to the transferor;
- (3) the payment must be bargained for;
- (4) the asset transferred or acquired with the payment must benefit the transferee with a value commensurate with its cost; and
- (5) the asset transferred or acquired must ordinarily be employed in or contribute to the production of additional income.

The focus of the five factors is on the absence of specific *quid pro quo* services provided in exchange for the contribution, and the presence of a meaningful and long-term benefit to the transferor. In most cases the key factor appears to be whether the payment constitutes compensation for a specific service provided to the transferor. n165.7 The five-factor test gives corporate taxpayers some certainty as to whether a government subsidy or grant will be gross income upon receipt.

[3] Tax Principles Relating to Below-Market Interest Loans

Separate provisions apply to below-market loans. Because the focus of current economic subsidies is to reduce the costs to business of moving to, or remaining in, a community, a frequent mechanism used by state and local governments is financing with an interest rate that is significantly below the market rate of interest. This type of assistance generally takes the form of a deeply subordinated and very long-term maturity loan by the governmental entity to the taxpayer.

IRC Section 7872 governs the tax treatment of below-market interest rate loans between taxpayers. *IRC Section 7872* was enacted to correct perceived abuses in the use of loans that have a zero or significantly below market interest rate. Generally, *IRC Section 7872* operates to impute interest income to the lender and a constructive cash transfer to the borrower, consistent with the form and purpose of the transaction, so as to give tax effect to the substance of the borrowing arrangement. In the case of a term loan, the borrower is treated as having received an amount from the lender, on the date the loan was made, equal to the excess of the amount loaned over the present value of all payments required under the terms of the loan. n165.8 In addition, a below-market term loan is treated as having original issue discount in an amount equal to the imputed transfer, in addition to any other OID on the loan determined without regard to *IRC Section 7872(b)(1)*. n165.9

The IRS is authorized to apply the Section 7872 rules to any loan having a significant effect on the tax liability of the lender or the borrower. n165.10 Obviously, a long-term,.05-percent interest rate loan from a government entity provides a significant subsidy to the borrower in the form of a lower cost of capital for the funds provided by the loan.

Temporary regulations provide an exception from the rules of *IRC Section 7872* in the case of loans subsidized by the federal, state (including the District of Columbia), or municipal government (or any agency or instrumentality thereof), and which are made available under a program of general application to the public. n165.11 If a taxpayer structures a transaction as a loan exempt under the temporary regulations, n165.12 and one of the principal purposes for doing so is the avoidance of federal tax, then the transaction can be recharacterized as a tax avoidance loan under *IRC Section 7872(c)(1)(D)*. n165.13 The legislative history of *IRC Section 7872* indicates that most government-subsidized loans, such as government-insured residential mortgage loans, were intended to be exempt from Section 7872, n165.14 and the IRS has applied the provision in a manner consistent with its legislative history. n165.15

The use of subsidized financing in the case of projects eligible for the low-income housing tax credit can affect the amount of the income tax basis of the property otherwise eligible for the credit. Effective for buildings placed in service after July 30, 2008, a federal subsidy includes only obligations the interest on which is exempt from tax under *IRC Section 103*. Thus, for these buildings, only the use of proceeds from a tax-exempt obligation can affect the amount of basis eligible for the credit. n165.15.1 For buildings placed in service before July 31, 2008, any below-market federal loan can reduce the basis eligible for the credit. n165.15.2 For these buildings, if the proceeds of an obligation funded in whole or in part with federal funds are or were used (directly or indirectly) with respect to new construction or a substantial rehabilitation, and the interest rate is below the applicable federal rate, then, the owner of the property generally must either reduce the basis eligible for the low-income housing tax credit by the amount of any federally subsidized financing, or compute the low-income housing tax credit based on a 30-percent present value on the entire cost of construction and/or rehabilitation. n165.16

[4] Taxation of Common Developer Incentives

[a] Government Grants

Generally, this form of incentive involves direct cash grants to the project, grants which take the form of contributions of property, or infrastructure development for property to be acquired by, or adjacent to property to be developed by the private entity. Assuming the five-factor test of the *Chicago, Burlington & Quincy Railroad* case can be met, n165.17 these types of grants ordinarily may be excluded from a corporate taxpayer's income. n165.18

The IRS has ruled in this area both publicly and privately. It has ruled that money received from a state or local government by a railroad to subsidize the cost of relocating railroad roadways is a contribution to capital and not includable in the railroad's gross income. n165.19 The underlying authority for the holding was the *Cuba Railroad* case, n165.20 a pre-1954 Code case which held that payments made by the Cuban government to a US railroad corporation operating in Cuba to subsidize the construction of railroad improvements were not "income" because the cash was

contributed by the Cuban government to benefit the Cuban public at large and because the contribution increased the taxpayer's equity and assets, but not its earned surplus.

The IRS has also ruled that payments received to subsidize job training costs of a corporate taxpayer that would otherwise have been required to be capitalized under *IRC Section 195* may be excluded from gross income as non-shareholder contributions to capital, provided that the five-part test of *Chicago, Burlington & Quincy* is met. n165.21 Note, however, that if the job training or business relocation costs would otherwise be deductible by the taxpayer, the five-part *Chicago, Burlington & Quincy* test would not be met because no asset would be created or transferred which becomes part of the capital of the recipient due to the current deductibility of the amount subsidized. n165.22 In that case, the amounts would be includable in the ordinary taxable income of the taxpayer. n165.23

The IRS has ruled in other cases that payments to subsidize capital expenditures of a taxpayer can be excluded as non-shareholder contributions to capital, as long as the payment was not for some demonstrable service provided to the payer. n165.24

In sum, the cases and rulings in this area ordinarily try to distinguish between payments made in consideration of the performance of services, as opposed to payments made in support of the public welfare. The line of demarcation has never been a sure one. Where a payment or property transfer meets the five-factor test of *Chicago, Burlington & Quincy*, n165.25 there is more certainty--the payment will be excluded from the gross income of the corporate recipient under *IRC Section 118*, and the recipient will acquire no basis in the property to the extent of the grant under *IRC Section 362(c)*.

[b] Extensions of Credit

As noted above, n165.26 below-market interest rate loans received from government entities generally do not result in the imputation of taxable income to the borrower on account of the below-market interest rate. n165.27 However, if a below-market interest loan were to fall outside the exemption under the *IRC Section 7872* regulations, certain consequences could arise. For example, in the case of a \$2 million, 0-percent interest term loan, due in 25 years, when the AFR is 6.5-percent per annum, the present value of the loan would be approximately \$1.585 million, resulting in the required payments being only a small fraction of the principal amount of the loan. Consequently, if the *IRC Section 7872* rules applied, the borrower would be treated as having received a payment from the lender that, in many cases, would equal virtually all of the amount of the funds advanced by the lender.

This transfer might be excluded under the principles of under *IRC Section 118* by applying the five-factor test in *Chicago, Burlington & Quincy*. n165.28 Even if the payment from the lender were treated as a non-shareholder capital contribution, however, a corporate recipient would lose virtually all of the income tax basis attributable to the expenditures financed with the loan. n165.29

[c] Tax Increment Financing

Tax increment financing (TIF) is an economic development tool that sets aside property tax revenue generated by a new project in a targeted area. These funds are used to pay for improvements associated with the project. n165.30 Municipalities in most states have been using TIFs for several decades to stimulate economic development in distressed areas. TIFs are popular tools because they are believed to raise tax revenue for development efforts without raising taxes, they provide incentives for businesses and developers, and are believed to be a revenue generator for municipal governments and regional development organizations. Moreover, they are popular because they are perceived to connect the public expenditures with the resulting tax revenues. The TIF concept began in the 1940s and was first implemented on a large scale in California in 1952 where it was used as a means to provide local matching funds for federal grants. Its popularity in California increased in reaction to the enactment of Proposition 13, which limited increases in local property taxes. n165.31

TIF programs fall into two general categories: programs that are funded on a "pay-as-you-go" basis (the programs are funded and carried out as the incremental revenue is generated), and those which use the expected revenues to borrow capital in advance that can be spent currently. Bond-financed TIF is often used to fund projects through the issuance of indebtedness by a municipality or authority to pay for acquisition, demolition, and infrastructure costs associated with redevelopment. Because of the up-front capital investment required to initiate a project, the "pay-as-you-go" method cannot generate enough capital to provide an effective subsidy.

Sometimes, a development is planned in a blighted area where property values and property taxes are declining. With public funding for the necessary site preparation, such as sidewalk improvements or demolition of existing structures, the development can go forward where it otherwise might not. The local government bodies that draw taxes from the blighted area agree to the development. A TIF district is then created around the area and its property tax base is frozen. The taxes on this frozen base continue to go to the local governments covering the district for the duration of the project. The authority sells bonds to finance the site improvements and gives the developer the bond proceeds to pay for the costs. Once the development is completed, the property tax revenues in the district should increase by at least by the revenues generated by the new facility. This marginal increase, or tax increment, is captured by the authority and is used to pay off the indebtedness incurred to pay for the site improvements. After the bonds are retired, the higher taxes revert to the city, county, school board, and any other taxing body that covers the district.

TIF districts have moved beyond the redevelopment of blighted areas to the financing of sports stadiums, retail shopping districts, and entertainment complexes. Mechanically, TIF financing depends upon the following: n165.32

- (1) The assessed value of the property is determined, based on the value of the property at the time the TIF district is established. The real property taxes determined with respect to this portion of the assessed value remain payable to the municipality.
- (2) The taxes generated by the increase in the assessed value of the real property are segregated and diverted to the district. These amounts are used either to pay off indebtedness incurred to finance the expenditures or to pay or reimburse expenditures on a "pay-as-you-go" basis.
- (3) Following the retirement of the indebtedness or the cessation of the TIF district, the diverted property tax revenues are payable 100-percent to the municipalities and taxing jurisdictions otherwise entitled to receive them.

The tax consequences to the real estate owner depend largely on the manner in which the subsidy is provided. If the funds are expended for general improvements that benefit the TIF district, but are not expended to benefit a particular parcel (e.g., reconstruction of streets and off-ramps) rather than specific site costs for a project, and are not received specifically by the taxpayer for such work, it is likely that such amounts will not have to be included in its gross income using general tax principles under *IRC Section 61*.

If the funds are expended for specific site work that benefits an individual taxpayer (e.g., construction of a parking garage and building shell), the taxpayer can exclude the funds from gross income only if they are treated as a non-shareholder contribution to capital. n165.33

Another common form of direct subsidy is for the governmental authority to acquire the site on which the project will be built, clear the site, remediate any existing environmental contamination problems, and convey the site (with certain improvements) to the developer. As above, the taxpayer to avoid having significant gross income must rely on being treated as having received a non-shareholder (non-owner) contribution to capital, excludible from gross income. n165.34

In some cases, TIF can be used to subsidize the return to the developer by allowing some portion of the developer's equity contribution to be funded through a TIF borrowing. For example, assume that a developer agrees to construct a warehouse for use in its business that is anticipated to bring an additional 400 jobs to an otherwise depressed area. The cost to construct the facility (on land to be conveyed to the developer by the City for \$1.00) is budgeted at \$15 million. The developer will finance \$11 million with a third-party institutional lender, and intends to close the remaining \$4 million gap with its own funds. If the City creates a TIF district that includes the building, issues a TIF revenue bond that is repayable from the incremental growth in property taxes with respect to the new district, and the developer purchases the TIF revenue bond for \$3.5 million, the City would have an additional \$3.5 million that it could make available to the developer, either by a direct grant (which would be intended to be excludible under *IRC Section 118(a)*) or by completing additional work on the site prior to its conveyance to the developer.

Although the revenue bonds in the above case would be issued by a municipality authority, the IRS could challenge both the exclusion of any interest income under *IRC Section 103* and the characterization of the bonds as indebtedness of the issuing authority. Assume that, in the case outlined above, the revenue bonds are to be paid only out of the tax proceeds from the benefitted property. In that case, TIF revenue bonds issued to provide financing for major capital improvements to an industrial facility located in the taxing jurisdiction would be private activity bonds within the meaning of *IRC Section 141(a)*. Because the proceeds of the revenue bonds would not be expended for an essential government function, the revenue bonds would meet the private loan financing tests of *IRC Section 141(c)*. Therefore, the interest on the bonds would not be exempt under *IRC Section 103*. The tax increment payments would be treated as loan repayments because they are not taxes of general application. In actuality, the taxpayer in substance would be found to have received a loan of the revenue bond's proceeds in order to construct site improvements. The transfer of benefits to the developer could be seen in substance as a loan, especially if covenants and financing arrangements were not generally applicable to taxpayers in the TIF district. n165.35

A similar analysis applies under the private loan financing test of *IRC Section 141(c)*. In fact, the regulations now incorporate provisions that would have rendered the interest on the bonds in *Technical Advice Memorandum 9250005* taxable *ab initio*. Under *IRC Section 103*, the exclusion from gross income does not include interest on "private activity bonds" that are not qualified bonds. n165.36

Private activity bonds are obligations that meet either the private loan financing test or both the private business use and the private security or payment tests. n165.37 The private loan financing test is met if the proceeds of the issue which are to be directly or indirectly used to make or finance loans to persons other than governmental units exceeds the lesser of 5-percent of the proceeds or \$5,000,000. n165.38 The private business use test is met if more than 10-percent of the proceeds of the issue are to be used for any private business. Private business use is any direct or indirect use in a trade or business carried on by any person other than a governmental unit. n165.39 The private security or payment test is met if the payment of principal of, or interest on, more than 10-percent of the proceeds of the issue is directly or indirectly protected in a qualified manner.

The following rules apply to situations that are encountered often in connection with TIF financed projects:

(1) Under the private loan financing test, certain debt obligations are treated as private activity bonds if the proceeds of the issue are used to make or finance loans to persons other than a governmental person. n165.40 A grant of proceeds to a person is not treated as a "loan." Moreover, a grant using proceeds of an issue that is secured by generally applicable taxes attributable to the improvements to be made with the grant is not treated as a loan, unless the grantee makes any impermissible agreements relating to the payment that results in the taxes imposed on that taxpayer not to be treated as "generally applicable taxes" under the regulations. n165.41

(2) The ownership of property financed by the proceeds of a debt issuance by a non-governmental person, or the use by a nongovernmental person of the financed property pursuant to a lease results in a

private business use of the property. n165.42 An arrangement that conveys special rights to the use of property can result in a private business use. In the case of financed property that is not available for use by the general public, private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons, even if those nongovernmental persons have no special legal entitlements to use of the property. Use as a member of the general public is not treated as private business use. In determining whether a special economic benefit enjoyed by a nongovernmental user gives rise to private business use, the regulations consider the following factors: (i) whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person; (ii) whether only a small number of nongovernmental persons receive the special economic benefit; and (iii) whether the cost of the financed property is treated as depreciable by a nongovernmental person. n165.43

(3) The private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test considers payment of the debt service on the issue that is directly or indirectly derived from payments in respect of property, or borrowed money, used or to be used for a private business use. The private security portion of the test considers the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use. n165.44 This provision is implicated in TIF programs because the taxes payable with respect to the TIF district are the source of repayment of the obligations. The regulations have a series of special rules that deal with the characterization of tax payments for these purposes:

(a) For purposes of the private security or payment test, generally applicable taxes are not taken into account (that is, are not payments from a nongovernmental person and are not payments in respect of property used for a private business use). n165.45

(b) A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes. A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction and a generally applicable manner of determination and collection. n165.46 A payment for a special privilege granted or service rendered is not a generally applicable tax. Special assessments paid by property owners benefitting from financed improvements are not generally applicable taxes. For example, a tax or a payment in lieu of tax that is limited to the property or persons benefited by an improvement is not a generally applicable tax. n165.47

(c) A tax does not have a generally applicable manner of determination and collection to the extent that one or more taxpayers make any impermissible agreements relating to payment of those taxes. n165.48 The following are impermissible agreements that cause a tax to fail to have a generally applicable manner of determination and collection: n165.49

- an agreement to be personally liable on a tax that does not generally impose personal liability, to provide additional credit support such as a third party guarantee, or to pay unanticipated shortfalls;
- an agreement regarding the minimum market value of property subject to property tax; and
- an agreement not to challenge or seek deferral of the tax.

Thus, the regulation would expressly address the factors that were the basis for *Technical Advice Memorandum 9250005*.

The following diagram illustrates the flow of funds in the type of project described above: n165.50

[Click here to view image.](#)

The principle to be learned from *Technical Advice Memorandum 9250005* is that attempts to tie the revenue bond financing too closely to the underlying project will cause the interest on the revenue bonds to be treated as taxable. n165.51 More importantly for the developer, they will also cause the funds advanced from the TIF to be treated as a loan to the project and the TIF payments to be treated as a repayment of the loan, rather than as a deductible payment of taxes or payments-in-lieu-of-taxes. Therefore, the taxpayer would not be able to currently deduct the payments. Assuming the loan is from a qualifying governmental entity, *IRC Section 7872* would not apply, however, so there would be no imputation of interest. n165.52

Use of the TIF borrowing in this fashion may also permit some portion of the developer's return to escape state and local taxes that would otherwise be imposed on the project. For example, if the developer in the above example were to transfer the TIF debt obligation to an entity located outside the relevant taxing jurisdiction, e.g., to a Delaware or Nevada holding company, the interest payable on the TIF borrowing should be sourced to Delaware or Nevada, as the case may be, rather than to the state in which the project is located. This may permit the developer to avoid the state or local taxes on the income attributable to interest on the TIF borrowing.

[5] Taxation of Real Estate Incentives for Taxpayers Other than C Corporations

[a] Partnerships and LLCs

By its terms, the *IRC Section 118(a)* exclusion from gross income applies only to capital contributions to corporations. There is no similar exclusion for non-owner contributions to noncorporate entities, such as partnerships or LLCs. Thus, governmental subsidy payments to a noncorporate entity lack the statutory protection of *IRC Section 118(b)* and must rely on the earlier common law principles to avoid current taxation.

For federal income tax purposes, the receipt of capital contributions by a partnership in exchange for a partnership interest is nontaxable, n165.53 but the *IRC Section 118(a)* exclusion, which applies to all capital contributions, from whatever source derived, has no parallel under Subchapter K. n165.54

The Service's position on the taxability of capital contributions to noncorporate entities by a non-owner (not in consideration for a partnership interest or an LLC membership interest) has been inconsistent and lacking in analysis. Moreover, it has not been the subject of formally published guidance.

The IRS position was initially set forth in a private letter ruling, which concluded that there was a nonstatutory contribution to capital exclusion for partnerships and that third-party contributions could be excluded from a partnership's gross income. In the ruling, a municipality made available grants to a partnership in order to subsidize the costs of development by the partnership. The IRS ruled that the amounts were excluded from the partnership's taxable income but that the partnership had to reduce the income tax basis of the property acquired with the grants, by analogy to *IRC Section 362(c)*. n165.55

The IRS later reversed its position in *General Counsel Memorandum 38944*. n165.56 There, the IRS concluded that the pre-1954 Code case law that had developed in the corporate context n165.57 was *not* controlling when there was a

non-corporate taxpayer, because the coordinated income exclusion and basis reduction provisions of *IRC Sections 118* and *362(c)* did not apply. *General Counsel Memorandum 38944* relied on an assertion that pre-1954 Code case law was merely a "guide" to interpretation, and did not survive the enactment of *IRC Section 118* in 1954. The IRS concluded that the enactment of *IRC Section 118* supplanted prior case law; the IRS also focused on the absence of a parallel to *IRC Section 362(c)* in Subchapter K of the Code. *General Counsel Memorandum 38944* acknowledged its apparent inconsistency with the Service's earlier position in private rulings. n165.58

The IRS followed *General Counsel Memorandum 38944* in a later private letter ruling, which concluded that *IRC Section 118(a)* was limited in application to contributions to corporations and ruled that contributions from a local school board to a public utility partnership to defray the costs of construction of a sewage disposal plant were taxable income to the partnership. n165.59

Planning Tip:

Where the operating entity for a subsidized project is a noncorporate entity, there are certain strategies that a taxpayer might employ to provide a better technical argument for the application of the "contribution to capital" analysis to a subsidy payment, and thereby avoid the Service's position as set forth in *General Counsel Memorandum 38944*. One possibility would be to form the real estate-owning entity as a limited partnership with a sole corporate general partner. The governmental grant could then be made to the corporate general partner and, in turn, contributed to the partnership as the capital contribution of the general partner. n160.60 In form, the corporation could avail itself of the *IRC Section 118* exclusion, and could reduce the basis of the partnership interest under *IRC Section 362(c)*, thereby arguably meeting the Service's objection to the extension of the case law to contributions to noncorporate entities. There are, however, at least three significant risks to the use of this approach:

- (1) Under *IRC Section 269*, the IRS may challenge the acquisition of control of a corporation where control is acquired with the principal purpose of obtaining a tax benefit to which the taxpayer would not otherwise be entitled. *IRC Section 269* could be applied by the IRS to challenge the availability of the *IRC Section 118* exclusion to the corporate general partner, if the IRS were correct that the enactment of *IRC Section 118* was the exclusive path to obtain non-taxability. A counter-argument could be made if the corporate general partner entity bore risks of construction and thus the limited partnership would have a principal purpose other than tax avoidance for the transaction structure. Further, in some jurisdictions, the use of a limited partnership with a sole corporate general partner continues to be advantageous (as opposed to an LLC) because of state or local tax consequences. In those jurisdictions the IRS might have a harder time arguing for the application of *IRC Section 269* to the arrangement.
- (2) The IRS could challenge the use of the limited partnership as a device under *Regulation Section 1.701-2* to obtain a stepped-up basis in partnership assets by avoiding the application of the *IRC Section 362(c)* basis reduction rule and to achieve non-taxability upon the receipt of the subsidy.
- (3) The IRS could argue that the use of the sole corporate partner and the subsequent contribution to the partnership should be collapsed into a single transaction under the step-transaction doctrine. As under *IRC Section 269*, this argument could be countered if the corporate general partner has economic risk.

[b] S Corporations

It seems likely that *IRC Section 118(a)* applies to an S corporation because of the application of *IRC Section 1371(a)*, which provides that Subchapter C of the Code applies to an S corporation and its shareholders except to the extent that

Subchapter C is inconsistent with Subchapter S of the Code. Thus, although *IRC Section 118* is not in Subchapter C because the basis reduction rule of *IRC Section 362(c)* applies to S corporations, a non-shareholder incentive contribution to an S corporation should qualify for exclusion if it meets the principles of *IRC Section 118(a)* and meets the five-factor test of *Chicago, Burlington & Quincy Railroad Co.* n165.61

Example:

ARC is an S corporation. There are three shareholders of ARC: Individuals X and Y, and the Inner City Economic Union ("ICEU"). n165.62 ARC has entered into a negotiated Development Agreement with the local Tax Increment Financing Commission (the "TIFC"), in which ARC is to own or develop the property (the "Project") located in the inner city (the "Development Agreement"). The Project will consist of two large tenants and several other smaller tenants. The land needed to comprise the Project will be contributed to ARC by TIFC, with TIFC having acquired and cleared the land.

Pursuant to the Development Agreement, TIFC is to contribute cash and the property with which the Project will be developed. TIFC has issued bonds in the amount of \$46 million, but the Project is not security for that debt. The proceeds of the bond issue are to be used to pay past and future costs of the development of the Project. TIFC will also contribute funds to ARC to pay the future costs, which will total approximately \$22 million. This \$22 million will be used for infrastructure (e.g., parking lots, lights, and flood control) and buildings in the Project. The past costs (i.e., the acquisition of the property, environmental clean-up, and the clearing of the land) paid by TIFC were approximately \$24 million. The above-described land, infrastructure improvements, and buildings will all be owned by ARC or ARC and its investors.

To determine whether TIFC's cash and property contributions are includable in ARC's gross income, the five-factor test of *Chicago, Burlington & Quincy Railroad Co.* must be applied. n165.63 Under that test, it is likely that the cash and property contributions will be treated as a nontaxable capital contribution to ARC because (i) the payments do not appear to be for a specific purpose; (ii) the Development Agreement was negotiated; (iii) a governmental entity, TIFC, desires for economic development and civic reasons to locate a shopping center in a particular area of inner city; and (iv) the property and cash will be used to construct the development which will produce income. Thus, property and cash contributions to ARC, except with respect to the fees paid for services, would be nontaxable to ARC under *IRC Section 118(a)*. ARC would be subject to the basis reduction required by *IRC Section 362(c)*. ARC's status as an S corporation would not affect this result, because S corporations are subject to Subchapter C of the Code. n165.64

If ARC wishes to obtain additional capital from persons who cannot be S corporation shareholders (such as foreign investors), n165.65 ARC might organize a limited liability company taxed as a partnership to own and operate the Project (the "LLC"). If this is done and TIFC makes its cash and property contributions to the LLC, the IRS takes the position that the LLC's receipt of the contributions are not tax-free contributions to capital under *IRC Section 118(a)*, but are taxable to the LLC (and hence, the LLC members). n165.66

[6] Tax Credits

Tax credits, such as the rehabilitation credit and the low-income housing credit, are another form of government subsidy. *IRC Section 38* allows an income tax credit for various amounts, including the rehabilitation credit authorized by *IRC Section 47* and the low-income housing credit authorized by *IRC Section 42*. The rehabilitation credit is the sum of (a) 10 percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure, and (b) 20 percent of the qualified rehabilitation expenditures with respect to any

certified historic structure. The low-income housing tax credit is a percentage of the eligible basis of the low-income housing units in a low-income housing project. The low income housing credit is generally designed to subsidize 30 percent of the cost of constructing new federally subsidized low income housing units or acquiring existing buildings and 70 percent of the cost of new low-income housing that is not federally subsidized. The rules relating to rehabilitation and low-income housing tax credits are discussed in Chapter 5. Credits operate as an up-front subsidy that can help a developer finance a real estate project because they can be "sold" for an up-front discounted payment to persons who invest in the partnership that will own the project.

Taxpayers can irrevocably elect to claim an advance rehabilitation investment credit for progress expenditures on certain rehabilitated buildings before the property is placed in service. n166 An election is made separately by each partner, shareholder, or beneficiary for progress expenditure property rehabilitated by or for a partnership, S corporation, trust or estate. n167 Claiming credits on a progress expenditure basis will accelerate the time in which the investor-partners receive the economic benefit of the credit and therefore will increase the amount that a developer will receive with respect to the "sale" of the credits if the developer is able to cause the project to comply with the rules applicable to progress expenditure-based credits.

Investment credits will be recaptured if there is an early disposition of the property. n168 A developer will therefore have to provide assurance to its investors that it will comply with the rules necessary for them to avoid recapture.

FOOTNOTES:

(n1)Footnote 161. *IRC § 61(a)*.

(n2)Footnote 162. But see *GCM 38944* (contending that the legislative enactment of *IRC § 118* pre emptied the field and limited the field to corporate recipients). For a criticism of the rationale of *GCM 38944*, see Blanchard, *The Taxability of Capital Subsidies and Other Targeted Incentives* 85 *Tax Notes* 781 (Nov. 8, 1999).

(n3)Footnote 163. *Edwards v Cuba Railroad Company*, 268 *US* 628 (1925). This rule has been codified in the context of corporations in *IRC § 118*.

(n4)Footnote 164. *US v Chicago, Burlington & Quincy Railroad Co*, 412 *U.S.* 401 (1973). *Texas & Pacific Railway Company v United States*, 286 *US* 285 (1932); *Helvering v Clairborne-Annapolis Ferry Co*, 93 *F2d* 875 (4th *Cir* 1938).

(n5)Footnote 165. *Detroit Edison Company v Commissioner*, 319 *US* 98 (1943); *IRC § 118(a)*.

(n6)Footnote 165.1. See *GCM 38944* (Dec 13, 1982), discussed in detail in [5][a], below.

(n7)Footnote 165.2. *Treas Reg § 1.118-1*.

(n8)Footnote 165.3. *IRC § 362(c)(1)*.

(n9)Footnote 165.4. *IRC § 362(c)(2)*; see *Treas Reg § 1.362-2* (allocation rules for reduction of basis among property owned by the taxpayer).

(n10)Footnote 165.5. *Deason v Commr*, 590 *F2d* 1377 (5th *Cir* 1979), *GCM 38944* (Dec 13, 1982), and *Ltr Rul 9238007*, citing *US v Chicago, Burlington & Quincy Railroad Company*, 412 *US* 401 (1973).

(n11)Footnote 165.6. *US v Chicago, Burlington & Quincy Railroad Company*, 412 *US* 401 (1973).

(n12)Footnote 165.7. See *Deason v Commr*, 590 *F2d* 1377 (5th *Cir* 1979).

(n13)Footnote 165.8. *IRC § 7872(b)(1)*.

(n14)Footnote 165.9. *IRC § 7872(b)(2)*.

(n15)Footnote 165.10. *IRC § 7872(c)(1)(E)*.

(n16)Footnote 165.11. *Temp Treas Reg § 1.7872-5T(b)(5)*.

(n17)Footnote 165.12. See *Temp Treas Reg § 1.7872-5T(b)*.

(n18)Footnote 165.13. *Temp Treas Reg § 1.7872-5T(a)(2)*.

(n19)Footnote 165.14. See Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, 1 Senate Comm on Finance, 98th Cong, 2d Sess, 482 (S Prt 169).

(n20)Footnote 165.15. See Rev Rul 98-34, 1998-2 CB 118 (IRS concluded that a below-market second mortgage loan made under the Multifamily Assisted Housing Reform and Affordability Act of 1997, by the Department of Housing and Urban Development (HUD) to the owner of a multifamily low-income rental property in connection with restructuring the existing first mortgage on the property, was exempt from *IRC § 7872*).

(n21)Footnote 165.15.1. *IRC § 42(i)(2)(A)*.

(n22)Footnote 165.15.2. *IRC § 42(i)(2)*, before amendment by Pub Law No 110-289.

(n23)Footnote 165.16. *IRC § 42(b)(1)(B)(ii)*, (d)(5); *IRC § 42(i)(2)*, before amendment by Pub Law No 110-289. There are certain exceptions to this rule.

(n24)Footnote 165.17. See *Chicago, Burlington & Quincy Railroad v US*, 412 US 401 (1973) , discussed in [2], above.

(n25)Footnote 165.18. See *IRC § 118(a)*; *Treas Reg § 1.118-1*.

(n26)Footnote 165.19. *Rev Rul 57-450*, 1957-2 CB 137 .

(n27)Footnote 165.20. *Edwards v Cuba Railroad Co*, 268 US 628 (1925) .

(n28)Footnote 165.21. *Ltr Rul 9238007* ; see *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) , discussed in [2], above.

(n29)Footnote 165.22. See *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) , discussed in [2], above.

(n30)Footnote 165.23. See *Springfield Street Railway v US*, 577 F2d 700 (Ct Cl 1978) ; *Ltr Rul 8612002* .

(n31)Footnote 165.24. *Ltr Rul 200048026* (payments to a pipeline utility); *Ltr Rul 9814019* (payment to relocate utility lines to facilitate community development ruled nontaxable).

(n32)Footnote 165.25. See *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) , discussed in [2], above.

(n33)Footnote 165.26. See [3], above.

(n34)Footnote 165.27. See Rev Rul 98-34, 1998-2 CB 118 (IRS concluded that a below-market second mortgage loan made under the Multifamily Assisted Housing Reform and Affordability Act of 1997, by HUD to the owner of a multifamily low-income rental property in connection with restructuring the existing first mortgage on the property, was exempt from § 7872 of the Code).

(n35)Footnote 165.28. See *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) , discussed in [2], above.

(n36)Footnote 165.29. *IRC § 362(c)*.

(n37)Footnote 165.30. See Johnson, and Man, *Tax Increment Financing and Economic Development 2001* (State University of New York Press Albany) (hereafter "Johnson and Man").

(n38)Footnote 165.31. See J Drew Kalick and Samuel Nunn, "A Primer on Tax Increment Financing," in Johnson and Man.

(n39)Footnote 165.32. The following assumes that the TIF district is based on the real property taxes generated therein, rather than sales taxes or other revenue.

(n40)Footnote 165.33. See *IRC § 118*; *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) , discussed in [2], above.

(n41)Footnote 165.34. See *IRC § 118*; *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) , discussed in [2], above.

(n42)Footnote 165.35. See TAM 9250005 .

(n43)Footnote 165.36. *IRC § 103(b)*.

(n44)Footnote 165.37. *IRC § 141*.

(n45)Footnote 165.38. *IRC § 141(c)(1)*.

(n46)Footnote 165.39. *IRC § 141(b)(1)*.

(n47)Footnote 165.40. *Treas Reg § 1.141-5(a)*.

(n48)Footnote 165.41. See *Treas Reg § 1.141-4(e)*.

(n49)Footnote 165.42. *Treas Reg § 1.141-3(a)*.

(n50)Footnote 165.43. *Treas Reg § 1.141-3(a)(7)(ii)*.

(n51)Footnote 165.44. *Treas Reg § 1.141-4(a)*.

(n52)Footnote 165.45. *Treas Reg § 1.141-4(e)(1)*.

(n53)Footnote 165.46. *Treas Reg § 1.141-4(e)(2)*.

(n54)Footnote 165.47. *Treas Reg § 1.141-4(e)(3)*.

(n55)Footnote 165.48. *Treas Reg § 1.141-4(e)(4)(i)*.

(n56)Footnote 165.49. *Treas Reg § 1.141-4(e)(4)(ii)*.

(n57)Footnote 165.50. See TAM 9250005 .

(n58)Footnote 165.51. See *IRC § 103(b)(1)*.

(n59)Footnote 165.52. See [3], above, for a discussion of below-market interest loans.

(n60)Footnote 165.53. *IRC* § 721.

(n61)Footnote 165.54. See *IRC* §§ 701-777.

(n62)Footnote 165.55. *Ltr Rul* 8038037 .

(n63)Footnote 165.56. GCM (Dec 13, 1982).

(n64)Footnote 165.57. See *Edwards v Cuba Railroad Co*, 268 US 628 (1925) ; *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) and the cases cited therein.

(n65)Footnote 165.58. See *Ltr Rul* 8038037, *TAM* 7950002 .

(n66)Footnote 165.59. See *Ltr Rul* 9032001 .

(n67)Footnote 160.60. See *IRC* §§ 118(a), 362(c), 721(a).

(n68)Footnote 165.61. See *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) , discussed in [2], *above*.

(n69)Footnote 165.62. See *IRC* § 1361(b), (c)(6).

(n70)Footnote 165.63. See *US v Chicago, Burlington & Quincy Railroad Company*, 412 US 401 (1973) , discussed in [2], *above*.

(n71)Footnote 165.64. *IRC* § 1371(a).

(n72)Footnote 165.65. See *IRC* § 1361(c)(1)(C).

(n73)Footnote 165.66. See GCM 38944 (Dec 13, 1982) .

(n74)Footnote 166. *IRC* § 47(d).

(n75)Footnote 167. *Treas Reg* § 1.46-5(o)(1).

(n76)Footnote 168. *IRC* § 42(j) (low income housing credit); *IRC* § 50(a) (rehabilitation credits).

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Federal Taxes Affecting Real Estate

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CHAPTER 19 Financing Commercial Real Estate Transactions *

2-19 Federal Taxes Affecting Real Estate § 19.05

§ 19.05 Plan Asset Issues Under ERISA

[1] Overview

One of the sources that a commercial real estate developer is likely to approach, when seeking equity investors for a major project, is the pension fund community and the funds through which they invest. The rules applicable to pension and profit-sharing plans subject to ERISA n169 will affect the relationship among such an investor, the fund through which it invests, the developer and the partnership that owns the project. Generally, when a qualified pension or profit-sharing plan subject to ERISA makes an equity investment in an entity (such as a real estate fund), the plan's assets include the equity interest, but will not include any of the underlying assets of the entity if the entity constitutes an "operating company." If, however, the entity does not constitute an "operating company," and if another exception is not available, n170 the assets of the plan investing in the entity include the equity investment and an undivided interest in each of the underlying assets of the entity.

[2] Consequences of a "Plan Assets" Conclusion

If the underlying assets of the entity are plan assets, those persons exercising any discretionary authority or control over the management of the entity or the management or disposition of the entity's assets, or who render investment advice for a fee, directly or indirectly, with respect to the entity's assets, or have any authority or responsibility to do so, become fiduciaries under ERISA subject to the duties, responsibilities and prohibitions prescribed by ERISA. This could give rise to a "prohibited transaction" within the meaning of ERISA, which provides, *inter alia*, that an ERISA plan fiduciary is prohibited from causing the plan of which it is a fiduciary to engage in a transaction involving the sale or exchange of property or the lending of money or other extensions of credit between the plan and a party in interest. For example, if an ERISA plan invested in a real estate fund and the fund loaned money or leased property to the sponsor of the plan, a prohibited transaction would occur if the assets of the fund were treated as "plan assets" of the plan, but would not arise if the plan asset was only the investment in the fund. Transactions by those individuals involving the entity's assets must be reviewed for compliance with ERISA and the Code (e.g., payment of fees by the investment partnership to its general partner). It is generally considered to be quite undesirable to be subject to these rules.

[3] Qualification as an Operating Company

It is possible to organize a real estate investment partnership that will satisfy the "operating company" exception and

avoid the application of the look-through rules described above by complying with the "Plan Asset Regulation" promulgated under ERISA. n171 Pursuant to the Plan Asset Regulations, an "operating company" is an entity that is primarily engaged, directly or through one or more majority owned subsidiaries, in the production or sale of a product or service other than the investment of capital. Whether an entity is an operating company under the Plan Asset Regulations is a factual question to be determined by taking into account all relevant facts and the particular characteristics of the entity. The preamble to the Plan Asset Regulations (the "Preamble") states that certain companies may have elements of both an operating company and investment fund, but that, except as noted below, it is impractical to provide detailed guidance with respect to the types of activities necessary for characterization as an operating company. The term "operating company" also includes an entity that does not meet the general definition, but that is a "real estate operating company" ("REOC") or a "venture capital operating company" ("VCOC"). n172 A real estate investment partnership will qualify as a general operating company if it is actively involved in the management of the properties in which it invests, either through its own employees or through the use of independent contractors. Actively negotiating leases, maintaining the buildings and common areas, and the supervision and responsibility for the engagement or termination of employees and/or independent contractors are all indicative of management services. Accordingly, a commercial real estate developer seeking equity investment from a fund with ERISA investors may find that its equity investor will insist on having significant management rights.

[4] Definition of Real Estate Operating Company

A REOC is an entity, at least 50 percent n173 of the assets of which (other than short-term investments pending long-term commitment or distribution to investors) are invested in real estate that is managed or developed by the entity and with respect to which the entity (i) has the right to substantially participate directly in management or development activities and (ii) actually exercises those rights in the ordinary course of its business. For this purpose, management rights would include the right to negotiate leases, maintain common areas and conduct maintenance activities with respect to the properties. n174 If such activities are carried out by an independent contractor, management rights would then include the authority to direct and terminate such independent contractor. A real estate investment partnership that maintains appropriate levels of investments and has and exercises management rights with respect to the properties in which it invests will satisfy one of the operating company exceptions to the Plan Asset Regulation. Accordingly, the general partners of such an investment partnership will not be subject to the fiduciary duties of ERISA as a result of pension plan investments therein.

[5] REOC Status Must be Attained in First Year

The investment threshold for a REOC is generally determined with respect to a 12-month period. The requirement that management rights be exercised may be satisfied any time during the 12-month period. However, initial status as a REOC is determined as of the date of the entity's first long-term investment. Accordingly, in order for a real estate investment partnership to qualify initially as a REOC, its first long-term investment must be an investment that confers management rights, and is in real estate (and not mortgages). A prohibited transaction could result if an investment fund held pension plan money prior to its first qualifying investment.

The Department of Labor has announced that an entity seeking to qualify as a VCOC may use an escrow arrangement to facilitate initial capital contributions by pension plans. n175 The Department of Labor has approved arrangements in which the VCOC acquires a contingent interest in funds placed in escrow by pension plans and the plans acquire a contingent interest in the VCOC. Upon full performance of the terms of the escrow agreement, which would include a qualifying investment by the VCOC, legal title to the escrow property vests and the plans' interests in the VCOC become unconditional. By using such a structure, the escrow agent does not become a fiduciary with respect to the pension plans and VCOC status can be achieved. A similar rule should be applicable to REOCs. If the initial equity contribution of partners in a real estate investment partnership will be called as investments are made, a prohibited transaction will not occur if the capital contribution by pension plans are invested on the date of the call or held in escrow after the date of call until closing.

FOOTNOTES:

(n1)Footnote 169. *The Employee Retirement Income Security Act of 1974*, as amended ("ERISA").

(n2)Footnote 170. Other exceptions exist. One exemption is for a fund in which 25 percent or less of the equity interests in the fund are held by benefit plan investors (i.e., ERISA and certain non-ERISA plans and IRAs). ERISA plans and IRAs that invest in such a fund will not be deemed to own an interest in the underlying assets owned by the fund, and the investment activities of the fund will therefore generally not invoke the prohibited transaction rules. However, fund sponsors may find it undesirable to limit the potential amount that they can raise from ERISA plans in order to enable the fund to meet this test. Another exemption applies if the fund in which the ERISA plan invests is organized as a regulated investment company registered under the *Investment Company Act of 1940*. Under the plan asset regulations, a regulated investment company is not treated as a look-through entity, and the plan is treated as having an investment in the shares of the regulated investment company, but not its underlying assets. This latter exception is not particularly useful to real estate funds--a general exemption from the *Investment Company Act* rules is available to real estate funds.

(n3)Footnote 171. Department of Labor Treas Reg § 2510.3-101; 29 *CFR* § 2510.3-101.

(n4)Footnote 172. A VCOC is an entity, at least 50 percent of the assets of which (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are invested in portfolio companies that are operating companies (other than VCOCs) with respect to which the entity has or obtains management rights that it, in fact, exercises in the ordinary course of its business.

(n5)Footnote 173. For purposes of this test, assets are valued at cost.

(n6)Footnote 174. It is not necessary for the real estate investment partnership to manage *each* property in which it invests, but it must, in fact, exercise management rights with respect to some of the properties.

(n7)Footnote 175. DOL Opinion Letter 95-04A.

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CHAPTER 20 Valuation Of Real Property

2-20 Federal Taxes Affecting Real Estate 20.syn

§ 20.syn Synopsis to Chapter 20: Valuation Of Real Property

§ 20.01 Overview of Valuation in Tax Cases

[1] In General

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Federal Taxes Affecting Real Estate

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CHAPTER 20 Valuation Of Real Property

2-20 Federal Taxes Affecting Real Estate § 20.01

§ 20.01 Overview of Valuation in Tax Cases

[1] In General

The value of property is a question of fact determined after consideration of all relevant evidence of record. n1 All factors bearing on value are relevant, including, where pertinent, cost, n2 stipulations of value by the parties, n3 selling price of the subject property, n4 use to which the property is (or is not) put, n5 leases or other restrictions on the property, n6 threats of litigation with respect to the property, n7 available access (e.g., to roads), n8 zoning, n9 opinion evidence, and expert appraisals. n10

Valuation is admittedly not an exact science, and each case necessarily turns on its own particular facts. Therefore, the weight given to a particular factor in a particular case is unlikely to be of significant precedential value in future cases. n11

Note:

For estate tax purposes, qualifying taxpayers may elect to value farms and real estate used in closely held businesses at their current value rather than their "highest and best use." n12 The special use valuation election and valuation under *IRC § 2032A* are discussed in Chapter 18, "Estate Planning for Real Estate."

[2] Appellate Court Standard of Review

An appellate court's review of the Tax Court's valuation determines whether the Tax Court's valuation finding is clearly erroneous or not supported by substantial evidence. n13

[3] Weight of Position Taken in Tax Return

Often, a taxpayer will take a valuation position before the Tax Court that differs from the value given in an estate or other tax return. The valuation given in the return is treated as an admission by the taxpayer when that value is inconsistent with a later position taken by the taxpayer. The admission is not conclusive, however, and the court may determine the weight to be given to it. n14

Even if testimony before the Tax Court indicates a different value, the court may find a value equal to the one originally

given in the tax return. n15 A different value can be substituted by the court only with cogent proof that the reported value was incorrect. n16

[4] Assessed Value for Local Real Estate Tax Purposes

The assessed value of property for local property tax purposes is generally rejected as probative evidence of fair market value because assessed value is almost never a reliable criterion of fair market value. n17 Assessed values determined by probate court representatives are also not controlling, but may be accepted absent other evidence. n18

A court has also rejected as irrelevant for valuation purposes data from a county assessment sales ratio study indicating the median ratio of assessed values to sales price for all property in the county. n19

The use of *tax comparables* may provide "some insight" to value, but the use of *comparable sales* is much preferred. A tax comparable is used to determine a value or price per square foot based on the assessed value of property. n20

Practice Tip:

If a relationship between assessed value and fair market value can be demonstrated, assessed value should generally be used only to corroborate the fair market value as determined by another, more reliable method. Courts do place some reliance on assessed value if it is used primarily as corroboration. n21 In addition, even though assessed valuation is not often a reliable criterion in estimating fair market value, it has been used as a guide for determining the relative values of several parts of a larger piece of property. n21.1

[5] Sale of Subject Property

A direct arm's length sale of the property being valued at a time near the valuation date is probably the best evidence of fair market value, and it is given great weight in determining value. n22

A binding agreement to sell property for a stated price may also fix the value of the property. n23 The market in which the property is sold must be similar to the market on the valuation date, however; and intervening events between the sale date and the valuation date--such as a rapidly escalating or declining market--must not have affected the sale price. n24 Even a sale of the subject property, or portions of it, several years after the valuation date may be relevant in determining fair market value on the valuation date, provided that it can be shown that fluctuating market conditions since the valuation date do not dissipate the evidentiary value of the sale. n25

A sale of the subject property is not always accepted as the best evidence of valuation, if circumstances of the sale indicate it is not a sale at arm's length n26 or that it is otherwise a sale for a price different than fair market value. n27

A bona fide offer, made by a willing and able purchaser, but rejected by the owner, is some evidence of what the owner considers the lower limits of the value of the property to be. n28 It does not, however, conclusively establish the fair market value of the property. n29

[6] Events Occurring After the Valuation Date

[a] In General

It is well settled that events occurring after the valuation date are not considered in determining fair market value, except to the extent that those events were reasonably foreseeable on the valuation date. n30

Subsequent events may be considered for the limited purpose of establishing what a willing buyer's and seller's expectations were on the valuation date, and whether those expectations were reasonable. n31 For example, if a buyer

purchases undeveloped land in a wooded area at an unusually high price, the subsequent building of a nearby highway and shopping mall may be considered in determining expectations of buyer and seller on the valuation date. Did they know these major improvements were in the works at the time of valuation?

Actual ignorance of particular facts that may affect value on the valuation date is not sufficient to remove reasonably discoverable facts from consideration, however. Facts that a reasonable investigation would have disclosed must be taken into account. n32 For example, the presence of fuel tanks on a property might alert a taxpayer to the possibility of potential hazardous waste problems that could reduce the value of the property. n33

[b] Future Development and Re-zoning

The possibility of future development or re-zoning after the date of valuation is often present, particularly with property located in areas undergoing rapid growth and urban expansion. Whether and how they should be factored into the valuation of property on the valuation date depends on whether and how the likelihood of development would have influenced a buyer and seller on the valuation date. The likelihood or risks of obtaining the re-zoning and developing the property, the time frame in which they are likely to occur, and the costs involved must all be considered in making that determination. n34

Zoning and future development are discussed in further detail in connection with the "highest and best use" of property, at § 20.04[2].

[7] Burden of Proof of Valuation

In the usual case, the IRS's determination of fair market value of property in a notice of deficiency is presumed correct. The taxpayer bears the burden of proving a different value. n35

If the IRS pleads an increased deficiency in its answer before the Tax Court, the IRS has the burden of proving a value to the extent that it increases the deficiency claimed in the notice of deficiency. n36

[8] Costs of Removing Structures

The cost of removing undesirable structures after the sale usually causes a reduction in the value of the underlying land. n37

[9] Restrictive Agreements and First Offer Provisions

A restrictive agreement may affect the value of real estate. A restrictive agreement can affect valuation only if it has some legitimate business or other purpose and is not just a substitute for a testamentary disposition. In considering whether a restriction agreement may fix value or have some effect on the value of real estate, the following factors are considered: n38

- whether the price is determinable under the terms of the agreement;
- whether the owner of the interest is obligated to sell at the contract price and the other interest holders are obligated to purchase at that price;
- whether the obligation to sell at the contract price is binding upon the owner of the interest during the owner's lifetime and also binding upon the owner's estate upon the owner's death; and
- whether the agreement is a bona fide business arrangement and not a testamentary device.

Courts have distinguished "first offer" provisions from other types of restrictions and have held them to be only a factor in considering value, rather than determinative of value. n39

Evidence that a first offer provision has not been enforced in the past may lead to a finding that the restriction has little effect on value. n40

[10] Miscellaneous Indications of Value

Miscellaneous items or circumstances may be treated as relevant to, or determinative of, value in particular cases. The following have been mentioned in court cases:

- value recited in various documents relating to a sales transaction; n41
- value of revenue stamps placed on a deed of transfer; n42
- amount of a loan the taxpayer was able to obtain with the property; n43
- amount of a condemnation award; n44
- price at which the subject property was listed for sale; n45
- option price agreed to in a previously executed lease and option agreement; n46
- long-term leases on the property; n47
- evidence of the local economy and the real estate market; n48
- existence of local rent control laws; n49
- evidence of valuations in similar cases. n50

[11] Evidence Not Deemed Relevant to Value

The following have been held in particular cases to be irrelevant in determining the fair market value of real estate:

- data from a county assessment sales ratio study indicating the median ratio of assessed values to sales price for all property in the county; n51
- value for which buildings were insured; n52
- unaccepted offers to purchase or sell; n53
- incompleting sales; n54
- the taxpayer's initial cost, investment or basis in the property; n55
- the value of a "mortgage benefit" as a component of value (a mortgage benefit is the cost savings a purchaser of property would obtain by being able to assume a mortgage on property bearing a rate of interest below prevailing rates); n56

- options giving a right of first refusal, if the taxpayer is not under compulsion to sell; n57
- options granted to purchase property for a specified price; n58
- book value of real estate shown on the taxpayer's books; n59
- changes in the neighborhood based on ethnic or racial factors; n60
- deferred income tax liability that might be incurred on a future sale. n61

FOOTNOTES:

(n1)Footnote 1. *Propstra v Commr*, 680 F2d 1248 (1982) ; *Estate of Spruill v Commr*, 88 TC 1197 (1987) ; *Estate of Gilford v Commr*, 88 TC 38 (1987) ; *Kaplan v Commr*, 43 TC 663 (1965) .

(n2)Footnote 2. *Dressler v Commr*, TC Memo 1956-54 (taxpayer's cost of property in arm's length sale 8 months prior to gift was best evidence of value at time of gift); *Estate of Murphy v Commr*, TC Memo 1981-489 (court took into account taxpayer's purchase price of property 7 years before valuation date).

(n3)Footnote 3. *Estate of Haydel, Sr v Commr*, TC Memo 1991-507 .

(n4)Footnote 4. *Estate of Hillebrandt v Commr*, TC Memo 1986-560 .

(n5)Footnote 5. *Brigham v Commr*, TC Memo 1992-413 ; *Chiu v Commr*, 84 TC 722 (1985) .

(n6)Footnote 6. See *Carver v Commr*, TC Memo 1992-94 (value of property determined based on lease entered into with the lessee for the property); *Deukmejian v Commr*, TC Memo 1981-24 (gifted property could not be valued at fee because it was subject to condition subsequent with retained right of re-entry if the donee did not use it for open space purposes).

(n7)Footnote 7. *Estate of Sharp v Commr*, TC Memo 1994-636 (25-percent reduction in value to reflect costs and hazards of potential litigation over question of ownership of citrus groves).

(n8)Footnote 8. *Fiske v Commr*, TC Memo 1984-494 (court reduced value of portion of donated property that had no access).

(n9)Footnote 9. *Crowley v Commr*, TC Memo 1990-636 (Tax Court took into account zoning restrictions in valuing property contributed to state); see [6], below, for a discussion of future re-zoning.

(n10)Footnote 10. See § 20.03 for a discussion of expert valuation evidence.

(n11)Footnote 11. See *Messing v Commr*, 48 TC 502 (1967) ; *Estate of Spruill v Commr*, 88 TC 1197 (1987) ; *Estate of Gilford v Commr*, 88 TC 38 (1987) ; *Haught v Commr*, TC Memo 1993-58 .

(n12)Footnote 12. IRC § 2032A.

(n13)Footnote 13. *Hamm v Commr*, 325 F2d 934 (8th Cir 1963) , cert denied 377 US 993 (1964) ; *Estate of Juden v Commr*, 865 F2d 960 (8th Cir 1989) , affg TC Memo 1987-302 .

(n14)Footnote 14. *McShain v Commr*, 71 TC 998 (1979) ; *Estate of Hatchett v Commr*, TC Memo 1989-637 .

(n15)Footnote 15. *Hancock v Commr*, TC Memo 1960-230 (court found \$3,000 gift tax value for partial interests in property, although uncontroverted testimony indicated value of \$1,625); *Estate of Forbes v Commr*, TC Memo 2001-72 (court accepted 30-percent discount valuation originally reported in estate tax return).

(n16)Footnote 16. *Estate of Amlie v Commr*, TC Memo 2006-76 ; *Estate of Necastro v Commr*, TC Memo 1994-352 (unknown environmental contamination on property at time return was filed did not justify lower value because it wouldn't have been perceived as an environmental problem by a purchaser at the time the return was filed); *Estate of Hall v Commr*, 92 TC 312 (1989) ; *Estate of Desmond v Commr*, TC Memo 1999-76 (court accepted real estate broker's testimony that no material changes in the market conditions occurred between the valuation date and the date the property was sold, 20 months later, and concluded that property should have been valued at the lower sale price instead of the overvalued amount reported in the return).

(n17)Footnote 17. *Treas Reg* §§ 20.2031-1(b) (estate taxes), 25.2512-1 (gift taxes); *Frazee v Commr*, 98 TC 554 (1992) ; *Medlin v Commr*, TC Memo 2003-224 ; *Jacobson v Commr*, TC Memo 1989-606 ; *Environmental Preservation Co v Commr*, TC Memo 1992-100 ; *Lloyd A Fry Roofing Co v Commr*, TC Memo 1970-298 ; *Estate of Lippincott v Commr*, 27 BTA 735 (1933) , acq 1933-1 CB 8 , *revd on other issue* 72 F2d 788 (3rd Cir 1934) ; *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue* 935 F2d 1285 (4th Cir 1991) (court rejected use of locally assessed values for land in part because no relationship between assessed value and fair market value was demonstrated; county-wide statistical data was also rejected in valuing an individual property); *Estate of Stanton v Commr*, TC Memo 1989-341 ; *Estate of Adams v Commr*, TC Memo 1973-113 ; *Gilmartin v Commr*, TC Memo 1973-247 ; *Cullers v Commr*, 237 F2d 611 (8th Cir 1956) ; but see *Fannon v Commr*, TC Memo 1986-572 , *modified and remanded* 842 F2d 1290 (4th Cir 1988) (court looked to reduction in assessed value of property after the donation of a scenic easement in determining value); *Estate of Kaplin v Commr*, TC Memo 1987-337 , *on remand from* 815 F2d 32 (6th Cir 1987) , *remanding* TC Memo 1986-167 (assessed value relevant to fair market value because applicable state law required assessed value to represent fair market value); *Kellahan, Jr v Commr*, TC Memo 1999-210 (local assessment valuation of man-made canal given some weight because evidence showed assessment valuation was equal to 80 percent of fair market value); *Estate of Burckhard v Commr*, TC Memo 1984-389 (court found value for property higher than locally assessed value).

(n18)Footnote 18. *Estate of Stanton v Commr*, TC Memo 1989-341 ; *Pridmore v Commr*, TC Memo 1961-12 ; *Estate of Powel v Commr*, 10 BTA 166 (1928) ; but see *Estate of Dillon v Commr*, 3 BTA 1139 (1926) (state probate court appraisal accepted for federal tax purposes); *Estate of Buck v Commr*, 25 BTA 780 (1932) (appraised value for state inheritance tax accepted absent other evidence).

(n19)Footnote 19. *Estate of Bennet v Commr*, TC Memo 1989-681 (median figures not useful in determining value of individual properties).

(n20)Footnote 20. See *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 .

(n21)Footnote 21. *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue* 935 F2d 1285 (4th Cir 1991) ; *Northern Trust Co, Transferee v Commr*, 87 TC 349 (1986) , *affd on another issue sub nom Citizens Bank & Trust Co v Commr*, 839 F2d 1249 (7th Cir 1988) ; *Emmet v Commr*, 11 TC 90 (1948) ; *Estate of Frieders v Commr*, TC Memo 1980-184 , *affd* 687 F2d 221 (7th Cir (1982) , *cert denied* 460 US 1011 ; *Newton v Commr*, 11 TC 512 (1948) ; *Kelly v Commr*, 18 BTA 1049 (1930) (court accepted assessed value where the property was sold three years later at a lower price).

(n22)Footnote 21.1. *Medlin v Commr*, TC Memo 2003-224 .

(n23)Footnote 22. *Estate of Spruill v Commr*, 88 TC 1197 (1987) ; *Estate of Feuchter v Commr*, TC Memo 1992-97 ; *Estate of Stanton v Commr*, TC Memo 1989-341 ; *Estate of Keitel v Commr*, TC Memo 1990-416 (Tax Court valued motel at \$350,000, based on its sale for \$375,000 1 year after the valuation date); see *Epstein v Commr*, 53 TC 459 (1969) (although relying on the sale of the subject property, the court found that sale price did not equal fair market value of property because the price was to be paid on a long-term installment basis, and therefore included an interest component); *Estate of Sharp v Commr*, TC Memo 1994-636 (Tax Court valued taxpayer's 25-percent interest in a shopping center based on one-half the amount that a 50-percent interest in the shopping center had sold for 5 months

earlier); *Stanton v Commr*, TC Memo 1980-300 (sale of property by charitable donee one year after receiving it was the most persuasive evidence of value on the date of gift); *Wortmann et al v Commr*, TC Memo 2005-227 (purchase price 17 months before valuation date considered; value was corroborated by expert testimony).

(n24)Footnote 23. *Estate of Quinn v Commr*, TC Memo 1982-32 ; see Rev Rul 80-319, 1980-2 CB 252 (price negotiated for sale of property shortly before decedent's death treated as fair market value of the property).

(n25)Footnote 24. *Brigham v Commr*, TC Memo 1992-413 (\$30,000 sale price 16 months prior to gift did not support \$185,000 claimed value; Tax Court found value of \$80,000); *Chiu v Commr*, 84 TC 722 (1985) ; *Estate of Kaplin v Commr*, 748 F2d 1109 (6th Cir 1984) , revg TC Memo 1982-440 ; *Ketteman Trust v Commr*, 86 TC 91 (1986) (sale of subject property 15 months after valuation date given little weight because of rapidly escalating market and inability to reliably determine the rate of appreciation); *Tripp v Commr*, 337 F2d 432 (7th Cir 1964) , affg TC Memo 1963-244 ; *Baker v Commr*, TC Memo 1990-263 ; *Walker v Commr*, TC Memo 1982-495 .

(n26)Footnote 25. *Estate of Hillebrandt v Commr*, TC Memo 1986-560 .

(n27)Footnote 26. Cf. *First Republic Bank et al v US*, 88-2 USTC P 13,786 (WD Tex 1988) (court rejected sale of subject property 180 days after valuation date as determinative of value because the sale took place during a depressed market and did not reflect the highest and best use of the property, which was to be held until such time as there was demand for development; court therefore valued the property at \$12,500 per acre, rather than at the \$8,500/per acre argued by the taxpayer).

(n28)Footnote 27. *Estate of Sirmans v Commr*, TC Memo 1997-241 (property was sold to the county at a below-market price in a quick sale in order to end uncertainties over a county road project).

(n29)Footnote 28. *Estate of Brown v Commr*, TC Memo 1956-240 ; *Payne v Commr*, 12 BTA 781 (1928) .

(n30)Footnote 29. *Estate of Brown v Commr*, TC Memo 1956-240 .

(n31)Footnote 30. *Ithaca Trust Co v US*, 279 US 151 (1929) ; *First National Bank of Kenosha v US*, 763 F2d 891 (7th Cir 1985) ; *Estate of Van Horne v Commr*, 720 F2d 1114 (9th Cir 1983) , affg 78 TC 728 (1982) ; *Estate of Spruill v Commr*, 88 TC 1197 (1987) ; *Frazee v Commr*, 98 TC 554 (1992) ; *Estate of Gilford v Commr*, 88 TC 38 (1987) ; *Estate of Jephson v Commr*, 81 TC 999 (1983) ; *Estate of Hatchett v Commr*, TC Memo 1989-637 (deterioration in property, sale of property 4 years later at significantly lower price, and declining local economy after valuation date were not relevant to fair market value); see *Treas Reg § 20.2031-1(b)* (knowledge of future events that may have affected value cannot be attributed to hypothetical buyer); *Branch v Commr*, TC Memo 1987-321 (anticipated appreciation of property could be treated as an offset to discounting); *Barudin v Commr*, TC Memo 1996-395 (likely future termination of lease of office building relevant to value on valuation date); *Estate of Gilford v Commr*, 88 TC 38 (1987) ; *Lynch v Commr*, TC Memo 1983-173 (post valuation date changes in neighborhood were not evidence of decline in valuation); *Estate of Langer v Commr*, TC Memo 2006-232 (court valued decedent's 29% interest in an LLC, which depended on the value of 2 phases of a planned commercial development; in looking at comparables for one phase, the court focused on comparative location, exposure, configuration, accessibility, and zoning, and for the other phase, the most significant variables were location and exposure).

(n32)Footnote 31. *Estate of Pillsbury v Commr*, TC Memo 1992-425 ; *Estate of Gilford v Commr*, 88 TC 38 (1987) , quoting *Estate of Jephson v Commr*, 81 TC 999 (1983) , citing *Couzens v Commr*, 11 BTA 1040 (1928) ; *Estate of Jennings v Commr*, TC Memo 1976-152 (court limited value of property based on rescission of a pre-death contingent sale of property resulting from a post-death denial of a re-zoning permit); *Estate of Gilford v Commr*, 88 TC 38 (1987) ; *Estate of Clapp v Commr*, TC Memo 1983-721 (post-date sale admitted to show evidence of value).

(n33)Footnote 32. *Estate of Pillsbury v Commr*, TC Memo 1992-425 , quoting *Estate of Tully v US*, 78-1 USTC P 13,228 .

(n34)Footnote 33. See *Estate of Pillsbury v Commr*, TC Memo 1992-425 .

(n35)Footnote 34. *Frazee v Commr*, 98 TC 554 (1992) (likely re-zoning of property from agricultural to industrial should have been considered at time of valuation); *Losch v Commr*, TC Memo 1988-230 (court declined to increase value of property for effects of later zoning change because the purchase contract in issue was contingent on re-zoning, so any value attributable to the re-zoning was already reflected in purchase price); *Mathis v Commr*, TC Memo 1989-254 (downward adjustment required to reflect cost of zoning subject property and possibility that property might not be re-zoned); *Morris v Commr*, TC Memo 1982-508 , *affd* 761 F2d 1195 (6th Cir 1985) (valuation took into account likely development of agricultural property likely to occur 8-15 years later); *Estate of Pattison v Commr*, TC Memo 1990-428 (use of post-death date comparable sales held appropriate because the increasing prices shown by those sales reflected relevant facts that buyers and sellers would have known on the date of the decedent's death); *Lloyd v Commr*, TC Memo 1996-30 (court found highest and best use of property was commercial, notwithstanding that it was zoned as residential, because of its proximity to highways, likelihood of re-zoning, and developer interest); *Estate of Jennings v Commr*, TC Memo 1976-152 (court limited value of property based on rescission of a pre-death contingent sale of property resulting from a post-death denial of a re-zoning permit, and also because of costs of sewerage and road construction and extensive capital improvements that would be necessary to develop the property); *Estate of Wilson v Commr*, TC Memo 1964-17 (effect of rapid development on prices after gift of property was not foreseeable at time of gift); *Estate of Busch v Commr*, TC Memo 2000-3 (rejection of development permit by local authorities four years after the valuation date, largely due to a changed local political climate, could not have been foreseen, and could not be used to lower valuation); *Wolfe v Commr*, 13 TCM 22 (1954) (approved zoning change that was being appealed in court on the valuation date considered in determining value).

(n36)Footnote 35. *Welch v Helvering*, 290 US 111 (1933) ; *Frazee v Commr*, 98 TC 554 (1992) ; *Rule 142(a)*, Tax Court Rules of Practice and Procedure; *Estate of Murphy v Commr*, TC Memo 1981-489 ; *Jacobson v Commr*, TC Memo 1989-606 ; *Crock v Commr*, TC Memo 1983-351 .

(n37)Footnote 36. *Tax Court Rule 142(a)*; *Learner v Commr*, TC Memo 1983-122 ; *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue* 935 F2d 1285 (4th Cir 1991) ; *Imbesi v Commr*, TC Memo 1981-484 ; *Estate of Wineman v Commr*, TC Memo 2000-193 ; *Estate of Sels v Commr*, TC Memo 1986-501 ; *Estate of Brown v Commr*, TC Memo 1962-249 (court used IRS value in notice of deficiency for several properties because taxpayer failed to prove lower value, and IRS failed to substantiate higher value claimed before the Tax Court).

(n38)Footnote 37. See *Rainer v Commr*, 1977-351 (costs of removing baseball stadium so as to develop the property to its highest and best use (a shopping center) were not deducted in determining value because income the stadium would provide in the interim would offset the projected costs of removal).

(n39)Footnote 38. *Estate of Wildman v Commr*, TC Memo 1989-667 ; *US v Land*, 303 F2d 170 (5th Cir 1962) , *cert denied* 371 US 862 (1962) (restrictive agreement for the maintenance of family ownership and control may be a legitimate business consideration).

(n40)Footnote 39. *Estate of Wildman v Commr*, TC Memo 1989-667 (court gave 15-percent discount to reflect first offer restriction affecting the land, under which any beneficiary of the trust (which owned the land) who wished to sell or dispose of the interest had to first offer to sell the interest at its appraised dry farmland value to the other beneficiaries or the trustee); *Estate of Reynolds v Commr*, 55 TC 172 (1970) .

(n41)Footnote 40. *Estate of Wildman v Commr*, TC Memo 1989-667 .

(n42)Footnote 41. *Cochran v Commr*, TC Memo 1972-15 .

(n43)Footnote 42. *Cochran v Commr*, TC Memo 1972-15 .

(n44)Footnote 43. *Cochran v Commr*, TC Memo 1972-15 (in determining value, the court noted that state law did

not permit a savings and loan association to make a secured loan on real property in excess of 70 percent of the property's appraised value); *Hess v Commr*, 24 BTA 475 (1931), acq XI-I CB 4 (because of institutional loan requirements, mortgage of \$725,000 supported valuation of \$1.1 million).

(n45)Footnote 44. *Ariel Realty Co v Commr*, 115 F2d 659 (2nd Cir 1940); *Seaside Improvement Co v Commr*, 105 F2d 990 (2nd Cir 1939), cert den 308 US 618 (1939), affg *Jamieson Associates, Inc v Commr*, 37 BTA 92 (1938) (condemnation award was "some evidence" of fair market value).

(n46)Footnote 45. *Carr v Commr*, TC Memo 1985-19; *Aagard v Commr*, 56 TC 191 (1971), acq 1971-2 CB 1 (court noted that the fair market value of property was unlikely to be more than the price at which the taxpayer listed it for sale).

(n47)Footnote 46. *Cobb v Commr*, TC Memo 1985-208 (estate tax value of farm was limited to the \$100,000 option price agreed to in option agreement, rather than its \$270,000 fair market value); but see *Thornton v Commr*, TC Memo 1988-479, affd without publ opinion 908 F2d 977 (9th Cir 1990) (option granted to purchase property for a specified price not accepted as evidence of value).

(n48)Footnote 47. See *Hancock v Commr*, TC Memo 1960-230.

(n49)Footnote 48. *LeFrak v Commr*, TC Memo 1993-526; *Estate of Barudin v Commr*, TC Memo 1996-395 (economic recession and weak commercial real estate market on valuation date was relevant); *Feuchter v Commr*, TC Memo 1992-97 (land valued as agricultural, rather than as potential residential, commercial, or industrial property because long-standing recession in local economy made development unlikely); *Estate of Murphy v Commr*, TC Memo 1981-489 (prospect for commercial development unlikely because of poor local economy, numerous vacancies, and decreasing population).

(n50)Footnote 49. *LeFrak v Commr*, TC Memo 1993-526.

(n51)Footnote 50. *Fannon v Commr*, TC Memo 1989-136 (court rejected valuation evidence of both sides and valued a scenic easement by applying a percentage used in a similar, but unrelated, case).

(n52)Footnote 51. *Estate of Bennet v Commr*, TC Memo 1989-681 (median county figures not useful in determining value of individual properties).

(n53)Footnote 52. *Aagard v Commr*, 56 TC 191 (1971), acq 1971-2 CB 1 (little weight given to amount of fire insurance in valuing building); *Lloyd A Fry Roofing Co v Commr*, TC Memo 1970-298 (insured value rejected for valuing obsolete mill buildings because the amount for which they were insured was based on replacement cost less depreciation, and replacement cost was not, under the circumstances, indicative of fair market value).

(n54)Footnote 53. *Lloyd v Commr*, TC Memo 1996-30 (while offers and option contracts to buy might indicate commercial nature of property, there were entitled to no weight in valuing the property); *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412; *Sharp v US*, 191 US 341 (1903); *Estate of Stanton v Commr*, TC Memo 1989-341; but see *Glick v Commr*, TC Memo 1997-65 (amount offered for property considered in valuing the amount of charitable contribution; the offer supported other evidence of value offered by taxpayer).

(n55)Footnote 54. *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 but see *Estate of Murphy v Commr*, TC Memo 1981-489 (court took into account taxpayer's failure to sell property at listed price for several years before and after valuation date).

(n56)Footnote 55. *Hancock v Commr*, TC Memo 1960-230; but see *Dressler v Commr*, TC Memo 1956-54 (taxpayer's cost of property in arm's length sale 8 months prior to gift was the best evidence of value at time of gift); *Estate of Murphy v Commr*, TC Memo 1981-489 (court took into account taxpayer's purchase price of property 7 years

before the valuation date).

(n57)Footnote 56. *LeFrak v Commr*, *TC Memo* 1993-526 .

(n58)Footnote 57. *Estate of Quinn v Commr*, *TC Memo* 1982-32 ; but see [9] above, for a discussion of the effect of restriction agreements.

(n59)Footnote 58. *Thornton v Commr*, *TC Memo* 1988-479 , *affd without publ opinion* 908 F2d 977 (9th Cir 1990) .

(n60)Footnote 59. *Rolland v Commr*, 12 TCM 124 (1953) (taxpayer proved that amount paid, and not book value, was the fair market value of property; IRS offered no credible evidence and was arguing for the book market valuation).

(n61)Footnote 60. See *Lynch v Commr*, *TC Memo* 1983-173 .

(n62)Footnote 61. *Becker v US*, 751 F Supp 827 (D Neb 1990) (in a gift tax case, court rejected taxpayer's argument that the stipulated value of land transferred to a corporation should be further reduced to reflect the deferred income tax that would be due if the corporation sold the land).



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Federal Taxes Affecting Real Estate

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CHAPTER 20 Valuation Of Real Property

2-20 Federal Taxes Affecting Real Estate § 20.02

§ 20.02 Valuation Date

Property is valued on the valuation date. For estate tax purposes, this is the date of the death of the decedent. n62

If the alternate valuation date is chosen for valuing the decedent's estate, however, the valuation date is six months after the date of the decedent's death, n63 except for property that is distributed, sold, exchanged, or otherwise disposed of within six months after the decedent's death. That property is valued as of the date of distribution, sale, exchange, or other disposition. n64

For estate tax purposes, any interest or estate that is affected by mere lapse of time is valued as of the date of the decedent's death even if the alternate valuation date is chosen. An adjustment is made for any difference in its value as of the alternate valuation date that is not due to mere lapse of time. n65

Property affected by mere lapse of time includes estates for the lives of persons other than the decedent, remainders, and reversions, and other like properties, interests, or reversions. n66 For gift tax purposes, property is valued as of the date of the gift. n67 For purposes of the tax on generation-skipping transfers, property is generally valued as of the time of the generation-skipping transfer. n68

In the case of any direct skip of property that is included in the transferor's gross estate, the value of the property for purposes of the generation-skipping tax is determined as of the same date as for estate taxes (determined with regard to any alternate valuation date election). n69

The valuation date may also be any date upon, or as of, which the value of real property must be determined, including the following:

- the date of a purchase, for purposes of allocating basis among assets, n70 determining the basis of assets, n71 computing gain, n72 or for some other purpose; n73
- the date a residence is converted into income-producing property, for purposes of determining loss; n74
- the date a constructive dividend is determined to have been paid; n75

- the date of a liquidating distribution; n76
- the date upon which solvency of a subsidiary must be determined. n77

FOOTNOTES:

(n1)Footnote 62. See *IRC § 2031(a)*; *Treas Reg § 20.2031-1(b)*.

(n2)Footnote 63. *IRC § 2032(a)(2)*; *Treas Reg § 20.2032-1(a)*.

(n3)Footnote 64. *IRC § 2032(a)(1)*.

(n4)Footnote 65. *IRC § 2032(a)(3)*.

(n5)Footnote 66. *Treas Reg § 20.2032-1(f)*.

(n6)Footnote 67. *IRC § 2512(a)*.

(n7)Footnote 68. *IRC § 2624*.

(n8)Footnote 69. *IRC §§ 2032(a)(2), 2624(b)*.

(n9)Footnote 70. See *Freres Lumber Co v Commr, TC Memo 1995-589* (Tax Court determined the fair market value of land and a building for purposes of allocating basis on the purchase of a timber business).

(n10)Footnote 71. See *VanDuzer v Commr, TC Memo 1991-249* (issue was whether purchase prices of wind farms were in excess of their fair market value, which would reduce their basis).

(n11)Footnote 72. See *Cochran v Commr, TC Memo 1972-15* (the difference between the fair market value of property and the price the taxpayer paid was taxable to the taxpayer).

(n12)Footnote 73. See *Carver v Commr, TC Memo 1992-94* (the timeliness of a notice of deficiency (and whether a 6-year statute of limitations applied) depended on the value of property purchased by shareholders from their corporation and treated as a constructive dividend).

(n13)Footnote 74. See *Smith v Commr, 8 TCM 1041 (1949)*.

(n14)Footnote 75. *Terris v Commr, TC Memo 1983-29*; *Lanier, Inc et al v Commr, TC Memo 1998-7*; *Ole Bardahl v Commr, TC Memo 1965-116* (value of personal residence sold by shareholders to their corporation at more than its fair market value); *Epstein v Commr, 53 TC 459 (1969)*; *Kloppenber & Company et al v Commr, TC Memo 1986-325*.

(n15)Footnote 76. *Buda v Commr, TC Memo 1999-132*; *Barry v Commr, TC Memo 1963-225*.

(n16)Footnote 77. See *Continental Grain Co v Commr, TC Memo 1988-577*, *affd on reconsideration TC Memo 1989-155*.



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CHAPTER 20 Valuation Of Real Property

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§ 20.03 Use of Expert Opinion to Value Real Estate

[1] In General

Expert opinion is admissible in federal courts if it will assist the trier of fact to understand evidence that will determine the fact in issue. n78 An expert's valuation opinion is a guide in determining value. n79 A court is not bound by any expert opinion that is contrary to its own judgment, however, and it may either accept or reject an expert's testimony. n80 Furthermore, the court need not accept an expert's opinion on valuation in its entirety, but may be selective and accept certain parts and reject others. n81 It may also accept the general methodology of an expert, but reject that expert's ultimate conclusion if it is unsupported by the record. n82 It may also find one expert more persuasive on one element of valuation and another expert more persuasive on another element. n83 Furthermore, an expert's appraisal may be rejected even if it is the only opinion evidence in the record. n84

The following factors with respect to an expert's valuation opinion can add to its persuasiveness:

- personal inspection by the expert of the subject property, n85 especially if the inspection occurs at or near the valuation date; n86
- familiarity with local real estate market conditions; n87
- a detailed report describing facts and data upon which a valuation opinion is based, and reasons for conclusions. This should include a detailed explanation of the effect of each variable for comparable properties, and the weight given to any unique circumstances of comparable sales. n88

[2] Qualifications of Valuation Experts

Courts routinely weigh valuation evidence in light of the demonstrated qualifications of the experts and all other credible evidence. n89 For example, the testimony of a broker is likely to be given less credibility than the testimony of a professional appraiser, even if the broker is knowledgeable about local market conditions. n90

Nevertheless, a court will often permit testimony of valuation from a person with valuation experience and familiarity with local market conditions, even if formal appraisal credentials and memberships in professional appraisal societies are lacking. n91

Objections to the credentials of an expert typically go to the weight to be given to the valuation testimony or other evidence provided, rather than being grounds for exclusion of the evidence entirely. n92

In addition, opinion testimony of value by a lay witness is admissible if the testimony is based on the perception of that witness and is helpful to a clear understanding of either the witness's testimony or the determination of a fact in issue. n93 Thus, the owner of property is qualified, by ownership alone, to testify as to its value because of the presumption of special knowledge that arises out of ownership of the land. n94 There is also authority for the proposition that a witness is sufficiently qualified to give testimony as to land values as a "quasi-expert," where the witness is a resident, landowner, or farmer in the neighborhood. n95 A witness may be qualified as an expert by knowledge, skill, experience, training, or education. n96 It is within the discretion of a trial court to determine whether a witness qualifies as an expert. That determination will not be reversed on appeal unless it is clearly erroneous. n97

A court may refuse to admit into evidence valuation opinions by a person who does not qualify as an expert, n98 may restrict the matters upon which testimony may be given, n98.1 or it may give little or no weight to testimony or reports from someone who is not an expert. n99

In nearly all valuation cases, the court lists the qualifications and experience of the various experts, often listing the particular number of appraisals an expert has done. The relative qualifications of the competing experts are then considered in determining the weight the court gives to their valuation reports and testimony. n100

Of importance are the following: n101

- education and association memberships of the expert (membership in the American Institute of Real Estate Appraisers, Society of Real Estate Appraisers, or American Society of Appraisers is often mentioned);
- achievement of particular designations within those organizations is also mentioned, with the MAI designation considered the most highly recognized appraisal designation; n102
- experience in appraising and/or buying and selling the particular type of property involved; n103
- experience in appraising property in the locale of the subject property; n104
- experience with local zoning approval processes; n105
- experience in providing expert testimony, and in representing a variety of clients; and n106
- general familiarity with the local area and subject property. n107

Regardless of qualifications, however, courts are not reluctant to reject expert testimony that is unsupported or biased, n108 and they may give greater weight to more solid evidence presented by a less qualified expert. n109 Doubts about the reliability of an expert's valuation are more often due to the failure of facts to support valuation assumptions and the testimony of value, as well as internal inconsistencies or errors within appraisal reports and testimony, rather than to the qualifications of the expert *per se*. n110

[3] Litigation of Valuation Cases

The Tax Court hates valuation cases and has said repeatedly that valuation disagreements are far better resolved by negotiations between the parties rather than by judicial pronouncement. n111 Often, the Tax Court's final valuation

figure is summarily given, with little explanation of the process by which it was reached, or with a statement that explaining its reasoning in detail would serve no useful purpose. n112

The Tax Court has admitted that its valuation conclusions are subjective and that to fully explain its analysis would merely give an illusion of a process of reasoning, when in fact the result reached is simply an ultimate finding based on the record as a whole. n113

In case after case, the Tax Court simply does the best it can with the data presented by the parties, and it gleans what it can from the experts' often widely conflicting analyses and valuations. In the exercise of its "Solomon-like wisdom", it then arrives at its own conclusions as to value. n114

All too often, however, the valuation experts give blatantly result-oriented, self-serving valuation data that favors the side that hired them. In these cases, the court more or less throws its hands up in disgust, castigates the experts' credibility and evidence, and comes up with a figure on its own. The court's figure is not infrequently about mid-way between the figures promoted by the IRS and the taxpayer. This isn't surprising, given the ludicrous extremes experts claim as the value for a single parcel of property. n115

Even in cases where the integrity of the experts isn't questioned and their evidence is not clearly "result oriented," courts often reach a middle figure from those suggested by the parties. n116 Nevertheless, a "middle-of-the-road-compromise" is not always the end result. n117 Indeed, the Sixth Circuit has admonished the Tax Court for finding mid-point valuations without giving a detailed explanation of its rationale. n118

[4] Contents of Appraisal Reports

An appraisal of real property for tax purposes should be obtained from a qualified and reputable appraiser, and it should generally contain the following: n119

- a summary of the appraiser's qualifications;
- a statement of the value and the appraiser's definition of the value obtained;
- the bases upon which the appraisal was made, including any restrictions, understandings, or covenants limiting the use or description of the property;
- the date as of which the property was valued;
- the signature of the appraiser and the date of the appraisal.

FOOTNOTES:

(n1)Footnote 78. *Fed Rule of Evid 702*.

(n2)Footnote 79. *Bardahl v Commr, TC Memo 1965-116* .

(n3)Footnote 80. *Helvering v National Grocery Co, 304 US 282 (1938)* ; *Frazee v Commr, 98 TC 554 (1992)* ; *Jacobson v Commr, TC Memo 1989-606* ; *Estate of Kreis v Commr, 227 F2d 753 (6th Cir 1955)* ; *Fannon v Commr, TC Memo 1989-136* (court rejected valuation evidence of both sides and valued a scenic easement by applying a percentage used in a similar, but unrelated case); *Estate of Clapp, TC Memo 1983-721* (court found both experts unpersuasive and rejected their conclusions of value); *Estate of Hinz, TC Memo 2000-6* (court rejected inconsistent, poorly documented, and erroneous valuations by both sides and found its own value of four parcels from a miserable record); *Pabst Brewing Co v Commr, TC Memo 1996-506* (Tax Court rejected poor valuation evidence by all experts and valued breweries,

land, building, and other property based on valuations set forth in an allocation agreement corresponding to a stock transfer).

(n4)Footnote 81. *Buffalo Tool and Die Mfg Co v Commr*, 74 TC 441 (1980) ; *Parker v Commr*, 86 TC 547 (1986) ; *Frazee v Commr*, 98 TC 554 (1992) ; *Haught v Commr*, TC Memo 1993-58 ; *Estate of Palmer v Commr*, 1992-48; *Estate of Wineman v Commr*, TC Memo 2000-193 .

(n5)Footnote 82. *Owensby & Kritikos, Inc v Commr*, 819 F2d 1315 (5th Cir 1987) , *affg TC Memo 1985-267* ; *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 .

(n6)Footnote 83. *Estate of Langer v Commr*, TC Memo 2006-232; *Parker v Commr*, 86 TC 547 (1986); *Estate of Fittl v Commr*, TC Memo 1986-452 .

(n7)Footnote 84. *Estate of Palmer v Commr*, 1992-48.

(n8)Footnote 85. See *Mathis v Commr*, TC Memo 1989-254 .

(n9)Footnote 86. *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue*, 935 F2d 1285 (4th Cir 1991) (inspections 2 to 3 1/2 years after date of gift given little weight); *Crock v Commr*, TC Memo 1983-351 (inspection 6 years after date of gift).

(n10)Footnote 87. *Smith v Commr*, 8 TCM 1041 (1949) ; *Estate of Brown v Commr*, TC Memo 1962-249 (court accepted valuation of taxpayer's expert because he had a long familiarity with the property, its location, and various local factors that affected value); *Estate of Baird et al v Commr*, TC Memo 2001-258 (Tax Court accepted 60-percent discount in valuing decedents' fractional interests in a family trust holding timberland largely due to long-standing experience of the taxpayers' main expert with fractional interests in timber property).

(n11)Footnote 88. See *Estate of Harms v Commr*, TC Memo 1981-320 ; *Estate of Fittl v Commr*, TC Memo 1986-452 ; *Estate of Wineman v Commr*, TC Memo 2000-193 ; *Estate of Baird et al v Commr*, TC Memo 2001-258 .

(n12)Footnote 89. *Estate of Hatchett v Commr*, TC Memo 1989-637 ; *Haught v Commr*, TC Memo 1993-58 ; *Proios v Commr*, TC Memo 1994-442 ; *Rev Proc 66-49*, 1966-2 CB 1257 (guidelines for appraising donated property); *Clemens v Commr*, TC Memo 1992-436 ; see *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue* 935 F2d 1285 (4th Cir 1991) (taxpayer's unqualified expert used an appraisal method unknown to the court); but see *Estate of Wineman v Commr*, TC Memo 2000-193 (qualifications of experts did not play a part in court's decision).

(n13)Footnote 90. *Crane v Commr*, 49 TC 85 (1967) (court gave greater weight to testimony of IRS expert appraiser where taxpayer's experts based their valuations on subjective knowledge of local real estate market; the taxpayer's experts were real estate dealers, but were not qualified appraisers); See *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue* 935 F2d 1285 (4th Cir 1991) (taxpayer's unqualified expert used an appraisal method unknown to the court).

(n14)Footnote 91. *Smith v Commr*, 8 TCM 1041 (1949) (court permitted valuation testimony by two IRS engineer revenue agents); see *Krauskopf v Commr*, TC Memo 1984-386 (a witness may qualify as an expert without any particular study or training and without membership in any professional organization); but see *Estate of McCampbell v Commr*, TC Memo 1991-141 .

(n15)Footnote 92. See *Pinson III v Commr*, TC Memo 1990-77 (IRS valuation engineer who had given 200 appraisals in a 9-year career and had attended property appraisal course was qualified as an expert to value farm property).

(n16)Footnote 93. *Fed Rule of Evidence 701*.

(n17)Footnote 94. *Estate of McCampbell v Commr*, TC Memo 1991-141 ; *Estate of Nutter v Commr*, TC Memo 1982-530 ; *Harmon v Commr*, 13 TC 373 (1949) ; see *Estate of Nail v Commr*, 59 TC 187 (1972) (owner's self-serving testimony of value admitted, but given little weight).

(n18)Footnote 95. See *Estate of McCampbell v Commr*, TC Memo 1991-141 ; *Rudd v US*, 256 F2d 460 (9th Cir 1958) .

(n19)Footnote 96. *Fed Rule of Evidence 702*.

(n20)Footnote 97. *Estate of McCampbell v Commr*, TC Memo 1991-141 ; *Hamling v US*, 418 US 87 (1974) .

(n21)Footnote 98. *Estate of McCampbell v Commr*, TC Memo 1991-141 (trust officers of bank responsible for administering ranch properties could not testify as experts on the value of the ranches).

(n22)Footnote 98.1. *Estate of Amlie v Commr*, TC Memo 2006-76 (IRS did not establish qualifications of its expert, so court limited his testimony to a description of his methodology).

(n23)Footnote 99. *Haught v Commr*, TC Memo 1993-58 (court rejected testimony of general engineer with no experience appraising the type of property in question); *Estate of Pridmore v Commr*, TC Memo 1961-12 (executor of estate not qualified as an expert and court rejected his opinion of value); *Estate of McCormick et al v Commr*, TC Memo 1995-371 (court rejected valuation testimony of taxpayer's son; although he was a real estate broker, he had no appraisal expertise and had an interest in the outcome); but see *Estate of Cullison v Commr*, TC Memo 1998-216 (court accepted credible valuation testimony of farmland by decedent's son because IRS offered no credible evidence).

(n24)Footnote 100. *Estate of Dougherty v Commr*, TC Memo 1990-274 (Tax Court accepted IRS experts' valuations because they were more qualified and more familiar with general area, and were credible and specific with respect to adjustments to comparable sales in reaching their figures; court rejected valuations done by taxpayer's son, by a deceased appraiser who couldn't be cross examined, and by an Indiana appraiser who had never valued Florida land before); *Dennis v US*, 92-2 USTC P 50,498 (ED Va 1992) (court accepted taxpayer's expert's valuation because he was far more qualified, experienced and familiar with the county where the property was located and used seven comparable sales; IRS expert was less qualified and less familiar with the area where the property was located, and used only one comparable sale, which was suspect and occurred 10 years after the valuation date). *Estate of Amlie v Commr*, TC Memo 2006-76 (IRS did not establish qualifications of its expert and court therefore found his testimony less reliable).

(n25)Footnote 101. *Frazee v Commr*, 98 TC 554 (1992) ; *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue* 935 F2d 1285 (4th Cir 1991) .

(n26)Footnote 102. See *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue*, 935 F2d 1285 (4th Cir 1991) ; *Lynch v Commr*, TC Memo 1983-173 ; *Dise v Commr*, TC Memo 1986-87 .

(n27)Footnote 103. *Estate of Hatchett v Commr*, TC Memo 1989-637 (numerous appraisals of farmland noted); *Clemens v Commr*, TC Memo 1992-436 .

(n28)Footnote 104. *Estate of Baird et al v Commr*, TC Memo 2001-258 (Tax Court accepted report of taxpayer's expert in part because of his 20-year experience buying and selling timberland of the type being valued); *Estate of Hatchett v Commr*, TC Memo 1989-637 (court rejected IRS expert testimony in part because he had never appraised property in the state where subject property was located); *Branch v Commr*, TC Memo 1987-321 ; *Clemens v Commr*, TC Memo 1992-436 (appraiser had never appraised property on island where subject property was located).

(n29)Footnote 105. *Clemens v Commr*, TC Memo 1992-436 (court rejected testimony of appraiser with no experience valuing the type of property in question and no familiarity with the local zoning approval process; the court rejected his 23-lot plan for valuation and accepted a local expert's opinion that value should be based on expected

zoning approval for 40 lots).

(n30)Footnote 106. *Estate of Harms v Commr, TC Memo 1981-320* .

(n31)Footnote 107. *Estate of Harms v Commr, TC Memo 1981-320* ; *Branch v Commr, TC Memo 1987-321* (court placed greater weight on expert with more local experience and hands-on knowledge regarding development); but see *Estate of Vinson v Commr, TC Memo 1963-70* (evidence of out-of-area appraiser more reliable and detailed and given more weight than poor, unexplained appraisal by local expert) and *Walker v Commr, TC Memo 1975-303* (more weight given to more qualified expert, even though he was not a resident of, and had never appraised property in, the county, because he familiarized himself with local trends regarding demand for land, availability of financing, and comparable sales).

(n32)Footnote 108. *Estate of Hatchett v Commr, TC Memo 1989-637* ; *Proios v Commr, TC Memo 1994-442* ; *Rev Proc 66-49, 1966-2 CB 1257* (minimum information that should be included in appraisal report for donated property); *Estate of Palmer v Commr, 1992-48* (appraisal rejected because not supported by written report); *Estate of Vinson v Commr, TC Memo 1963-70* (little or no weight given to report and testimony that was internally inconsistent, used incorrect information about subject property, and gave no indication of how adjustments were made); *Silberman v Commr, TC Memo 1973-48* (little weight given to appraiser's evidence because he provided no information about comparable properties).

(n33)Footnote 109. *Branch v Commr, TC Memo 1987-321* ; see *Environmental Preservation Company v Commr, TC Memo 1992-100* .

(n34)Footnote 110. See *Estate of Fittl v Commr, TC Memo 1986-452* ; *Talkington v Commr/Sessions v Commr, TC Memo 1998-412* ; *Carr v Commr, TC Memo 1985-19* (IRS expert ignored 25-year lease on property with an option to purchase, which lowered the property's value considerably; for other properties, he ignored a payment to another party that the taxpayer would have to make on their sale); *Estate of Hillbrandt v Commr, TC Memo 1986-560* (flaws noted in reports of all the experts); *Wyatt v Commr, TC Memo 1991-621* (Tax Court valued avocado grove at \$700,000, rather than the \$2.6 million claimed by the taxpayer; court relied exclusively on the IRS appraiser, who used sales comparison approach with supporting detailed analysis of 22 comparable properties; the taxpayer's expert submitted only 2 letters, one a summary comment on a prior appraisal by the IRS, and the other a conclusory comparison of two property sales).

(n35)Footnote 111. *Buffalo Tool and Die Mfg Co v Commr, 74 TC 441 (1980)* ; *Symington v Commr, 87 TC 892 (1986)* ; *Estate of Heckscher v Commr, 63 TC 485 (1975)* ; *Messing v Commr, 48 TC 502 (1967)* ; *Losch v Commr, TC Memo 1988-230* ; *Talkington v Commr/Sessions v Commr, TC Memo 1998-412* ; *Estate of Forman, TC Memo 1978-510* (valuing real properties in order to value partnerships that owned them); *Dowlin v Commr, TC Memo 1994-183* ; *Walker v Commr, TC Memo 1982-495* ; *Branch v Commr, TC Memo 1987-321* .

(n36)Footnote 112. *Estate of Tarver v Commr, 26 TC 490 (1956)* .

(n37)Footnote 113. *Maples v Commr, TC Memo 1971-180* ; *Clark v Commr, TC Memo 1978-402* ; *Rainier Companies v Commr, TC Memo 1977-351* ; *Turner v Commr, TC Memo 1977-437* ; see *Small v Commr, TC Memo 1969-211* ; *Estate of Rabe v Commr, TC Memo 1975-26* , *affd without publ opinion 566 F2d 1183 (9th Cir 1977)* .

(n38)Footnote 114. *Frazee v Commr, 98 TC 554 (1992)* ; *Buffalo Tool and Die Mfg Co v Commr, 74 TC 441 (1980)* ; *Ketteman Trust v Commr, 86 TC 91 (1986)* ; *Estate of Murphy v Commr, TC Memo 1981-489* ; *Haught v Commr, TC Memo 1993-58* (Tax Court values gas and oil wells at a value midway between the figures offered by each side); *Estate of Palmer v Commr, 1992-48*; *Talkington v Commr/Sessions v Commr, TC Memo 1998-412* ; *Bardahl v Commr, 1965-116*.

(n39)Footnote 115. *Jacobson v Commr, TC Memo 1989-606* (\$260,000 vs \$750,000; Tax Court found \$538,000); *Frazee v Commr, 98 TC 554 (1992)* (testimony of values ranging from \$470,000 to \$1.65 million); *Mathis v Commr,*

TC Memo 1989-254 ; Brigham v Commr, TC Memo 1992-413 (IRS claimed \$30,000 value, taxpayer claimed \$185,000, and court found \$80,000); *Estate of Jennings v Commr, TC Memo 1976-152* (valuation figures ranged from \$400,000 to \$1.2 million; Tax Court found value of \$750,000); *Crocker, FKA et al v Commr, TC Memo 1998-204* (taxpayer claimed \$5.3 million value of property donated to charity, IRS claimed \$1.3 million, court found \$3.1 million); *Estate of Barge v Commr, TC Memo 1997-188* (Tax Court determined gift tax value of 25-percent undivided interest in timberland to be \$7.4 million; taxpayer had claimed \$2.45 million, and IRS argued \$12.8 million); *Haught v Commr, TC Memo 1993-58* (Tax Court valued gas and oil wells for purposes of charitable deduction, finding a valuation of \$534,144, about midway between the taxpayer figure of \$1 million, and IRS value of \$85,000).

(n40)Footnote 116. *Smith v Commr, 8 TCM 1041 (1949)* (taxpayer's experts claimed \$35,000 and \$37,500, and IRS experts argued \$19,750 and \$20,000; court found \$27,500); *Estate of Adams v Commr, TC Memo 1973-113 ; Sprenger v Commr, TC Memo 1979-196* (taxpayer claimed value of \$200/acre, IRS of \$375/acre; court found \$300/acre, largely based on its view of the improvements on the property).

(n41)Footnote 117. See *Estate of Bennett v Commr, TC Memo 1989-631 , affd on other issue 935 F2d 1285 (4th Cir 1991) ; Demery v Commr, TC Memo 1981-412* (taxpayer claimed charitable donation of marshland worth \$75,000, IRS claimed \$1,279, court found \$7,000).

(n42)Footnote 118. *Akers v Commr, TC Memo 1984-208 , revd 798 F2d 894 (6th Cir 1986) , on remand TC Memo 1992-476 .*

(n43)Footnote 119. *Rev Proc 66-49, 1966-2 CB 1257 .*



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CHAPTER 20 Valuation Of Real Property

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§ 20.04 Definition of Value

[1] "Fair Market Value" Standard

The figure at which property is valued is its "fair market value" as of the valuation date. n120

Fair market value is generally the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. n121 (In short, the transaction must be at arm's length.) The willing buyer and willing seller are necessarily hypothetical persons, not any particular person or type of person. n122 Thus, evidence of what a particular seller is likely to do, n123 what one particular buyer offered to pay for a property, n124 or the special value that a particular property has to a particular person n125 is given no weight in assessing a property's fair market value. For example, the sentimental value a seller places on his childhood home is irrelevant in determining its fair market value.

Fair market value depends upon value in the market and not on intrinsic worth. n126 The particular market in which the fair market value of property is determined is the market in which it is most commonly sold to the public, in the sense of the "customary purchasers" of the property. n126.1 This market may be the wholesale or retail market, and the market used to value the property may be different from the market in which the taxpayer purchased the property. n126.2

The determination of fair market value is a question of fact, and a court will consider all relevant facts and testimony of record in making its finding. n127

[2] Highest and Best Use

The fair market value of property must generally be based on the property's highest and best use on the valuation date, including potential development. "Highest and best use" is that use which will support the highest present value on the date of the valuation. In determining highest and best use, the realistic, objective potential uses of the property control. To determine what uses are reasonable and probable, courts focus on the highest and most profitable use for which the property is adaptable and needed or is likely to be needed in the reasonably near future. n128

A property's highest and best use may very well be different from its existing use. The fair market value of property is not affected by whether the owner has actually put, or ever intends to put, the property to its highest and best use. n129 Zoning restrictions may, of course, limit the uses to which property may be put and therefore affect a property's highest

and best use. n130 Nevertheless, the highest and best use for property may be one that is prohibited on the valuation date by some restriction in a deed, statute, or zoning regulation. n131

Determining highest and best use depends on many factors including the property's general location and physical features, and market conditions, such as supply and demand. n132

In determining whether a potential use is reasonably likely, existing zoning and historic preservation laws must also be taken into account. Any potential use must also be economically feasible. n133

The possibility of re-zoning and consequent development after the date of valuation is often in issue in determining the highest and best use of property, particularly with property located in areas undergoing rapid growth or development. Whether and how they should be factored into the valuation of property on the valuation date depends on the likelihood or risks of obtaining the re-zoning, the time frame in which re-zoning/development is likely to occur, and the costs of obtaining re-zoning or development permits. The value of the property is discounted by the reasonable estimates of the cost of, and time involved in, removing the restrictions. n134

Any projected highest and best use, however, must have a strong possibility of achievement and not be remote, speculative, or conjectural. n135

In rare cases, a property's highest and best use may not be relevant to valuation. In one case, the court refused to consider an underlying property's highest and best use in valuing a decedent's interest in the limited partnership that owned the property. Its rationale was that a 99-year ground lease to which the property was subject prevented the property from being used in its highest and best use. n136

Note:

For estate tax purposes, qualifying taxpayers may elect to value farms and real estate used in closely held businesses at their current value rather than their "highest and best use." n137 The special use valuation election and valuation under *IRC § 2032A* are discussed in Chapter 18, "Estate Planning for Real Estate." n138

FOOTNOTES:

(n1)Footnote 120. *Estate of Murphy v Commr*, TC Memo 1981-489 ; *Frazee v Commr*, 98 TC 554 (1992) ; *McShain v Commr*, 71 TC 998 (1979) ; *US v Cartwright*, 411 US 546 (1973) ; *Kettelman Trust v Commr*, 86 TC 91 (1986) ; see *Treas Reg §§ 1.170A-1(c)(1)* (charitable contribution), 20.2031-1(b) (estate taxes), 25.2512-1 (gift taxes).

(n2)Footnote 121. *US v Cartwright*, 411 US 546 (1973) ; *Estate of Palmer v Commr*, 839 F2d 420 (8th Cir 1988) ; *Orth v Commr*, 813 F2d 837 (7th Cir 1987) ; *Chiu v Commr*, 84 TC 722 (1985) ; *Jacobson v Commr*, TC Memo 1989-606 ; *Brigham v Commr*, TC Memo 1992-413 ; *Treas Reg §§ 1.170A-1(c)(2)* (charitable contributions), 20.2031-1(b) (estate taxes).

(n3)Footnote 122. *Estate of Bright v US*, 658 F2d 999 (5th Cir 1981) ; *Estate of Spruill v Commr*, 88 TC 1197 (1987) ; *US v Simmons*, 346 F2d 213 (5th Cir 1965) .

(n4)Footnote 123. *Propstra v Commr*, 680 F2d 1248 (1982) .

(n5)Footnote 124. *Estate of Hatchett v Commr*, TC Memo 1989-637 .

(n6)Footnote 125. *Arbor Towers Associates, Ltd v Commr*, TC Memo 1999-213 (in denying charitable contribution deduction for alleged bargain sale of property, court rejected "value in use" as a measure of a donated building's value, because it focused on the value the specific property had to the specific purchaser); *Serdar v Commr*, TC Memo

1986-504 (sale of comparable property not indicative of subject property value because purchaser paid excessive price to obtain railroad access); *Estate of Vinson v Commr*, TC Memo 1963-70 (sale to subdivider who was subdividing adjacent property; another sale to owner of adjacent property which contained an expensive home).

(n7)Footnote 126. *Frazee v Commr*, 98 TC 554 (1992) ; *Rev Proc* 66-49, 1966-2 CB 1257 (charitable contribution).

(n8)Footnote 126.1. *Anselmo v Commr*, 757 F2d 1208, (11[th] Cir 1985) , *aff'd* 80 TC 872 (1983) ; *Goldstein v Commr*, 89 TC 535 (1987) ; *Epic Associates 84-III et al v Commr/Epic Associates 83- XII et al v Commr*, TC Memo 2001-64 .

(n9)Footnote 126.2. *Epic Associates 84-III et al v Commr/Epic Associates 83- XII et al v Commr*, TC Memo 2001-64 .

(n10)Footnote 127. *Ketteman Trust v Commr*, 86 TC 91 (1986) ; *Anderson v Commr*, 250 F2d 242 (5th Cir 1957) , *cert denied* 356 US 950 (1958) ; *Kaplan v Commr*, 43 TC 663 (1965) .

(n11)Footnote 128. *Olson v US*, 292 US 246 (1934) ; *Stanley Works and Subs v Commr*, 87 TC 389 (1986) ; *Symington v Commr*, 87 TC 892 (1986) ; *Frazee v Commr*, 98 TC 554 (1992) (quoting definition of "highest and best use" from The American Institute of Real Estate Appraisers, *Appraisal Terminology and Handbook* (5th ed 1967); *Dorsey, Jr v Commr*, TC Memo 1990-242 ; *Crock v Commr*, TC Memo 1983-351 ; *Van Zelst et al v Commr*, TC Memo 1995-396 , *aff'd* 100 F3d 1259 (7th Cir 1996) (court found highest and best use of 93 acres of remote, steep Alaskan wilderness to be as recreational cabin site, and not as commercial resort, and therefore accepted IRS valuation of \$38,000 and not the \$2.75 million claimed by the taxpayers; for a separate property involving mineral rights, the court gave a zero value because mining would not be economically feasible); *Environmental Preservation Company v Commr*, TC Memo 1992-100 (group of donated islands in Chesapeake Bay valued at \$360,000, rather than \$5 million claimed by taxpayer, based on court's finding that their highest and best use was for noncommercial outdoor recreation activities and not as deep-water marine terminal, as claimed by the taxpayers); *Estate of Pattison v Commr*, TC Memo 1990-428 (highest and best use of unimproved land held to be rural residential property, rather than agricultural, because of nearby residential subdivision development); *Estate of Juden v Commr*, 865 F2d 960 (8th Cir 1989) , *aff'd* TC Memo 1987-302 (court accepted highest and best use of land as limestone quarry, suggested by taxpayer, but discounted value offered by taxpayer because of fault running through the property, costs of starting and operating a quarry business, and limited access to the property); *Estate of Murphy v Commr*, TC Memo 1981-489 (irregularly shaped parcel limited to highest and best use of parking lot rather than commercial development); *Einsiedler v Commr*, TC Memo 1994-155 (court valued property as highest and best use as residential property, not as agricultural property, as claimed by taxpayer, because property was located in an area where luxury residential lots were being developed).

(n12)Footnote 129. *Olson v US*, 292 US 246 (1934) ; *Stanley Works and Subs v Commr*, 87 TC 389 (1986) ; *Symington v Commr*, 87 TC 892 (1986) ; *Frazee v Commr*, 98 TC 554 (1992) ; *Dorsey, Jr v Commr*, TC Memo 1990-242 ; *Estate of Butscher v Commr*, TC Memo 1975-224 (highest and best use was general commercial/retail use, although building was being used as bowling alley); *Estate of Adams v Commr*, TC Memo 1973-113 (highest and best use of property was for development, rather than its current farm use, in part because of local urban growth); *Schapiro v Commr*, TC Memo 1991-128 (Tax Court found highest and best use of property was as subdivided residential building lots, not current use as single parcel, because there was subdivision activity in the area and development costs of subdividing the land would be minimal).

(n13)Footnote 130. *Crowley v Commr*, TC Memo 1990-636 (court accepted IRS's \$64,000 valuation and rejected the taxpayer's \$860,000 estimate for 8 acres of undeveloped land, based on zoning restrictions which precluded the taxpayer's alleged highest and best use for the property as a resort hotel).

(n14)Footnote 131. *Thornton v Commr*, TC Memo 1988-479 , *aff'd without publ opinion* 908 F2d 977 (9th Cir

1990); *Ebben v Commr*, TC Memo 1983-200, *affd on this issue* 783 F2d 906 (9th Cir 1986); *Crowley v Commr*, TC Memo 1990-636; *Stanton v Commr*, TC Memo 1980-300 (because of surrounding growth and good highway access, highest and best use of property, currently zoned agricultural, was for commercial development).

(n15)Footnote 132. *Crock v Commr*, TC Memo 1983-351; *Van Zelst et al v Commr*, TC Memo 1995-396, *affd* 100 F3d 1259 (7th Cir 1996) (court found highest and best use of 93 acres of remote, steep Alaskan wilderness to be as recreational cabin site, and not as commercial resort, and therefore accepted IRS valuation of \$38,000 and not the \$2.75 million claimed by the taxpayers; for a separate property involving mineral rights, the court gave a zero value because mining would not be economically feasible); *Tidler v Commr*, TC Memo 1987-268 (highest and best use of property as hospital rejected because local market would not have supported additional hospital on valuation date and other evidence showed that construction of a hospital was not financially feasible); *Lloyd v Commr*, TC Memo 1996-30 (unaccepted offers and option contracts to purchase may indicate commercial nature of property if investors and developers are involved).

(n16)Footnote 133. *Losch v Commr*, TC Memo 1988-230 (possible addition of two stories to building rejected in determining property's highest and best use because taxpayer failed to show economic feasibility of the addition); *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 (court found highest and best use of parcel to be its current agricultural use, even though it was zoned for industrial use, because local industrial market was weak, rental rates did not justify new construction, and access to property was not good); *Estate of Murphy v Commr*, TC Memo 1981-489 (prospect for commercial development of subject property was unlikely because of poor local economy, numerous vacancies, and decreasing population); *Great Northern Nekoosa Corp v US*, 711 F2d 473 (1st Cir 1983) (parcel could not be valued as hydroelectric dam site, because federal government had selected the site as a possible part of a wildlife and scenic river system); *McMurray v Commr*, 985 F2d 36 (1st Cir 1993), *affg* TC Memo 1992-27 (value of peat bog property contributed to charity could not take into account the value of harvestable peat on the property because zoning and other harvesting restrictions for peat and the lack of a market made that value speculative).

(n17)Footnote 134. *Frazee v Commr*, 98 TC 554 (1992) (likely rezoning of property from agricultural to industrial should have been considered at time of valuation); *Estate of Feuchter v Commr*, TC Memo 1992-97 (land valued as agricultural, rather than as potential residential, commercial, or industrial property because long-standing recession in local economy made development unlikely); *Mathis v Commr*, TC Memo 1989-254; *Turner v Commr*, TC Memo 1977-437; *Lloyd v Commr*, TC Memo 1996-30 (court found highest and best use of property was commercial, notwithstanding that it was zoned as residential, because of its proximity to highways, likelihood of re-zoning, and developer interest); see *Walker v Commr*, TC Memo 1982-495 (value reduced because it was doubtful that necessary permits could be obtained to develop Florida marshland).

(n18)Footnote 135. *Hay v Commr*, TC Memo 1992-409 (highest and best use of California coastland was 71-lot subdivision, even though that residential use was prohibited at time of valuation; court rejected as too pessimistic the IRS claim that highest and best use was as 5-acre lot development); *Thornton v Commr*, TC Memo 1988-479, *affd without publ opinion* 908 F2d 977 (9th Cir 1990) (valuation of donated cemetery as multiple unit housing was too speculative in view of zoning legislation, and disinterment and other costs involved in adapting the property for that use); *Crowley v Commr*, TC Memo 1990-636; *Olson v US*, 292 US 257 (1934).

(n19)Footnote 136. *Estate of Lehmann v Commr*, TC Memo 1997-392.

(n20)Footnote 137. IRC § 2032A.

(n21)Footnote 138. IRC § 2032(a)(2),(3).



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Federal Taxes Affecting Real Estate

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CHAPTER 20 Valuation Of Real Property

2-20 Federal Taxes Affecting Real Estate § 20.05

§ 20.05 Valuation Methods

[1] In General

A variety of methods are used to value real property. Courts typically describe the particular methods being used in a given case, often quoting from one of several appraisal textbooks. n139

Although common methodologies are used in valuation, the result as to the particular value of a property, the weight given to a particular factor within a particular methodology, and whether the result is pro-taxpayer or pro-IRS are all issues that are extremely fact- and property-specific. Therefore, prior decisions are typically of little, if any, use in predicting what result will be reached in another case.

The three most common methodologies used are the comparable sales (or market data) approach, n140 the income approach, n141 and the cost approach. n142 When possible, all three approaches to valuation should be used, in order to check each against the others. n143

Easements are typically valued using a "before and after" approach, which looks to the change in value of the property resulting from the imposition of the easement. n144 The failure to use a recognized appraisal method will cause any conclusions reached to be discredited or ignored. n145

[2] Comparable Sales Approach

[a] In General

The "comparable sales" approach--also called the "market data," "direct sales," or "sales comparison" approach--generally involves locating parcels of land that are physically similar to the property being valued and which have been sold within a reasonable time of the valuation date. The sales prices of comparable properties are adjusted up or down to reflect differences between them and the subject property. Adjustments are typically made for location, size, age, condition, type of improvements, different uses to which comparables are put, zoning differences, terrain, topography, and other physical attributes of the land, water supply, water rights, access to roads and utilities, market conditions, and sale date. The existence and type of financing may also warrant an adjustment. The estimated values of comparable properties, as so adjusted, provide an indication of the value of the subject property on the valuation date. n146 Results determined from comparable sales will generally be an array of indicated values for the subject property.

These values should not be averaged. n147 Rather, those comparables with the least adjustments should be considered most comparable. n148 The comparable sales approach tends to be seen as the most reliable method of valuation. n148.1

It is critical that any value adjustments made to compensate for differences between a comparable property and the subject property be fully explained. If they are not, the comparable, and the expert's opinion based on it, may be disregarded altogether, or the court may make whatever adjustments it feels are necessary. n149

Most valuation cases involve the court's grappling with inconsistencies in the comparable valuation evidence or errors in the application of the comparable sales approach. The court frequently modifies valuations based on its finding that so-called comparable properties used were not in fact comparable, n150 or were improperly adjusted to reflect for differences. n151 The court may also reject comparables used in their entirety if they are not analyzed with reference to the subject property. n152 Errors or difficulty in assessing the subject property itself may also influence a court's application of the comparable sales method. n153

The type of sale may affect the comparability of an otherwise similar property. Thus, allegedly comparable sales that do not reflect fair market value may be ignored or given little weight in determining the fair market value of a subject property. The following sales may be less reflective of fair market value, and therefore they may need to be significantly adjusted or even ignored as comparables: n154

- distress sales, such as foreclosure sales, or other highly motivated sales;
- transactions that are part sale and part gift;
- transactions with unusual terms of sale;
- cash transactions;
- transactions with unusual or different financing, such as owner financing, or assumable financing at a lower rate; n155
- transactions that are not at arm's length (as with below-market sales to relatives or premium sales to adjoining landowners who attach a special value to the property); n156
- sales in exchange for services. n157

Indefinite or unaccepted offers of purchase of comparable properties are generally not substantial evidence of value, nor are incompleted sales or mere listings of property for sale. These should therefore not be used as comparables. n158

[b] Comparable Sales Approach in Valuing Unimproved Real Estate

In the case of vacant, unimproved property, the comparable sales approach is considered the most reliable method of valuation, the rationale being that the market place is the best indicator of value, based on the conflicting interests of many buyers and sellers. n159

The IRS has issued guidance on how to use the comparable sales approach for valuing unimproved real property for federal income, estate, and gift tax purposes. The following factors should be considered in an appraisal: n160

- location, including proximity to roads, schools, shopping, transportation, and other amenities;

- configuration, topographic features, and total area;
- restrictions as to land use or zoning;
- road frontage and accessibility;
- available utilities and water rights;
- existing easements, rights of way, leases, etc.;
- soil characteristics;
- vegetative cover, such as grass, brush, trees, or timber;
- status of mineral rights;
- riparian rights; and
- other factors affecting value.

[c] Usefulness of Comparable Sales Approach

The use of the comparable sales method itself is seldom contested, and the method is generally considered to be the most reliable method of valuation, the rationale being that the market place is the best indicator of value. n161

The usual disagreements that arise relate to the accuracy of the particular comparable sales used and the correctness of the adjustments made to reflect the differences in the comparable properties. The resolution is an extremely fact- and property-specific one, and the particular result or weight attributed to a particular item of value in any given case is of little use in other cases. n162

The comparable sales approach is considered especially useful for valuing residential properties. n163

The comparable sales method is obviously not useful when there are no comparable properties to the property being valued. In that case, reproduction cost may be considered in determining value. n164 In other words, builders would be called upon to testify about the cost of creating from scratch a building identical to the one whose value is being determined.

[3] Income Method

The income method, also called the income capitalization method, is generally used to value income-producing property such as office buildings, rental property, and farms. The income method determines fair market value by considering the value of the stream of future income to be produced by the property. The estimated gross income is reduced by estimated vacancy losses and expenses to compute net income. This net income is then processed into an indication of value by using one or several different methods to determine the proper capitalization or discount rate for the current market. n165 The higher the risk perceived to be associated with a given income stream, the higher the capitalization rate, and the lower the fair market value of the property. n166 A reversionary value for land and improvements may also be taken into account in applying the income method of valuation. n167

Income from a property is often determined by looking to the rental rate per square foot commanded by similar properties. Adjustments are then made for quality, condition of property, location, parking areas, vacancy rates, and

other relevant differences. The income capitalization approach is often considered more appropriate than the market data or cost approaches for valuing commercial and other income-producing property. n168

The income method may not always be appropriate for valuing single-family or even small multi-family properties, if there is evidence that those properties are seldom rented n169 or not generally bought and sold locally for the purposes of producing income. n170

The income method is also not useful to value property that is held for its land value as opposed to income-producing value, as with damaged property or property in disrepair. n171 It is also not useful if use of that method is inconsistent with the highest and best use of the property. n172

[4] Cost Methods

[a] Replacement Cost Method

The replacement cost method, or cost approach, estimates value by determining the replacement cost of the improvements, reduced for depreciation, and then adding the estimated fair market value of the land to reach a final value. n173

The cost approach estimates value based on the assumption that a prudent person will not pay more for a property than it would cost to acquire a site and erect a comparable structure (less accrued depreciation). This approach is especially applicable to new or nearly new structures when the land value is also reliable. n174 When the replacement cost method is used to value improvements, the underlying land may be valued by another method, such as the comparable sales method. n175

The replacement cost method is of questionable value for older, historic properties, n176 unique, individualized properties, n177 or functionally obsolete properties, n178 because of the unlikelihood that those properties would be reconstructed in their existing form. In addition, for properties that are several years old, it is often difficult to precisely estimate the accrued depreciation, and the problem is compounded if depreciation exists in more than one form (i.e. physical, functional, and economic obsolescence). n179

The replacement cost can also be of limited value when the local market conditions are extremely low on the valuation date. n180

[b] Reproduction Cost Method

The reproduction cost method can be used as a relevant measure of fair market value when the property to be valued is unique, its market limited, and when there is no evidence of sales of comparable properties. n181

Reproduction cost is the current cost of reproducing or replacing a property, less loss in value from deterioration and functional or economic obsolescence (sometimes referred to as accrued depreciation). n182

Reproduction cost differs from replacement cost n183 in that reproduction cost is the cost of duplicating the existing improvements exactly as they are, rather than replacing them with similar improvements. n184

The method generally assumes that the property being valued is worth replacing. n185 This is often not the case, as reproduction cost will often exceed the property's fair market value. n186

For the reproduction cost appropriately to have an impact on a subject property's fair market value determination, however, the taxpayer must establish a probative correlation between it and fair market value. n187 In other words, even

if a reproduction cost is established, evidence must also be offered to convert that figure into a resulting fair market figure for the property. Otherwise, the court may engage in a "guesstimate" based on an incomplete record. n188

The accrued depreciation used in the reproduction cost method must be determined by inspection. Factors such as actual use, condition, and age are all relevant in arriving at an appropriate rate. n189

[5] "Before and After" Method

[a] In General

In the case of gifts of easements on property (usually involving charitable contributions, such as conservation easements), there is rarely an established market, and often no comparable sales of the particular type of easement donated. Therefore, the fair market value of the easement is often determined indirectly by using the "before and after" valuation method. The "before and after" method determines the negative effect the easement has on the value of the total property. It determines the difference in the value of the property with and without the easement by subtracting the value of the property immediately after the imposition of the easement from the value of the property immediately before the imposition of the easement. This method has been approved by the courts and the IRS in valuing easements. n190

The fair market value of the easement is based on the highest and best use for the property on the valuation date, including potential development. n191 In determining the "before" value, consideration is given to the effect of existing preservation and zoning laws restricting the property's development apart from the easement, n192 but the value is not affected by whether the owner actually intends to put, or has put, the property to its highest and best use on the valuation date. n193

[b] Anticipated Use Valuation Technique

The anticipated use technique is widely accepted in valuing conservation easements and is used in conjunction with the "before and after" method. The following steps are followed in applying the technique: n194

- for both "before" and "after" conservation gift scenarios, the market is studied, and an overall plan reflecting the highest and best use for each scenario is derived.
- from these plans, by comparison with the development and sale experience for similar types of property, gross sale proceeds for developed lots are projected. The sale proceeds can reflect per-lot sales, anticipated absorption, and built-in factors for property appreciation.
- from the gross sale proceeds projected for each of the "before" and "after" conservation scenarios are deducted respective development costs, including the following:
 - planning and design;
 - roadway construction;
 - utility and installation;
 - administration and overhead;
 - legal and audit;

- survey and testing;
- sales and marketing;
- finance and carry; and
- developer profit.

■ The net available after all costs of creation have been deducted for each of the "before" and "after" subdivision plans represents an annual net income imputable to the land. Applying a discount factor to account for the time-value concept of money results in a net present value for the land as generated by the anticipated use (development) methodology.

■ the final step in the valuation of the subject conservation easement involves the comparison of "before" and "after" restriction land values. The difference between these two values reflects the value of development rights implicit in the donation of a partial conservation restriction.

[6] Development Method

The development method may also be used to value property. The development approach to valuation is used to determine the value of undeveloped land by treating it as if it were subdivided, developed, and sold. The expected proceeds from the sale of the property are discounted over the estimated period required for market absorption of the developed sites. From the proceeds of sale, development costs, incentive costs, and carrying charges are subtracted in order to determine the amount a developer would pay for the undeveloped property, i.e., the property's fair market value. Costs that are incurred at the beginning of the development of the property are subtracted from the projected income after discounting the income stream, while expenses incurred in relation to selling the developed sites are subtracted prior to discounting the income stream. n195

[7] Land Residual Method

The land residual method is a form of income valuation method that is designed to show the maximum amount a developer could afford to pay for land, while earning a reasonable profit, after all costs of construction and operation are taken into account. The method uses discounted forecasted net income streams. The method first estimates the market value of a completed and operating development and then, after subtracting the total cost of development, including the developer's profit, arrives at a residual land value. n196 This method is not a favored one n197 and has been rejected by the Tax Court in one case as a purely academic exercise. The Tax Court objected to its flexibility and to the fact that its benchmark is sometimes what a developer willing to take high risks--rather than a reasonably prudent investor--would pay for property. n198

FOOTNOTES:

(n1)Footnote 139. *Estate of Hatchett v Commr*, TC Memo 1989-637 (quoting the Appraisal of Rural Property, by the American Institute of Real Estate Appraisers; *Dorsey, Jr v Commr*, TC Memo 1990-242 (citing B Boyce, Real Estate Appraisal Terminology (1975); *Frazee v Commr*, 98 TC 554 (1992) (referring to The American Institute of Real Estate Appraisers, Appraisal Terminology and Handbook (5th ed 1967)).

(n2)Footnote 140. See [2], below, for a discussion.

(n3)Footnote 141. *Morris v Commr*, TC Memo 1982-508, *aff'd* 761 F2d 1195 (6th Cir 1985); see [3], below, for a discussion.

(n4)Footnote 142. See [4], below, for a discussion.

(n5)Footnote 143. *Estate of Palmer*, 1992-48, *citing* American Institute of Real Estate Appraisers, *The Appraisal of Real Estate* 65 (7th Ed 1978); see *Continental Grain Co v Commr*, TC Memo 1988-577, *affd on reconsideration* TC Memo 1989-155.

(n6)Footnote 144. *Hilborn v Commr*, 85 TC 677 (1985); *Stanley Works and Subs v Commr*, 87 TC 389 (1986); *Symington v Commr*, 87 TC 892 (1986); see [5], below, for a discussion.

(n7)Footnote 145. *Estate of Bennett v Commr*, TC Memo 1989-681, *affd on other issue* 935 F2d 1285 (4th Cir 1991).

(n8)Footnote 146. *Amlie v Commr*, TC Memo 2006-76 (in a case involving comparable valuations of Iowa farm property, the court found persuasive differences in soil composition based on county-adjusted corn suitability ratings; court rejected taxpayer's argument that a downward adjustment was necessary to reflect the sale being at a public auction between two competitive neighbors). *Wolfsen Land & Cattle Co v Commr*, 72 TC 1 (1979); *Estate of Murphy v Commr*, TC Memo 1981-489; *Jacobson v Commr*, TC Memo 1989-606 (sales in residential areas large distances from major thoroughfares were not comparable to subject property, which was located on busy thoroughfare and suitable for commercial development); *Frazee v Commr*, 98 TC 554 (1992) (sales 2 to 4 years prior to valuation date entitled to little weight; sales in escrow that have not closed cannot be used as accurate reflection of market value); *Estate of Rabe v Commr*, TC Memo 1975-26, *affd without publ opinion* 566 F2d 1183 (9th Cir 1977) (appraisal of subject property 2 years prior to valuation date entitled to little weight; court accepted IRS expert's testimony, which detailed similarities and differences among comparables and double-checked his "comparables method" figures through a computation based on subdivision analysis of the property); *Crock v Commr*, TC Memo 1983-351 (inspection 6 years after date of gift not useful); *Clark v Commr*, TC Memo 1978-402 (allegedly comparable sale rejected because property contained a building built in 1700 with special historical significance and value to purchaser); *Imbesi v Commr*, TC Memo 1981-484 (comparables of less than 25 acres should have been considered because size is merely a factor to be considered in judging comparability; frontage on improved road required upward adjustment to value of subject property); *Estate of Fawcett v Commr*, 64 TC 889 (1975) (adjustments made for riverfrontage location, improvements on the property, and existence of access to property); *Estate of Nail v Commr*, 59 TC 187 (1972) (adjustment required for lack of mineral rights in surface estate being valued and for cost of obtaining road access and damage to property from oil drilling); *Walker v Commr*, TC Memo 1982-495 (sales occurring 5 and 6 years after valuation date too remote to be indicative of value); *Branch v Commr*, TC Memo 1987-321; *Estate of McCampbell v Commr*, TC Memo 1991-141 (downward adjustment necessary for lack of easement of access); *Estate of Feuchter v Commr*, TC Memo 1992-97 (comparable sales 7 to 10 years prior to valuation date given little weight); *Nelson v Commr*, TC Memo 1980-518 (comparable sales 6 years before valuation date entitled to "some probative value" if properly adjusted); *Estate of Vinson v Commr*, TC Memo 1963-70 (expert modified comparables based on whether purchase price was financed); *Japhet v Commr*, TC Memo 2000-157 (comparable was more valuable because it had assumable mortgage at lower rate).

(n9)Footnote 147. See *Crowley v Commr*, TC Memo 1990-636; but see *Ketteman Trust v Commr*, 86 TC 91 (1986) (court valued subject property in part based on the average of per-acre prices that comparables sold for).

(n10)Footnote 148. See Rev Proc 79-24, 1979-1 CB 565.

(n11)Footnote 148.1. *Estate of Spruill v Commr*, 88 TC 1197 (1987); *Estate of Langer v Commr*, TC Memo 2006-232.

(n12)Footnote 149. *Estate of Michael Dunia, et al v Commr*, TC Memo 2004-123 (adjustments made for location, topography, frontage, and the need for offsite improvements for development access); *Frazee v Commr*, 98 TC 554 (1992); *Estate of Bennett v Commr*, TC Memo 1989-681, *affd on other issue* 935 F2d 1285 (4th Cir 1991) (mere statement that value of subject property was different "because of its size and location" is insufficient); *Estate of Wineman v Commr*, TC Memo 2000-193; *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 (adjustments under unexplained category of "other" criticized); *Estate of Nail v Commr*, 59 TC 187 (1972) (court placed more weight

on taxpayer's expert's report in part because IRS expert failed to explain adjustments to comparables); *Estate of Vinson v Commr*, TC Memo 1963-70 (IRS expert failed to explain adjustments); *Estate of Langer v Commr*, TC Memo 2006-232 (court valued decedent's 29% interest in an LLC, which depended on the value of 2 phases of a planned commercial development; in looking at comparables for one phase, the court focused on comparative location, exposure, configuration, accessibility, and zoning, and for the other phase, the most significant variables were location and exposure).

(n13)Footnote 150. *Turner v Commr*, TC Memo 1977-437 (75-acre tract not comparable to 1-acre tract); *Estate of Palmer v Commr*, 839 F2d 420 (8th Cir 1988) , on remand TC Memo 1992-48 (various residential properties not comparable to unique "shrine" mansion located on university property); *Kellahan, Jr v Commr*, TC Memo 1999-210 (ponds not comparable to canal); *Estate of Wineman v Commr*, TC Memo 2000-193 (properties located hundreds of miles away not comparable); *Environmental Preservation Company v Commr*, TC Memo 1992-100 (properties found not comparable to subject island properties because they were not similarly located and did not have the extensive wetlands of the subject islands); *Estate of Hillbrandt v Commr*, TC Memo 1986-560 (properties 20-26 miles from subject property too geographically remote to be comparable; another expert's reliance on undisclosed sales undermined court's confidence in his report); *Eugene D Lanier, Inc et al v Commr*, TC Memo 1998-7 (sales not comparable because they took place 6 years after valuation date, market conditions had significantly improved at time of sales, and sales took place outside the local real estate market); *Forte, Jr v Commr*, TC Memo 1991-36 (properties one-half the size of subject property not comparable).

(n14)Footnote 151. *Mathis v Commr*, TC Memo 1989-254 (downward adjustment required to reflect cost of re-zoning subject property and possibility that property might not be re-zoned; adjustment also required to reflect cost of sewerage access; other adjustments required for properties located 5-6 miles away, and for properties without access to, or location on, a highway interchange, which subject property had); *Morris v Commr*, TC Memo 1982-508 , affd 761 F2d 1195 (6th Cir 1985) (adjustment required to reflect availability of utilities); *Estate of Harms*, TC Memo 1981-320 (adjustments needed for ditch and drainage problems on farm); *Turner v Commr*, TC Memo 1977-437 (adjustment necessary to reflect planned extension of sewer and water lines); *Crock v Commr*, TC Memo 1983-351 (adjustments necessary for expenses of subdividing, costs associated with surveying, obtaining approval for plats, abstracting title, and developing roads, and brokerage commissions and other sales expenses); *Estate of Wineman v Commr*, TC Memo 2000-193 (adjustment necessary for water supply and presence of irrigated cropland when compared to grazing land); *Carver v Commr*, TC Memo 1992-94 (adjustments necessary to reflect lease restrictions, and differences in location, lot size, and improvements); *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 (time adjustment given for comparable sales was inappropriate because local market was slow and there had been no local population growth); *Estate of Rabe v Commr*, TC Memo 1975-26 , affd without publ opinion 566 F2d 1183 (9th Cir 1977) (adjustments necessary to reflect commercial acreage on subject property; also no comparables for meadowland and other parts of acreage were used; report was also criticized because one portion of property was sold shortly after the appraisal for a sum 25 percent greater than the figure determined, and because no double check was used); *Sels v Commr*, TC Memo 1986-501 (time differential of comparable sales not accounted for, and erroneous acreage used); *Estate of Ratcliffe v Commr*, TC Memo 1992-305 (adjustment necessary to reflect cost of adding sewer connection); *Einsiedler v Commr*, TC Memo 1994-155 (comparables not adjusted properly to take into account lack of access to subject property); *Walker v Commr*, TC Memo 1975-303 (expert improperly classified subject property as irrigated farmland and deducted the cost of an irrigation well; court held the property should have been valued as dry land and that adverse soil conditions should also have been taken into account); *Estate of Stanton v Commr*, TC Memo 1989-341 (downward adjustment to subject property necessary because comparable sales of two properties adjacent to each other to a single developer resulted in premium due to their greater potential); *Estate of McCormick et al v Commr*, TC Memo 1995-371 (adjustment necessary for potential flooding problems on property; for another property, the court reduced the IRS valuation to take into account costs of grading and filling the land before it could be developed); *Dise v Commr*, TC Memo 1986-87 (adjustments necessary for size, location, absence of utilities, shortage of water, and time of sale); *Estate of Kolczynski v Commr*, TC Memo 2005-217 (adjustment for improvements on property, value of timber, time [comparable sale was more than 2 years before the valuation date], and size).

(n15)Footnote 152. *Crowley v Commr*, TC Memo 1990-636 ; *Forte, Jr v Commr*, TC Memo 1991-36 (taxpayer's expert failed to explain valuation conclusions, and testimony contained no information of discounts or other adjustments to comparable to reach valuation figure).

(n16)Footnote 153. *Estate of McCampbell v Commr*, TC Memo 1991-141 (two parcels located 28 miles apart should have been valued separately, and not as a single parcel); *Crane v Commr*, 49 TC 85 (1967) (court reduced value due to abnormal drainage problem on property).

(n17)Footnote 154. *Lloyd A Fry Roofing Co v Commr*, TC Memo 1970-298 (donee's sale of property not indicative of value because donee was under economic compulsion to dispose of the property with minimum delay); *Jacobson v Commr*, TC Memo 1989-606 ; *Rev Proc* 66-49, 1966-2 CB 1257 (property donated to charity); *Morris v Commr*, TC Memo 1982-508 , *affd* 761 F2d 1195 (6th Cir 1985) (adjustment necessary to convert terms of owner financing of comparable sales into institutional financing or cash sales); *Bardahl v Commr*, TC Memo 1965-116 (sale not comparable because evidence showed that purchaser of comparable property paid premium price to buy the particular property at that particular time); *Estate of Harms v Commr*, TC Memo 1981-320 (explanations needed of allegedly comparable sales from father to son, and from decedent's estate to beneficiary); *Estate of Vinson v Commr*, TC Memo 1963-70 (special sale conditions included sale of land to subdivider who was subdividing adjacent property, or sale of land to owner of adjacent property which contains an expensive home); *Zable v Commr*, TC Memo 1990-55 (distress sale not useful as comparable).

(n18)Footnote 155. *Japhet v Commr*, TC Memo 2000-157 ; *Estate of Simpson v Commr*, TC Memo 1994-207 (allegedly comparable sales showed inflated value because they involved seller financing at below-market interest rates).

(n19)Footnote 156. See *Silberman v Commr*, TC Memo 1973-48 .

(n20)Footnote 157. See *Walker v Commr*, TC Memo 1982-495 .

(n21)Footnote 158. *Fleming v Commr*, TC Memo 1989-323 (purported offer of purchase not reliable evidence of value of property absent evidence that offer was arm's length transaction between unrelated parties or otherwise bona fide); *Cullers v Commr*, 237 F2d 611 (8th Cir 1956) (offer of purchase of neighboring property not evidence of value of subject property where there was no evidence that the neighboring property was of similar quality and value); *Serdar v Commr*, TC Memo 1986-504 (testimony of grant of purchase option without agreed upon price did not establish property's market value); *Lloyd v Commr*, TC Memo 1996-30 (unaccepted offers to buy and option contracts to purchase entitled to little weight in valuing property); *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 (mere listing of comparable property, rather than actual sale, given less weight in determining value of subject property); *Ketteman Trust v Commr*, 86 TC 91 (1986) (unaccepted offer not conclusive evidence of value).

(n22)Footnote 159. *Estate of Rabe v Commr*, TC Memo 1975-26 , *affd without publ opinion* 566 F2d 1183 (9th Cir 1977) ; *Estate of Ratcliffe v Commr*, TC Memo 1992-305 ; see *Estate of Spruill v Commr*, 88 TC 1197 (1987) .

(n23)Footnote 160. *Rev Proc* 79-24, 1979-1 CB 565 .

(n24)Footnote 161. See *Estate of Wineman v Commr*, TC Memo 2000-193 ; *Estate of Spruill v Commr*, 88 TC 1197 (1987) ; *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 ; *Einsiedler v Commr*, TC Memo 1994-155 ; *Estate of Burckhard v Commr*, TC Memo 1984-389 .

(n25)Footnote 162. See *Estate of Hatchett v Commr*, TC Memo 1989-637 .

(n26)Footnote 163. See *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue* 935 F2d 1285 (4th Cir 1991) .

(n27)Footnote 164. *Estate of Palmer v Commr*, 839 F2d 420 (8th Cir 1988) (single family residences not comparable to unique mansion serving as college social and ceremonial building); see [4][b], below, for a discussion of reproduction cost.

(n28)Footnote 165. *Frazee v Commr*, 98 TC 554 (1992) ; *Estate of Hatchett v Commr*, TC Memo 1989-637 (approach used to value productive farmland); *Learner v Commr*, TC Memo 1983-122 ; *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 ; *LeFrak v Commr*, TC Memo 1993-526 .

(n29)Footnote 166. *Learner v Commr*, TC Memo 1983-122 .

(n30)Footnote 167. *Estate of Butscher v Commr*, TC Memo 1975-224 (conversion costs of converting a bowling alley to commercial/retail use at the end of the lease taken into account).

(n31)Footnote 168. See *Frazee v Commr*, 98 TC 554 (1992) ; *Estate of Hatchett v Commr*, TC Memo 1989-637 (income approach used to value productive farmland); *Learner v Commr*, TC Memo 1983-122 (valuation of office building and land); *LeFrak v Commr*, TC Memo 1993-526 (rental apartment buildings and office buildings).

(n32)Footnote 169. *Bardahl v Commr*, 1965-116.

(n33)Footnote 170. *Estate of Bennett v Commr*, TC Memo 1989-681 , *affd on other issue* 935 F2d 1285 (4th Cir 1991) (income method inapplicable for valuing residential properties because evidence showed nearly all comparables were owner-occupied); *Estate of Harms v Commr*, TC Memo 1981-320 (comparable sales method more appropriate than income method in valuing farm residences where there were few renters in the area and the structures were not investment-type property).

(n34)Footnote 171. *Estate of Forman v Commr*, TC Memo 1978-510 (income method not appropriate where building was 50-percent vacant because of prior fire); *Silberman v Commr*, TC Memo 1973-48 (income method not appropriate to value vandalized property that could not be kept in repair).

(n35)Footnote 172. *Rainier Companies v Commr*, TC Memo 1977-351 (baseball stadium could not be valued using the income method because the property's highest and best use was as a shopping center).

(n36)Footnote 173. *Frazee v Commr*, 98 TC 554 (1992) ; *Losch v Commr*, TC Memo 1988-230 ; *Meyer v Commr*, TC Memo 1987-357 (replacement cost method used to value sub-surface drainage systems of farms); *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 .

(n37)Footnote 174. *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 .

(n38)Footnote 175. *Frazee v Commr*, 98 TC 554 (1992) ; *Crock v Commr*, TC Memo 1983-351 .

(n39)Footnote 176. *Losch v Commr*, TC Memo 1988-230 .

(n40)Footnote 177. *Black v Commr*, TC Memo 1968-247 (replacement cost method is of limited value for old oceanfront home with 7-car garage, servants' quarters, and one story used as an open storage area); *Bardahl v Commr*, 1965-116 (unique house with unusual features built by individual for his own use).

(n41)Footnote 178. *Clark v Commr*, TC Memo 1978-402 (extremely large outdated mansion with large adjoining grounds).

(n42)Footnote 179. *Talkington v Commr/Sessions v Commr*, TC Memo 1998-412 .

(n43)Footnote 180. See *Eugene D Lanier, Inc et al v Commr*, TC Memo 1998-7 .

(n44)Footnote 181. *Estate of Palmer v Commr*, 839 F2d 420 (8th Cir 1988) (reproduction cost method used to value unique "shrine" mansion serving as college social and ceremonial building); *Krauskopf v Commr*, TC Memo 1984-386 ; *First Wisconsin Bankshares Corp v US*, 369 F Supp 1034 (ED Wis 1973) (reproduction cost less depreciation was only method useful to value 52-year old building because there were no comparable sales or similar rental properties); *Scheidelman v Commr*, TC Memo 1970-70 .

(n45)Footnote 182. *Estate of Palmer v Commr*, 839 F2d 420 (8th Cir 1988) , on remand TC Memo 1992-48 .

(n46)Footnote 183. See [a], above.

(n47)Footnote 184. See *Estate of Palmer v Commr*, 839 F2d 420 (8th Cir 1988) , on remand TC Memo 1992-48 .

(n48)Footnote 185. *Brigham v Commr*, TC Memo 1992-413 (replacement cost for valuing donated water tower rejected in part because the tower had been replaced by a larger, better water storage tower); *Lloyd A Fry Roofing Co v Commr*, TC Memo 1970-298 (method not useful for valuing obsolete mill property for which there was no demand); *Rainier Companies v Commr*, TC Memo 1977-351 (method not useful for valuing baseball stadium when highest and best use of property was as a shopping center).

(n49)Footnote 186. See Rev Proc 66-49, 1966-2 CB 1257 ; *Rainier Companies v Commr*, TC Memo 1977-351 (baseball stadium would not be replaced because highest and best use of land was as a shopping center).

(n50)Footnote 187. *Estate of Palmer v Commr*, 839 F2d 420 (8th Cir 1988) , on remand TC Memo 1992-48 ; *Brigham v Commr*, TC Memo 1992-413 (reproduction cost evidence of donated water tower rejected); *Rainier Companies v Commr*, TC Memo 1977-351 ; Rev Proc 66-49, 1966-2 CB 1257 .

(n51)Footnote 188. *Estate of Palmer v Commr*, 839 F2d 420 (8th Cir 1988) , on remand TC Memo 1992-48 (using reproduction cost method, court added one-half of the established \$215,000 reproduction cost to the land value to derive a total value for the property of \$187,000).

(n52)Footnote 189. *Barton Theatre Co v Commr*, TC Memo 1980-128 , *affd on other grounds* 701 F2d 126 (10th Cir 1983) ; *Scheidelman v Commr*, TC Memo 1970-70 (court used 50 percent depreciation factor in reducing the cost of reproducing the building).

(n53)Footnote 190. *Hilborn v Commr*, 85 TC 677 (1985) ; *Stanley Works and Subs v Commr*, 87 TC 389 (1986) ; *Symington v Commr*, 87 TC 892 (1986) ; *Fannon v Commr*, TC Memo 1989-136 (court determined scenic easement value was 37 percent of pre-easement value of the land, based on guidance from a prior case); *Dorsey, Jr v Commr*, TC Memo 1990-242 ; *Losch v Commr*, TC Memo 1988-230 ; *Clemens v Commr*, TC Memo 1992-436 ; Rev Rul 73-339, 1973-2 CB 68 , as clarified by Rev Rul 76-376, 1976-2 CB 53 ; *Schapiro v Commr*, TC Memo 1991-128 ; *Simmons v Commr*, TC Memo 2009-208 (court allowed 5 percent reduction in values of two properties due to facade easements; the taxpayer claimed 11- and 13-percent reductions).

(n54)Footnote 191. *Hilborn v Commr*, 85 TC 777 (1985) ; *Stanley Works and Subs v Commr*, 87 TC 389 (1986) ; *Dorsey, Jr v Commr*, TC Memo 1990-242 ; see § 20.04[2] for discussion of "highest and best use"; *Higgins v Commr*, TC Memo 1990-103 (Tax Court values conservation easement by applying "before and after" approach, rejecting IRS figures because they were based on the incorrect assumption that the highest and best use for the property before the easement was as a single-family residential lot, rather than subdivision).

(n55)Footnote 192. *Griffin v Commr*, TC Memo 1989-130 , *affd* 911 F2d 1124, (5th Cir 1990) ; *Dorsey, Jr v Commr*, TC Memo 1990-242 ; *Losch v Commr*, TC Memo 1988-230 (15 percent diminution in value from conservation easement); *Treas Reg* § 1.170A-14(h)(3)(ii) (conservation easement valuation).

(n56)Footnote 193. *Dorsey, Jr v Commr*, TC Memo 1990-242 ; *Stanley Works and Subs v Commr*, 87 TC 389

(1986) ; *Symington v Commr*, 87 TC 892 (1986) ; *Clemens v Commr*, TC Memo 1992-436 .

(n57)Footnote 194. *Clemens v Commr*, TC Memo 1992-436 .

(n58)Footnote 195. *Branch v Commr*, TC Memo 1987-321 .

(n59)Footnote 196. *Tidler v Commr*, TC Memo 1987-268 .

(n60)Footnote 197. *Tidler v Commr*, TC Memo 1987-268 ; *Crosswhite v US*, 438 F Supp 368 (D Or 1977) .

(n61)Footnote 198. *Estate of Spruill v Commr*, 88 TC 1197 (1987) .



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Federal Taxes Affecting Real Estate

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CHAPTER 20 Valuation Of Real Property

2-20 Federal Taxes Affecting Real Estate § 20.06

§ 20.06 Valuation Discounts

[1] In General

A variety of discounts may be applied in valuing a property. A taxpayer bears the burden of showing that a discount is appropriate, and the amount of any discount. n199

[2] Lack of Marketability Discount

A marketability discount measures the diminution in value attributable to the lack of a ready market for real property. n200 Although distinct, this discount is often discussed in conjunction with, and sometimes as a component part of, a minority or fractional interest discount. n201 The likely reason is that one of the factors making a minority interest in property less desirable than a fee interest is its lack of marketability. n202

[3] Minority and Fractional Interest Discounts

[a] In General

The economic theory underlying a minority or fractional interest discount is that the value of a part may be *less* than a proportionate part of the value of the whole--i.e., the undivided partial interest in real estate is worth less than its allocable share of the entire value. n203

Discounts are not just given for minority interests in property. A fractional interest discount may be given even when the ownership interest being valued is 50 percent or more. n204

There are several underlying rationales for permitting a minority or fractional interest discount: n205

- A holder of a fractional interest in property can compel partition of the property, which is not available with other types of shared ownership interests; therefore, a minority discount should reflect the cost, uncertainty, and delays attendant upon partition proceedings, and the value of the interest secured thereby. n206
- Difficulty of marketing undivided interests in real property; n207

- General disadvantages of owning real estate jointly with others, n208 along with the significance of the control factor. n209

In order to be entitled to a minority or fractional interest discount, a taxpayer must offer evidence that a partial interest in the real property would sell for less than its proportionate share of the entire value of the property. Absent that evidence, no discount will be allowed. n210

Evidence of the amount of discount to be given can be from comparable sales of partial interests or testimony of local real estate market practices. n211 It may also be helpful to provide evidence of discord among current owners, evidence that a new purchaser is likely to be unable to get along with existing owners, and evidence that the property is not readily divisible in kind. n212

[b] Property Interests Eligible for Minority or Fractional Interest Discounts

Minority or fractional interest discounts are allowed for property held in tenancy in common n213 and for community property. n214 Ownership of remainder interests in the subject property by family members does not necessarily preclude the discount. n215 Discounts are also given for fractional ownership interests in entities that hold real estate, such as partnerships, n216 limited partnerships, n217 corporations, n218 or trusts. n219

Separate interests in the same property that are included in a decedent's estate under different statutory provisions or held in different capacities by the same taxpayer are also eligible for a fractional interest discount. The interests are not aggregated so as to preclude the discount. n220 Fractional interest discounts are not permitted for property held in joint tenancy because of the right of survivorship that is characteristic of that property. n221 A fractional discount may not be allowed when the property in question, for some reason, must be sold as a fee interest. n222 A fractional interest discount also cannot be taken for estate tax purposes with respect to real property for which a special use valuation election is made under *IRC Section 2032A*. n223

[c] Amount of Discount

The minority or fractional interest discounts given in various cases vary widely. The amount given depends on the percentage ownership being discounted, unique facts and circumstances of each case, and, perhaps most importantly, the expert evidence presented in support of the discount. For this reason, it is difficult to predict the likely amount of discount, if any, to be applied in valuing a fractional interest in a particular property. Sometimes, the existence of a fractional interest is given as a factor in establishing value, but the court does not specify the exact weight given to it. n224

Factors favoring a lower discount include the following: n225

- good condition of the property;
- desirable location;
- good rental histories with creditworthy tenants.
- long-term leases.

[4] Market Absorption or Blockage Discount

A market absorption (or blockage) discount may be given for properties where the addition of numerous similar

properties into the market within a short period of time depresses their price. This can occur when a decedent dies owning numerous parcels of real estate in the same geographic area. n226 For the discount to be available, a taxpayer must show that a sale of all the properties at once would depress the market and result in a lower price for each property than would result if the properties were sold gradually over a period of time. The price reduction can then be reflected in the properties' values for valuation purposes. n227

The Tax Court applies a five-part analysis in determining whether and how a market absorption discount should apply: n228

- (1) Examine the assets to be valued and categorize them by type.
- (2) Ascertain the market value (without market absorption discount) of each asset in each category, assuming that each asset will be marketed separately.
- (3) Compare the number of assets in each category to the number of assets of that type that are traded in the market over a reasonable period of time.
- (4) Ascertain how much longer than this reasonable time period it would take to sell at market value each asset that could not be sold in this reasonable time period.
- (5) Discount the value of each asset in the category of assets that cannot be sold within a reasonable time period, taking into account the time value of money and the period of time that the category of assets would have to be marketed in order to sell each asset.

[5] Combined Discounts on Same Property

A single property may be entitled to multiple discounts, such as both a minority interest discount and lack of marketability discount, n229 both a minority interest discount and lack of accessibility discount, n230 or both a market absorption and minority interest discount. n231

Discounts are, and generally should be, considered and weighted separately. At times, however, discounts are combined to come up with a single valuation discount figure. n232 In addition, courts sometimes discuss various discounts and then lump them into a composite discount percentage without clarifying the amount attributable to each particular type of discount. n233 Multiple discounts may be found even though family members own all interests in the property. n234

FOOTNOTES:

(n1)Footnote 199. *Tax Court Rule 142(a)*; *Estate of Stevens v Commr*, *TC Memo 2000-53* ; *Estate of Van Horne v Commr*, *78 TC 728 (1982)* , *affd 720 F2d 1114 (9th Cir 1983)* .

(n2)Footnote 200. *LeFrak v Commr*, *TC Memo 1993-526* ; *Ward v Commr*, *87 TC 78 (1986)* .

(n3)Footnote 201. *Estate of Grootemaat v Commr*, *TC Memo 1979-49* ; see [3], below, for a discussion of minority or fractional interest discount.

(n4)Footnote 202. See *Sels v Commr*, *TC Memo 1986-501* ; *Harwood v Commr*, *82 TC 239 (1980)* , *affd per order* (9th Cir 1986) (50 percent discount applied for the liquidity and marketability factors associated with a minority interest in a limited partnership engaged in the timber business).

(n5)Footnote 203. See *Estate of Young v Commr*, *110 TC No 24 (1998)* ; *Estate of Iacono v Commr*, *TC Memo 1980-520* ; *Estate of Youle v Commr*, *TC Memo 1989-138* ; *Knapp v Commr*, *TC Memo 1977-389* (20 percent discount given for charitable donation of 10 percent minority interest in tract of land); *Estate of Cervin v Commr*, *TC Memo*

1994-550, *revd & remanded on another issue 111 F3d 1252 (5th Cir 1997)* (20-percent discount for decedent's 50-percent tenancy-in-common interest in Texas farm and homestead; IRS argued for a 6.54 to 8.2 percent discount; cost and/or feasibility of partition taken into account in valuing both farm and homestead); *TAM 9336002* (discount given for estimated cost of partitioning property); *Estate of Sharp v Commr, TC Memo 1994-636* (Tax Court valued gift of taxpayer's 25-percent interest in a shopping center, accepting taxpayer's figure, which was half the amount that a 50-percent interest in the shopping center had sold for 5 months prior to the gift); *Estate of Forbes v Commr, TC Memo 2001-72* (30-percent discount given for undivided 42-percent interest in two parcels of property that were held in a QTIP trust for the benefit of the decedent).

(n6)Footnote 204. *Estate of Amlie v Commr, TC Memo 2006-76* (15-percent discount given to parcels in which decedent had 50-percent and 7/12's interests); *Estate of Pillsbury v Commr, TC Memo 1992-425* (Tax Court allowed a 15-percent fractional interest discount in valuing 77-percent interest in property for estate tax purposes); *Estate of Brocato v Commr, TC Memo 1999-424* (20 percent discount allowed for decedent's 50-percent interest in several properties); *Estate of Stevens v Commr, TC Memo 2000-53* (25 percent discount allowed for decedent's 50-percent interest in several properties); *Estate of Busch, TC Memo 2000-3* (10 percent fractional interest discount applied to decedent's 50-percent interest in property); *Chertkof v Commr, 72 TC 1113 (1979)* (10 percent discount for one-third interest in property).

(n7)Footnote 205. *LeFrak v Commr, TC Memo 1993-526*; but see *Stewart v Commr, 31 BTA 201 (1934)* (suggestion that a premium should be given to a minority interest because of its nuisance value).

(n8)Footnote 206. See *Estate of Barge v Commr, TC Memo 1997-188* (In valuing timberland for gift tax purposes, court determined that a purchaser of the 25-percent interest would force a partition of the property in order to escape the taxpayer's conservative timber management philosophy and maximize cash return; the court took the cost and effect of this partition into account in valuing property); *Estate of Pillsbury v Commr, TC Memo 1992-425*; *Estate of Wildman v Commr, TC Memo 1989-667*; *Estate of Youle v Commr, TC Memo 1989-138*; *Sels v Commr, TC Memo 1986-501*; *Estate of Feuchter v Commr, TC Memo 1992-97* (15 percent fractional interest discount given to taxpayer's one-half interest in real estate partnership); *Estate of Henry v Commr, 4 TC 423 (1944)*; *TAM 19943003* (one method for determining the fair market value of an undivided interest in property was to value the fee, multiply the value of the fee by the undivided interest, and subtract the proper share of the costs of partition allocable to the undivided interest); *Estate of Fittl v Commr, TC Memo 1986-542*; but see *Estate of Stevens v Commr, TC Memo 2000-53* (holding that reliance of partition cost alone did not give adequate weight to other reasons for discounting a fractional interest).

(n9)Footnote 207. *Estate of Henry v Commr, 4 TC 423 (1944)*; *Estate of Stevens v Commr, TC Memo 2000-53*; *Estate of Baird et al v Commr, TC Memo 2001-258*.

(n10)Footnote 208. *Estate of Henry v Commr, 4 TC 423 (1944)*; *Estate of Baird et al v Commr, TC Memo 2001-258*.

(n11)Footnote 209. *Estate of Stevens v Commr, TC Memo 2000-53*; *Williams v Commr, TC Memo 1998-59*.

(n12)Footnote 210. *Estate of Clapp v Commr, TC Memo 1983-721* (no discount for one-third interest in real property because taxpayer offered no evidence to show that the interest would sell for less than its proportionate share of the entire value of the property); *Estate of Iocono v Commr, TC Memo 1980-520* (no fractional interest discount given for one-quarter or one-half interest in property because no evidence was offered to show those interests would sell for less than their aliquot share of the full value); *Estate of Clafin v Commr, 2 BTA 126 (1925)* (court denied fractional interest discount for 9/14 interest in three buildings); *Estate of Barclay v Commr, 2 BTA 696 (1925)* (court denied fractional interest discount for one-half interest, notwithstanding evidence of local market discounting of those interests); *Estate of Feuchter v Commr, TC Memo 1992-97*.

(n13)Footnote 211. *Estate of Feuchter v Commr, TC Memo 1992-97*; *Estate of Campanari v Commr, 5 TC 488*

(1945) (court based its decision on testimony that it was common practice in the local real estate market to deduct a percentage of an individual fractional interest in appraising real estate and that it was difficult to find a buyer for an undivided fractional interest).

(n14)Footnote 212. See *Estate of Henry v Commr*, 4 TC 423 (1944) ; see *Coddington v Commr*, TC Memo 1960-95 (no discount given for one-half interest in property because joint owners had long held the property in harmony and there was no credible expert evidence supporting a discount).

(n15)Footnote 213. See *Estate of Barclay v Commr*, 2 BTA 696 (1925) ; *Estate of Young v Commr*, 110 TC No 24 (1998) ; *Estate of Youle v Commr*, TC Memo 1989-138 ; *Sels v Commr*, TC Memo 1986-501 (60 percent discount given for taxpayer's interests in various parcels of timberland, ranging from 2.4 to 25.8 percent).

(n16)Footnote 214. *Propstra v US*, 680 F2d 1248 (9th Cir 1982 (15-percent discount allowed in valuing decedent's undivided one-half interest in community real property); *Anderson v Commr*, TC Memo 1988-423 (court allowed 20-percent discount because decedent's interest in Texas farmland was a one-half undivided interest in community property).

(n17)Footnote 215. *Mooneyham v Commr*, TC Memo 1991-178 (Tax Court applies a 15-percent fractional interest discount in valuing taxpayer's gift to a brother of a 50-percent fractional interest in real estate).

(n18)Footnote 216. *Graham v Commr*, TC Memo 2005-68 (taxpayer had 22% interest in partnership which held a 50% interest in one property and a 25% interest in another; court applied 35% minority/marketability discount in valuing the partnership interest); *Estate of Feuchter v Commr*, TC Memo 1992-97 (15 percent fractional interest discount given to taxpayer's one-half interest in real estate partnership).

(n19)Footnote 217. *Harwood v Commr*, 82 TC 239 (1980) *affd* 786 F2d 1174 (9th Cir 1986) ; *Knott v Commr*, TC Memo 1988-120 (30 percent discount for 65-percent interest in real estate limited partnership).

(n20)Footnote 218. *Estate of Folks v Commr*, TC Memo 1982-43 (50 percent discount for lack of liquidity and additional 50 percent discount for lack of marketability (net 75 percent discount) given for minority stock interest in closely held family corporation engaged in the lumber business).

(n21)Footnote 219. *Estate of Lopes v Commr*, TC Memo 1999-225 ; *Ludwick v Commr*, TC Memo 2010-104 (court determined gift tax value of partial interest in Hawaii vacation property by looking to costs of selling property, likelihood of partition, and operating costs of property; comparable sales offered by experts for determining a proper discount were found irrelevant).

(n22)Footnote 220. *Estate of Bonner, Sr, v US*, 84 F3d 196 (5th Cir 1996) (estate allowed fractional interest discount on properties in which he held 62.5 percent and 50 percent undivided interests, even though the balance of those properties were included in his estate because they had been bequeathed to a QTIP trust that had been established by the decedent's spouse); *Estate of Lopes*, TC Memo 1999-225 (interests in multiple ranch properties held by a decedent through two different trusts--a survivor's trust and a QTIP marital trust that had been established by the decedent and her predeceased husband--were not aggregated so as to preclude a fractional interest discount); *Estate of Baird v Commr*, TC Memo 2001-258 (55% fractional interest discount for estates' interest in Louisiana timberland, with additional 5% discount due to unique circumstances with decedents' family members. The IRS argued that the only discount allowable was the cost of partitioning the property so that the partitioned interest of each decedent could be sold separately. The unreasonableness of the IRS position enabled the taxpayers to recover substantial litigation costs [see *Estate of Baird v Commr*, TC Memo 2002-299 , *revd and remanded* 416 F3d 442 (5th Cir 2005) , *on remand* TC Memo 2006-140]; see *Estate of Bright v US*, 658 F2d 999 (5th Cir 1981) .

(n23)Footnote 221. *Estate of Fratini v Commr*, TC Memo 1998-308 , *Estate of Young v Commr*, 110 TC 297 (1998) .

(n24)Footnote 222. *Estate of McCullen v Commr, TC Memo 1988-500* (no discount because trust instrument required the sale of the entire land as a single parcel); *Estate of Casey v Commr, TC Memo 1996-156* (no fractional interest discount because the trustee of the liquidating trust holding the property could sell the property without consent of the beneficiaries, but court gave a 15 percent discount for the value of money lost during the time delay in liquidating and selling a 50-acre estate).

(n25)Footnote 223. *Estate of Hoover v Commr, 102 TC 777 (1994)* (Tax Court denied a minority interest discount; the decedent, through a revocable trust, held a 26-percent interest in a limited partnership that owned and operated a ranch); *Maddox v Commr, 93 TC 228 (1989)* (estate was not entitled to a minority discount in valuing decedent's stock interest in an incorporated family farm).

(n26)Footnote 224. *Estate of Fawcett v Commr, 64 TC 889 (1975)* .

(n27)Footnote 225. *Estate Stevens v Commr, TC Memo 2000-53* ; regarding discounts with respect to partnership interests, see "Fractional Interests in Real Estate Limited Partnerships," *The Appraisal Journal*, 184-194 (April 1992).

(n28)Footnote 226. *Estate of Aufer v Commr, TC Memo 1998-185* ; *Estate of Brocato v Commr, TC Memo 1999-424* ; *Estate of Grootemaat v Commr, TC Memo 1979-49* (15 percent discount given for parcels in 300 acres); *Carr v Commr, TC Memo 1985-19* (30 percent discount given for shares in real estate corporation based on market absorption if all lots were put on market).

(n29)Footnote 227. *Estate of Aufer v Commr, TC Memo 1998-185* (6.189 percent market absorption discount applied); *Estate of Brocato v Commr, TC Memo 1999-424* (11-percent blockage discount given for seven apartment buildings).

(n30)Footnote 228. *Estate of Aufer v Commr, TC Memo 1998-185* ; *Estate of Brocato v Commr, TC Memo 1999-424* .

(n31)Footnote 229. *LeFrak v Commr, TC Memo 1993-526* (gave 20-percent minority interest discount and 10 percent lack of marketability discount); *Estate of Barudin v Commr, TC Memo 1996-395* (19 percent minority interest discount for decedent's interest in real estate partnership, along with 26 percent lack of marketability discount); *Estate of McCormick et al v Commr, TC Memo 1995-371* (for multiple properties held in real estate partnerships, court gave 18 to 32-percent minority discounts and 20 to 22-percent lack of marketability discounts); *Estate of Berg et al v Commr, TC Memo 1991-279* (Tax Court agrees with IRS and applies 20-percent minority interest discount and 10 percent lack of marketability discount in valuing a decedent's 27-percent interest in a corporate real estate holding company; taxpayer provided only general appraisal data, lacked specific analysis of the real property, and failed to provide any convincing evidence to support larger discounts).

(n32)Footnote 230. *Estate of Baggett v Commr, TC Memo 1991-362* (35-percent minority interest discount given for taxpayer's 25-percent interest in surface rights, along with 10-percent lack of accessibility discount).

(n33)Footnote 231. *Estate of Grootemaat v Commr, TC Memo 1979-49* (11 percent market absorption discount given along with 25-percent discount for minority interest/restricted market for shares of real estate corporation); *Estate of Brocato v Commr, TC Memo 1999-424* (11-percent blockage discount given for seven apartment buildings in addition to 20-percent fractional interest discount); *Carr v Commr, TC Memo 1985-19* (30 percent market absorption discount along with 25 percent minority interest discount of the net asset value of stock in real estate corporation).

(n34)Footnote 232. *Williams v Commr, TC Memo 1998-59* (combined 44-percent marketability and lack of control discount in valuing gift of 50-percent interest in property); *Estate of Barudin, TC Memo 1996-395* (taxpayer's expert argued for combined minority interest and lack of marketability 67.5 percent discount); see *Estate of Casey et al v Commr, TC Memo 1996-156* (15 percent discount given in valuing decedent's 50-percent interest in a liquidating trust for the time delay in liquidating real estate owned by the trust).

(n35)Footnote 233. *Moore v Commr*, *TC Memo 1991-546* (Tax Court found that interests in a real estate partnership were subject to discount of 35 percent, comprised of unspecified amounts for minority interest and lack of liquidity of partnership interest); *Estate of Wildman v Commr*, *TC Memo 1989-667* (court lumped together various discounts in valuing a decedent's one-fifth interest in farmland, including minority interest, restrictions on sale, noncontiguous acreage); *Estate of Langer v Commr*, *TC Memo 2006-232* (IRS conceded a 47.5 percent discount "for all applicable discounts" relating to 29-percent interest in family LLC, which owned multiple properties).

(n36)Footnote 234. *Andrews v Commr*, *79 TC 938 (1982)* (lack of control and lack of marketability discounts given, even though the decedent and siblings owned all stock in a real estate holding corporation).



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Appendix Forms: FORMS

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[A] Real Estate Entities



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Appendix Forms: FORMS

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[A] Real Estate Entities

A.1 Tenancy in common--equal ownership by two individuals--unimproved property

COMMENT

This group of forms illustrates various joint ventures for the coownership of property. Generally, a joint venture is a union of two or more persons or corporations in a business enterprise with well-defined restrictions on its activities. If the joint venture is involved in real estate, one of the first questions that arises is the form in which title to the real estate is to be held by the joint venturers. In many instances title is taken in the name of all of the participants as tenants in common. In other cases title is taken in the name of the joint venture. In some cases a nominee is designated to hold title for the benefit of the joint venture. This technical problem as to how title is to be held will often depend upon the number of participants in the joint venture and the extent of the proposed real estate activity, and must be governed by rules of local real estate law, considerations of title, control, and the practice of title insurance companies.

Tax classification:

From the viewpoint of the income tax law, the first problem with respect to a real estate joint venture is to determine whether it is subject to the partnership provisions of the Code, or whether the coowners can compute and report their respective shares of income or losses separately and without reference to those provisions. The venture may be classified as a mere coownership, in which event the partnership provisions will not be applicable. Even a venture which has the technical characteristics of a partnership may be excluded from the partnership provisions if it qualifies as an "investing or operating venture." If it does not fall into either of these two categories, the partnership provisions will be applicable to the venture unless it elects to be taxable as a corporation. For these purposes the results depend upon the provisions of the Code and the applicable Regulations thereunder.

Coownership vs. partnership tax status:

The Regulations define a partnership as including "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Code." The Regulations also provide that the mere ownership of property which is maintained, kept in repair, and

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rented or leased does not constitute a partnership. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if coowners of an apartment building lease space and in addition provide service to the occupants either directly or through an agent. It has been held, however, that cotenants do not become partners by reason of an agreement to appoint an agent for management, collection of rents, and sale. The result in any given case seems to depend upon the extent of the business activities of the venture. If the relationship is solely for the coownership of property, the characteristics of a partnership are absent.

Limited election to be excluded from partnership taxation:

The statute recognizes the existence of certain borderline relationships. It provides that even if a business arrangement fits the definition of a partnership, it may elect to be excluded from the partnership provisions of the Code if it is availed of either for investment purposes only and not for the active conduct of a business, or for the joint production, extracting, or use of property, but not for the purpose of selling services or property produced or extracted. In either case, exemption from the partnership provisions is possible only if the income of the members may be adequately determined without the computation of partnership income.

Investing partnership exclusion election:

The Regulations state that an "investing partnership" qualifies where "the participants in the joint purchase, retention, sale, or exchange of investment property (a) own the property as coowners, (b) reserve the right separately to take or dispose of their shares of any property acquired or retained, and (c) do not actively conduct business, or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year." This definition would include the usual stock pool, or a syndicate for investment in land or in improved real estate subject to a lease under which the lessee incurs all operating expenses. The "active conduct of business" requirement, however, would seem to exclude syndicates which operate an office building or an apartment house, whether directly or through an agent. The election not to be treated as a partnership, however, has no effect upon the classification of the organization as an "association" subject to corporate tax.

Election procedure:

The election to be excluded from treatment as a partnership is made by filing a properly executed partnership return containing only the name and address of the organization, together with a statement containing the names and addresses of all members, a statement that the organization qualifies for the election, a statement that all of the members of the organization so elect, and a statement indicating where a copy of the agreement under which the organization operates is available. However, the election is not effective if any member notifies the Commissioner that he desires the partnership provisions to apply, but such notice must be filed within 90 days after the formation of the organization and the notice must state that the member has so notified all other members by registered mail. The election is irrevocable so long as the organization remains qualified, except with the consent of the Commissioner. It is not affected by a sale of a member's interest.

Coownership forms:

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Many of the forms in this group relate to ventures which qualify either as mere coownership arrangements, or as investing partnerships which may elect to be excluded from the operation of the partnership provisions of the Code. Keep in mind that the classification in each instance depends upon the activities of the venture. In cases where the activity extends beyond the mere ownership of property, it is strongly advisable to submit the formal election to be excluded from the partnership provisions, rather than to rely upon the position that the venture does not have any partnership characteristics. Of course, the terms of the cotenancy or joint venture agreement by themselves cannot be the excuse for the failure to file a regular partnership return, if in fact the venture pursues the "active conduct of a business."

Joint acquisition for investment:

This form illustrates an arrangement for the joint acquisition of property where no substantial business activity is contemplated. The primary objective is to hold the property as an investment for future resale. On these facts, the venture could elect to be excluded from the operation of the partnership provisions. The venture is predicated upon a contract for the purchase of property in a state where the unpaid portion of the purchase price is generally secured by a deed of trust to a bank. The coownership agreement is designed to insure that each venturer will promptly contribute to the installments due under the deed of trust and to other expenses as they become due. Thus, the agreement defines certain penalties to be imposed upon a defaulting party. In addition, the agreement outlines the conditions under which one coowner may dispose of his interest to an outsider. Here, the objective, as in many agreements of this kind, is to give the other coowner the so-called right of first refusal.

Tax basis of coowner:

The tax basis of a coowner of his interest in property acquired by purchase is his cost, including amounts contributed on behalf of a defaulting coowner (as well as costs relating to acquisition, such as payments for perfecting title, architects' fees, brokers' commissions, and appraisal fees).

For further information, see Chapters 1, 2, and 14.

FORM

AGREEMENT entered into on November 30, 2002, between Harold Stern, a married man dealing with his sole and separate property (Stern), and Frank Realty Corporation (Frank).

Recitals

The parties are purchasing as tenants in common the property described in Exhibit A attached hereto.

Each of the parties has an individual one-half interest in the property.

The parties desire to provide for the management and disposition of such property.

It is, therefore, agreed as follows:

1. *Down payment and title.* The down payment, including closing costs, on such property under Escrow No. 100, Desert Land Title & Trust Company, Flagstaff, Arizona, shall be contributed by Frank. Title to such property shall be

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conveyed to Desert Land Title & Trust Company under the terms of its usual title holding trust agreement, modified to incorporate, either by reference or otherwise, the terms of this agreement.

2. *Subsequent contributions.* Subsequent contributions of principal, interest, taxes, and all other costs on such property shall be paid equally by each party.

3. *Sale of property.* Any decision to sell all or part of such property shall be made by both parties. Except as hereinafter otherwise provided, the net proceeds of any sale or sales shall be distributed equally between both parties.

4. *Default.* Each party shall promptly contribute, when and as the same becomes due, his equal share of all future payments required to be made pursuant to the trust agreement under which the property is being purchased, including principal, interest, taxes, and all other costs with respect to such property. If either party is unable to pay his share of such costs, the other party is authorized to make such payment or payments so as to avoid a default under the trust agreement. All amounts so advanced by either party on behalf of the other party shall bear interest at the rate of 9 percent per year from the date of advance, and shall be due immediately upon written demand for payment in the manner hereinafter provided. If the full amount of such advance or advances, together with interest thereon is not paid by the party for whom such advance was made, within ten days after receipt of such notice of demand for payment, then such party shall be a defaulting party hereunder. In the event of any sale of such property, the proceeds shall be distributed equally between both parties, but a defaulting party shall in no event be entitled to receive an amount in excess of the total contributions made by such party, without interest. All other proceeds of sale shall belong to the nondefaulting party. In the event of a sale at a loss such defaulting party shall bear his one-half share of such loss.

5. *Management.* All matters relating to the management and sale of the property shall be decided by both parties, except that if either of the parties becomes a defaulting party, the other party shall have full power to make all decisions relating to the management and sale of such property.

6. *Restrictions.* Neither party shall sell, transfer, mortgage, or otherwise dispose of, or encumber his undivided interest in such property without first giving written notice to the other party of his intention to do so. The notice shall set forth the terms on which the offering party proposes to sell, transfer, mortgage, or otherwise dispose of or encumber his interest, and the identity of the person or persons to whom it is proposed to sell, transfer, or encumber such interest. The other party shall have ten days after the giving of notice in which to elect to acquire the interest for a purchase price based upon \$3,000 per acre, less the amount per acre of any unpaid balance or other encumbrance against the property. The purchase price shall be paid on the same terms as the original price paid by the parties pursuant to the escrow referred to in paragraph 1, including percentage of down payment, amortization of principal balance, and interest rate. If the party to whom the notice is given does not elect to acquire the interest on the terms provided herein within the ten-day period, then the party giving the notice shall have the right to sell, transfer, mortgage, or otherwise dispose of, or encumber his interest, on the same terms as provided in the notice, for a period of 30 days after the expiration of the ten-day period. After the expiration of the 30-day period, the party giving the notice shall not sell, transfer, mortgage, or otherwise dispose of, or encumber his interest without again complying with the terms of this paragraph. If the party to whom notice is given elects to purchase, an escrow shall be established forthwith with a title company having an office in Flagstaff, Arizona, for the purpose of consummating the purchase. The escrow shall, by its terms, provide for a closing not more than 30 days after its establishment.

7. *Notices.* Any and all notices and demands given under this agreement shall be given by registered or certified mail, return receipt requested, postage prepaid, addressed to the parties at the following addresses or at such other addresses as either or both may designate on written notice:

Harold Stern
100 Aspen Street

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Flagstaff, Arizona 85723

Frank Realty Corp.
200 West First Street
Tucson, Arizona 85718

8. *Binding effect.* This agreement shall be binding upon and shall inure to the benefit of each of the parties, and their respective heirs, executors, administrators, legal representatives, successors, and assigns.

9. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

10. *Non-waiver.* No delay or failure by either party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

11. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

12. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of Arizona.

13. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

	Harold Stern
Attest:	Frank Realty Corp.
_____	by _____
Secretary	President

A.2 Tenancy in common--acquisition of leasehold by a group--operation of property--provisions for sale by coowner

COMMENT

The basic purpose of this agreement is to control the relationship of a group of unrelated individuals who are involved in the common ownership of property that may continue over an extended period of time. In this situation, it becomes essential to set out numerous operating details. This agreement includes restrictive provisions on transfers and on sales, a provision setting up a technique for the sale of the entire property, a provision permitting a participant to borrow against his ownership interest, and a provision to take care of the possibility that an owner's interest may become subject to an involuntary lien. These provisions are designed to define the rights of the participants in certain prescribed contingent circumstances.

Partnership taxation:

In this agreement the ownership of the leasehold interest is to be taken by the participants as tenants in common. This in itself does not qualify the enterprise as an organization "for investment purposes only and not for the active conduct of business," permitting an election to be exempt from the operation of the partnership provisions of the Revenue Code (see comment on Form A.1). Generally, the exemption is available to a joint venture which owns land subject to a lease under which the lessee incurs all operating

expense. But the "active conduct of a business" requirement would generally exclude ventures which are organized to operate a building, whether directly or through an agent. Under this agreement, the leasehold is to be operated by subleasing portions of the premises to various subtenants. While all this is to be done through an agent, it nevertheless involves the active operation of property with all the risks attached to such a "business." This enterprise would, therefore, most likely be classified as a partnership, so that all the income tax requirements applicable to general partnerships would apply.

One of the practical problems in many joint ventures is the method of fixing the return on investment of the investor. Frequently such return is deferred until realized by the venture. Under this agreement, the ratio of investment by a participant does not necessarily correspond with his ratio of income distributions. Presumably, the investor will be compensated through a disproportionately larger share of the profits.

For further information, see Chapters 1, 2, and 14.

FORM

AGREEMENT made June 15, 2002, among John Richmond and Lester Franklin, partners trading as Richmond & Franklin, 51 West 18th Street, New York, New York; Benjamin White, 30 Maujer Street, Brooklyn, New York; Francis Bush, 445 East 65th Street, New York, New York; Arthur Abeles and Victor Young, partners trading as The Abeles Company, 40 Broadway, New York, New York; Herman Hahn, 150 Broadway, New York, New York; Charles King, 20 West 16th Street, New York, New York; and Harry Gordon, 20 West 16th Street, New York, New York (collectively the "Owners").

Recitals

The Owners are about to acquire a leasehold interest (the "Leasehold"), on the property more fully described in Schedule A, subject to the mortgage and other encumbrances recited in such Schedule A.

The Owners desire to provide for the holding of title to the Leasehold, division of the profits and losses thereon, restrictions upon disposition, management of the property, and other matters relating to their common ownership.

It is therefore agreed:

1. *Ownership.* Title to the Leasehold shall be taken in the names of the Owners as tenants in common, and the instrument of conveyance shall be duly recorded in the appropriate recording office.

2. *Profits and losses.* The interests of the Owners in the Leasehold and in its profits and losses shall be as follows:

(a) *Capital.* The capital interest of each of the Owners in the Leasehold is the amount of his investment in this joint venture as set opposite his name under the heading Capital Investment in Schedule B.

(b) *Profit and loss share.* All profits and losses in the operation of the leasehold shall be shared and borne by the Owners in the percentages set opposite their respective names under the heading Share of Profits in Schedule B. In the event that there is a deficit at any time in the operations of the Leasehold and it becomes necessary to obtain contributions from the Owners, each Owner shall be required, within five days after receipt of notice of such deficit, to pay an amount equivalent to his pro rata share of the deficit based upon his share of profits.

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(c) *Distribution on sale.* In the event of the sale of the Leasehold, the net proceeds of sale shall be distributed as follows:

(1) *Adjusted capital investment.* Each of the Owners shall first receive a return equal to his adjusted Capital Investment. For all other purposes of this agreement, the adjusted Capital Investment of each Owner shall be the amount set opposite his name under the heading Capital Investment in Schedule B, as reduced, at any given time, by his proportionate share of amortization as reflected on the books of the joint venture. Amortization shall be allocated to each Owner on the basis of his proportionate interest in the total Capital Investments of all the Owners. If the net proceeds of sale are less than the adjusted Capital Investments of all the Owners, distribution shall be made among the Owners on the basis of their proportionate interests in the total adjusted Capital Investments.

(2) *Special payment.* All additional net proceeds of sale, but in no event in excess of \$50,000, shall then be paid to Harry Gordon (in addition to all net proceeds of sale distributable to him as an Owner under subdivision (1) above).

(3) *Profits.* All remaining net proceeds of sale shall then be shared by the Owners, including Harry Gordon, in the proportions set opposite their respective names under the heading Share of Profits in Schedule B.

3. *Restrictions on transfer.* Except as hereinafter set forth, none of the Owners shall sell, dispose of, transfer, or encumber the Leasehold or any interest therein. Notwithstanding the foregoing:

(a) Any partnership which is a party to this agreement may at any time dissolve such partnership and distribute its interest in kind to the individuals who comprise it.

(b) Any partnership which is a party to this agreement may transfer all of its interest to a successor partnership in which its present members have more than a 50 percent interest in capital and profits.

(c) Each individual Owner may, during his life time, transfer all or any part of his interest to his spouse, his adult issue, or the adult spouses of his issue.

(d) Each individual Owner may, at death, either by will or by operation of law, transfer his interest to one or more persons, provided that if a fiduciary, including but not limited to a testamentary trustee, guardian, executor, or administrator, shall be the holder of legal title to such interest, such fiduciary shall be subject to all of the terms of this agreement.

4. *Sale of interest of owner.* In the event that any Owner shall receive an acceptable offer from a competent adult, who is not a fiduciary, for the purchase of all of such Owner's interest in the Leasehold, such Owner shall have the right to sell his interest only after complying with the following requirements:

(a) *Notice.* Such Owner shall procure and deposit with the Mailing Agent, as designated in paragraph 7, a certified check for 10 percent of the amount of the offer and the written offer signed by the prospective purchaser.

(b) *Option to purchase.* The Mailing Agent shall forthwith notify all of the Owners of the terms of the offer. Each of the other Owners shall then have the option to purchase the interest of the offering Owner upon the same terms set forth in the offer, provided notice of purchase in writing is mailed to the Mailing Agent within 20 days after the initial receipt by the Mailing Agent of the offer. Each Owner who exercises his option to purchase shall set forth in his letter of acceptance the amount of the interest he is willing to purchase. If the total interests which the Owners offer to purchase are in excess of the interest offered, each Owner shall then purchase that proportion of the offered interest which that acceptor's offer to purchase bears to the total offers of all the acceptors. If the total interests which the acceptors have offered to purchase shall be less than the interest offered, the Mailing Agent shall immediately give notice in writing to the acceptors of the amount of the difference. If within 30 days after the initial receipt by the Mailing Agent of the offer, the acceptors do not make satisfactory arrangements for the purchase of the difference, then the offer of the entire

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interest shall be deemed to have been rejected. In the latter event, the Owner offering his interest shall have the right to sell to the person named in the offer, provided that the sale is concluded within 30 days of the date upon which he is notified by the Mailing Agent that his offer has been rejected, and provided further that the sale is made strictly in accordance with the terms of the offer and at no less favorable terms.

(c) *Purchase.* If the interest of the offering Owner is purchased pursuant to the option referred to in subparagraph (b) of this paragraph, payment for the interest shall be made by certified check to the order of the Owner within 30 days after the initial receipt by the Mailing Agent of the offer, against the delivery to the purchasers of appropriate instruments transferring title to the interest of the Owner.

5. *Assumption by assignee.* All permitted transferees or other persons to whom an interest in the Leasehold may be transferred by the terms of this agreement, and any assignee receiving an interest pursuant to the terms of this agreement, shall automatically take that interest subject to all of the terms and conditions of this agreement, and shall not be considered to have title to that interest until they and each of them have signified their acceptance and assumption of the terms and conditions of this agreement in writing.

6. *Sale of leasehold.* (a) *Offers to purchase.* If any Owner acting individually or jointly with other Owners (the "offering party"), shall receive a bona fide offer in writing acceptable to him to purchase the Leasehold, he shall obtain from the prospective customer and deposit with the Mailing Agent, designated in this agreement, a certified check in the amount of \$150,000, an agreement to hold all Owners of the Leasehold harmless in respect to any brokerage commissions in the event that the sale is not consummated, and an executed contract for the purchase of the Leasehold providing for the payment of the purchase price in the form of all cash above mortgages and conditioned upon the acceptance of the offer within 45 days by all of the Owners of the Leasehold.

(b) *Option to purchase.* The Mailing Agent shall forthwith notify all of the Owners of the terms of the offer. The offering party and any Owner accepting the offer (the "offerors") shall be deemed to have offered their interests for sale to the other Owners upon the same terms set forth in the offer. (Any Owners rejecting the offer shall be referred to as rejectors).

(c) *Acceptance of offer.* Each Owner other than the offering party shall notify the Mailing Agent in writing, within 20 days after the initial receipt of the offer by the Mailing Agent, whether he accepts or rejects the offer. If the Mailing Agent does not receive any notice within the 20-day period, the Owner shall be deemed to have accepted the offer. If no Owner shall reject the offer, then it shall be deemed accepted by all of the Owners. In such event, the Owners shall take any and all steps necessary and proper to pass title pursuant to the offer.

(d) *Rejection of offer.* Any rejector shall set forth in his letter of rejection, the amount of the interest of the offerors that the rejector is willing to purchase if available, provided, however, that in any case any rejector shall be obligated to purchase, if available, from the offerors an interest equal to a percentage of the interest then held by the rejector. If the total interests which the rejectors offer to purchase are in excess of the total interests of the offerors, each rejector shall then purchase that proportion of the interests offered that the total interests which the rejector has offered to purchase bears to the total offers to purchase made by all rejectors. If the total interests which the rejectors have offered to purchase shall be less than the total interests of the offerors, the Mailing Agent shall immediately give written notice to the rejectors of the amount of the difference. If within 35 days after the initial receipt by the Mailing Agent of the offer, the rejectors do not make satisfactory arrangements for the purchase of the difference, then the offer shall be deemed accepted by all of the parties, and they shall take all of the steps necessary and proper to pass title pursuant to the offer.

(e) *Sale.* In the event of a sale of the Leasehold pursuant to the offer, each Owner shall share in the net proceeds of the sale in accordance with the terms of paragraph 2(c). In the event that, pursuant to the provisions of subparagraph (d) above, any rejectors shall purchase the interests of any offeror, the price to be paid to each offeror shall be such offeror's pro rata share of the difference between the selling price (less brokerage) set forth in the offer and the outstanding

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principal of any mortgages, plus or minus all usual real estate adjustments, in accordance with the interest of each offeror. Payment for the interest shall be made by certified check to the order of the offeror within 60 days after the initial receipt of the offer by the Mailing Agent, against the delivery to the purchasers of appropriate instruments transferring title to the interests of the offerors.

7. *Mailing agent.* Donald B. Held is designated Mailing Agent, and all notices to him shall be sent to 575 Park Avenue, New York, New York, or to such other address as he shall, from time to time, designate in a notice given to all the Owners. The Mailing Agent or such other Owner or Owners as may be required to give notice under the terms of this agreement shall mail all notices required herein by registered or certified mail to the addresses of the Owners set forth in this agreement, or to the last address as the Owners or any of their transferees shall, from time to time, give in writing to the Mailing Agent. The Mailing Agent hereby is relieved of all liability by virtue of his undertaking herein, except for malfeasance or fraud.

8. *Loan to owners.* Any Owner may borrow money on his interest in the Leasehold on the following terms and conditions:

(a) The amount of the loan may be no more than 75 percent of the Owner's investment in the Leasehold, less any capital returned to the Owner.

(b) The hypothecation of the Owner's interest in the Leasehold, whether in the form of a mortgage or pledge, shall provide for prepayment of the loan without penalty.

(c) The Owner's pro rata share of the proceeds on any new mortgage placed upon the Leasehold may be applied toward the payment of the loan made to the Owner, and any payment may be made directly to the lender.

(d) The unpaid balance of any mortgage or pledge by an Owner shall be subordinate to any mortgage placed upon the entire Leasehold, and the lender shall undertake to execute all documents necessary and proper to effectuate the subordination of his loan to any mortgage on the entire Leasehold.

(e) The Owner's pro rata share of the proceeds of the sale of the Leasehold may be applied towards the payment of the loan made by an Owner, and any proceeds may be paid directly to the lender.

(f) The terms of any mortgage or pledge shall in no manner prevent or unreasonably delay the sale or mortgage of the entire Leasehold.

(g) The lender shall undertake to be bound by the terms and conditions of this agreement whenever required to carry out the purposes of this agreement.

(h) Any owner's mortgage or pledge shall provide that, in the event there is any default in the mortgage or pledge (provided the default is not a default on the part of the Owners as lessees under the terms of the Leasehold) the lender, his successors, heirs, and assigns, shall give immediate notice of the default to the Mailing Agent. The notice shall constitute an irrevocable offer for a period of 30 days, on the part of the lender and the Owner to sell the Owner's interest in the Leasehold, and any interest of the lender in the Owner's leasehold, to all other Owners for the amount of the loan then outstanding plus interest to the date of payment.

9. *Partition.* No Owner shall, either directly or indirectly, make application to or petition any court for a partition of the Leasehold.

10. *Managing agent.* (a) *Commission and statements.* The Owners appoint Enterprises, Inc., as agent to supervise and manage the Leasehold. Enterprises, Inc., shall pay all employees engaged in the operation of the Leasehold out of the

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sums paid to it by the Owners. In full consideration of its services, Enterprises, Inc., shall be paid a yearly sum not to exceed 3 percent of the collected rents, the sums to be paid monthly within 20 days after the end of each month. Brokerage payable to outside brokers shall not be deemed included in the 3 percent item payable to Enterprises, Inc. Monthly statements of the Leasehold's operation shall be submitted by Enterprises, Inc., to each of the Owners within 20 days after the end of each month, and the statements shall include an itemized list of all income and expenses in connection with the Leasehold.

(b) *Term.* Enterprises, Inc., shall be employed for a term of one year from the date of the execution of this agreement. Such term shall be automatically extended from year to year thereafter unless written notice of termination signed on behalf of the Owners is served upon Enterprises, Inc., at least 60 days prior to the termination of any yearly period.

(c) *Profit payments.* Enterprises, Inc. shall from time to time during the year, but at intervals of no more than three months, distribute to the various Owners their share of all profits earned from the operation of the Leasehold.

11. *Meetings.* Meetings of the Owners may be called, upon five days notice, by the Mailing Agent or by Owners who have a 10 percent or greater interest in the capital of the Leasehold as set out under the heading Capital Investment in Schedule B. Meetings shall be held in New York, New York, at the office of the Mailing Agent, or at the office of any Owner who has a 5 percent or greater interest in the capital of the Leasehold. The power to make all decisions with respect to the management of the Leasehold is vested in the Owners. The decisions of the Owners shall be binding upon all the Owners if made by Owners who have a 50 percent or greater interest in the capital of the Leasehold, at a meeting called pursuant to the provisions of this paragraph.

12. *Separability.* If any part or provision of this agreement shall be determined to be invalid or unenforceable under the laws of the State of New York, the remaining portions of this agreement which can be separated from the invalid, unenforceable provisions shall nevertheless continue in full force and effect.

13. *Arbitration.* Any dispute or controversy arising under or as a result of this agreement shall be settled and determined by arbitration held in New York, New York, in accordance with the governing rules of the American Arbitration Association. Any award pursuant to such arbitration may be entered in any court of competent jurisdiction.

14. *Modification.* This agreement embodies the full understanding of the Owners. This agreement may not be changed orally. Any modifications of this agreement must be in writing signed by all of the parties hereto.

15. *Binding effect.* Except as herein otherwise specifically stated, this agreement shall bind and inure to the benefit of the parties to this agreement, their legal representatives, successors, and assigns.

16. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

17. *Notices.* All notices under this agreement shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

18. *Non-waiver.* No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

19. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

20. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New York.

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21. *Counterparts*. This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

In witness whereof the parties hereto have signed and sealed this agreement.

Richmond & Franklin (L.S.)

by _____

John Richmond, Partner

by _____

Lester Franklin, Partner

_____ (L.S.)

Benjamin White

_____ (L.S.)

Francis Bush

The Abeles Company (L.S.)

by _____

Arthur Abeles, Partner

by _____

Victor Young, Partner

_____ (L.S.)

Herman Hahn

_____ (L.S.)

Charles King

_____ (L.S.)

Harry Gordon

A.3 Joint venture--between partnership and corporation--contribution in kind by one venturer

COMMENT

Because one of the participants in this joint venture is a partnership, the agreement must cover the possibility that the partnership may be dissolved by reason of the death, incapacity, bankruptcy, or default of any one of its partners. The problem is to preserve the continuity of the joint venture. To achieve this continuity, the agreement obligates each member of the partnership to continue the partnership if a dissolution does in fact occur. Restrictions are imposed upon the transfer of a partner's interest in the partnership. In addition, a member of the partnership is irrevocably authorized to act for the partnership in matters relating to the joint venture. All of this is designed to insulate the corporate joint venturer from the internal problems of the partnership joint venturer.

As to requirement that partnership must file an annual information return, Form 1065, which discloses its profits and distributive shares of income.

For further information, see Chapters 1, 2, and 14.

FORM

AGREEMENT made and entered into February 10, 2002, by and between Camden Realities, Inc., a Delaware corporation ("Camden"), and David Wohl, Harvey Lorins, James Burnes, and Frank Mason, individually and as copartners and members of the general partnership created under a general partnership agreement dated January 5, 2002, between all of the such persons (the "Wohl Partnership").

Recitals

Camden owns certain real and personal property described in Exhibit A, which is attached hereto and made a part hereof (the "Camden Property").

The legal title to the real property described in Exhibit A is held in a real estate land holding trust, under which Central Title Guarantee & Trust Company is Trustee, and all of the beneficial interest is owned by Camden.

The parties desire to form a joint venture to operate, lease, and exploit the Camden Property,

Now, therefore, it is agreed as follows:

1. *Joint venture.* The parties hereby form a joint venture (the "Venture"), upon the terms and conditions herein set forth.

2. *Name of venture.* The name of the Venture shall be the Camden Venture.

3. *Purpose.* The purpose of the Venture shall be to maintain, lease, and exploit the Camden Property and to engage in such operations and business as may be deemed necessary or appropriate to such purposes.

4. *Capital.* Simultaneously, with the execution of this agreement, the parties shall contribute the following:

Camden--The Camden Property.

Wohl Partnership--\$750,000.

5. *Interests of parties in venture.* The respective interests of the parties in the Venture, and in the assets, property, profits, and losses of the Venture, shall be as follows:

Camden 50%

Wohl Partnership 50%

6. *Additional funds.* All further funds required in connection with the ownership, maintenance, leasing, and exploitation of the Camden Property shall be contributed by the parties in proportion to their respective interests as set forth in paragraph 5.

7. *Title.* The legal title to the real property described in Exhibit A shall continue to be held in the real estate land holding trust, with Central Title Guarantee & Trust Company as Trustee. The remainder of the Camden Property and all other property of any kind which shall be owned, held, or operated by the Venture shall be owned, held, or operated in the name of the person or entity which shall be designated for that purpose by the parties, as nominee solely for the

Venture.

8. *Term.* This agreement shall continue in full force and effect until March 31, 2010, unless sooner terminated as provided in this agreement. Unless at least three months prior to March 31, 2010, either party gives notice to the other electing that the Venture shall terminate as of March 31, 2010, the Venture and this agreement shall be renewed and continue until December 31, 2011. Thereafter, this agreement shall be renewed and continued from fiscal year to fiscal year unless at least three months prior to December 31, 1992, or to the end of any such other fiscal year, either party gives written notice to the other terminating the Venture as of the end of the then fiscal year. The Venture shall terminate as of the end of any fiscal year in which all of its property and assets are sold or otherwise disposed of. In the event of the dissolution of the Wohl Partnership for any reason, it shall not wind up or terminate until the end of the term of this Venture, as such term is herein provided, it being the parties' intention that this Venture shall not be terminated or affected on account of any dissolution of the Wohl Partnership.

9. *Assignment.* The respective interests in the Venture of the parties hereto shall not be transferred or assigned in whole or in part.

10. *Books of account.* The Venture shall keep accurate books and accounts. As soon as practicable after the end of each fiscal year of the Venture (but in no event later than 120 days after the end of any fiscal year), a general accounting and audit shall be made by certified public accountants, covering all matters and things customarily included in such accounts and audits. In addition, a full and detailed statement shall be furnished to each party to the Venture, showing its assets, properties, net worth, and profits and losses for the preceding fiscal year. Each party shall have the right to object to such statement by giving written notice to the other party within 60 days after the statement is received by the objecting party, setting forth in reasonable detail the objections and the basis for the objections. If either party shall fail to give such notice within the 60-day period, such statement and its contents shall be deemed conclusive and binding upon the party failing to give such written notice. Each party to the Venture shall have the right to examine, at all reasonable times, its books, records, and accounts. The fiscal year of the Venture shall end on December 31 of each year.

11. *Distributions.* Until otherwise determined in accordance with the provisions of paragraph 14, except for a working capital balance in the aggregate amount of \$15,000 which shall be retained in the Venture, there shall be paid to each of the parties, in proportion to their respective interests in the Venture as set forth in paragraph 5, all moneys and funds at any time held by the Venture, as and when received.

12. *Salaries.* The Venture shall pay no salary, fees, commissions, or other compensation to either party or to any of the persons comprising the Wohl Partnership, for any services rendered to the Venture, or in connection with any of its business or property, except as both parties may expressly agree to in writing.

13. *Provisions affecting partnership member.* Each of the persons comprising the Wohl Partnership warrant and represent to, and agree with, each other and Camden, as follows:

(a) *Buy-out.* In the event of the dissolution of the Wohl Partnership because of the death, incapacity, bankruptcy, default, other act or omission of any partner (the "Retiring Partner"), the other partners ("Surviving Partners"), shall forthwith:

(1) acquire, in the same proportions as their present interests in the Wohl Partnership, the interest of the Retiring Partner at a price and upon terms which are and shall be specified in definitive and ascertainable terms in the Wohl Partnership agreement, and in connection with the acquisition, the Surviving Partners shall assume all of the liabilities and obligations of the Retiring Partner in, under, and in connection with the Wohl Partnership; or in the alternative, in the event of the dissolution of the Wohl Partnership because of the death or incapacity of any such partner, the Surviving Partners shall continue the Wohl Partnership with the heirs, executors, administrators, or guardian of the deceased or

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incapacitated partner succeeding to the interest of such deceased or incapacitated partner, upon the same terms and conditions as set forth in the Wohl Partnership agreement; and

(2) in the case of either alternative set forth in (1) above, continue the Wohl Partnership, its affairs and business, upon the same terms and conditions as set forth in the Wohl Partnership agreement; and

(3) cause the general partnership continuing the affairs and business of the Wohl Partnership to continue as a member of this Joint Venture upon the same terms and conditions as set forth in this agreement.

(b) *No assignment.* The interests of the members of the Wohl Partnership shall not be assigned or transferred, without Camden's prior written consent, except as follows: (1) the transfers provided for in subparagraph (a) of this paragraph 13, and (2) the transfer by one member of the Wohl Partnership to one or more of its other members.

(c) *No release.* Nothing in this agreement, including, without limitation, the provision of subparagraphs (a) and (b) of this paragraph 13, and any assumption by any one or more members of the Wohl Partnership ("Assumption Member"), of the obligations and liabilities of any other members of the Wohl Partnership ("Transferring Member"), in, under, or in connection with the Wohl Partnership (as provided in subparagraph (a) of this paragraph 13, or otherwise), shall be deemed to release or relieve any of the obligations or liabilities (individual, personal, or as a member of the Wohl Partnership) of such Transferring Member (or of his estate) to Camden, whether the obligations or liabilities are incurred or arise under this agreement or under any other agreement, lease, note, or instrument to which the Wohl Partnership is or shall be a party.

(d) *Partnership agent.* (1) *Appointment and powers.* Any provisions in this agreement or in the Wohl Partnership agreement to the contrary notwithstanding, David Wohl (or in the event of his death, incapacity, failure, or refusal to act, then Harvey Lorins), shall have, and is irrevocably granted, full and complete power and authority, for and on behalf of the Wohl Partnership, and for and on behalf of all the members of and the persons comprising the Wohl Partnership to make, consent, and agree to any and all determinations and decisions (including, without limitation, all of the decisions and determinations referred to and provided for in paragraph 14) with respect to any and all questions relating to the management, operation, and conduct of any and all affairs and activities of the Venture and to any and all of its assets or properties; to execute and deliver any and all instruments and documents under, in connection with or with respect to this agreement and the Venture; and to give or to receive any and all notices and demands, given or received, in, under, or in connection with, or with respect to this agreement or the Venture.

(2) *Effect.* All of the determinations, decisions, notices, demands, instruments, and documents which may or shall be made, executed, or delivered (at any time and from time to time during the entire period until the Venture shall terminate, and whether before or after any dissolution of the Wohl Partnership) by David Wohl or Harvey Lorins, as the case may be, are irrevocably authorized, approved, confirmed, and ratified, and shall be binding and conclusive upon the Wohl Partnership and upon each and all of the persons comprising the Wohl Partnership, with the same force and effect as though made, executed, or delivered by each and all of such persons themselves.

(e) *Partnership agreement.* The Wohl Partnership agreement dated January 5, 2002, and all agreements amending or supplementing the general partnership agreement, shall contain provisions consistent with, and implement, all the provisions and undertakings set forth above in this paragraph 13.

14. *Management.* All questions relating to the conduct, management, or operation of the affairs, activities, or business of the Venture, and all questions relating to any or all of its assets or property, shall be determined by mutual agreement of both members. All determinations made in accordance with this paragraph shall be deemed to be the determinations of the Venture and of all its members and parties.

15. *Notices.* All notices and demands shall be in writing, and shall be deemed to have been given and received 48 hours

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after it shall have been deposited in a United States Post Office depository by Registered or Certified Mail, postage prepaid, addressed to the parties hereto as follows:

To: Wohl Partnership
c/o David Wohl
500 East Pine Street
Newark, New Jersey

To: Camden Realities, Inc.
200 River Road
Camden, New Jersey

Each party shall have the right by written notice given to the other pursuant to the provisions of this paragraph 15 to change, from time to time, the respective addresses at which notices shall be given.

16. *Office.* The principal office of the Venture shall be at 200 River Road, Camden, New Jersey.

17. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New Jersey.

18. *Personal liability of partnership members.* Each and all of the obligations and liabilities provided in this agreement as the obligations or liabilities of the Wohl Partnership shall be the obligations and liabilities of the Wohl Partnership as a general partnership, and the obligations and liabilities of each and all of the persons comprising the Wohl Partnership as members and copartners, and shall also be the separate, individual, and personal obligations and liabilities, jointly and severally, of each and all of the persons comprising the Wohl Partnership. All references to the Wohl Partnership herein shall be deemed to include each and all of the copartners and members thereof, not only as members and copartners, but also individually and personally.

19. *Binding effect.* The terms and conditions of this agreement shall be binding upon, and inure to the benefit of the parties, and all of the persons comprising the Wohl Partnership, and their respective heirs, executors, administrators, successors, and (except as herein otherwise provided) assigns.

20. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

21. *Non-waiver.* No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

22. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

23. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

In witness whereof the parties have executed this joint venture agreement the day and year first above written.

Camden Realty, Inc.,
a Delaware corporation

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President by _____

Attest:

Secretary _____

David Wohl _____

Harvey Lorins _____

James Burnes _____

Frank Mason _____

Personally, and as members of the Wohl Partnership, a general partnership.

A.4 General partnership--real estate operation

COMMENT

The choice of the partnership as the form in which to carry on a real estate business depends upon a combination of tax and nontax factors. The principal nontax factor is the rule which imposes individual responsibility upon each of the partners for all of the liabilities of the partnership. This is a major deterrent to the use of the partnership in any business enterprise. However, the ownership of real estate is one of the areas in which this problem of unlimited liability has frequently been solved by the use of the limited partnership.

Comparison of partnership and corporate taxation:

The problem of unlimited liability may be solved by the use of the corporate form. The choice will often depend upon the potential impact of the income tax, by comparing the rate of tax levied upon corporations with the rate of tax on individual partners. A partner is taxed each year on his share of partnership earnings, whether or not distributed to him; a shareholder is taxed only when corporate income is distributed to him. A corporation may offer advantages if the shareholders are high bracket taxpayers or if the income is to be retained for further expansion, especially if it will not be distributed until liquidation of the corporation. On the other hand, corporate income faces a double tax: the corporate rate plus the tax at individual rates on dividend distributions. Thus, if corporate income is to be frequently distributed the partnership form may be preferable. It should be noted also that the advantage of accumulation by a corporation is not unlimited. There is an additional tax on "unreasonable" accumulations (accumulations above \$250,000 beyond "the reasonable needs of the business"). Moreover, there are many situations in which partnership operations may be desirable in order to secure for each partner the tax benefit of depreciation, operating losses, or other deductions.

Passive activity loss limitation:

Individuals, including partners or limited partners, are limited in the tax use of losses and expenses from passive activities. Passive activity losses (including expenses) can only be used to offset income from other passive activities of the taxpayer. Unused passive activity losses are carried forward indefinitely to

offset future passive activity income or are allowed on a complete taxable disposition of the passive activity. Passive activities include a trade or business, or activity for the production of income, in which the taxpayer does not materially participate.

Generally speaking, rental real estate activity is considered to be a passive activity. *IRC § 469(c)(2)*. Therefore, deductions and credits from rental activities can only offset income from other passive activities. Such deductions and credits **cannot be deducted from nonpassive income, such as wages, dividends, interest, etc. However, there are two major exceptions to this general rule.**

First, beginning in 1994, certain eligible taxpayers who **materially** participate in rental real estate activities can deduct losses from such activities against nonpassive income. These eligible taxpayers include individuals and closely-held C corporations that meet special eligibility requirements. *IRC § 469(c)(7)*. Second, an individual who owns at least a 10-percent interest and **actively** participates in rental real estate activity is permitted to offset up to \$25,000 of passive activity losses against his nonpassive income. *IRC § 469(i)*.

Elements of agreement:

In general, a partnership agreement should cover at least the following points: (1) name and business; (2) term; (3) capital; (4) profit and loss; (5) salaries and drawings; (6) interest on capital; (7) management, duties, and restrictions; (8) banking; (9) books; (10) voluntary liquidation; (11) retirement; and (12) death. The forms in this group are designed to illustrate the special problems encountered in drafting partnership and limited partnership agreements in the real estate area.

Partnership tax aspects:

A partnership as such is not subject to the income tax. Fundamentally, the partnership entity is disregarded and only the partners in their individual capacities are liable for the payment of income tax. However, the partnership is the basic accounting unit and must file an annual information return. The taxable income of the partnership is computed in the same manner as that of an individual, except that certain items of income and deduction must be separately itemized, and except that the standard deduction, the deduction for personal exemptions, the deduction for foreign taxes, the charitable contribution deduction, the net operating loss deduction, and other itemized deductions applicable only to individuals, such as child care and medical expenses, are not allowed to the partnership.

Partnership and partner tax returns:

The partnership, in its return, must separately state, and the partner must separately take into account on his return, his distributive shares of certain items including gains and losses from the sale or exchange of property; charitable contributions; dividend income; partially tax-exempt interest; and miscellaneous items required by the regulations.

Each partner's share of income is derived from the partnership return, with the character of each item of income, gain, loss, deduction, or credit retaining the same character as it had for the partnership. However, the tax treatment of items of partnership income, loss, deductions, and credits are determined at the partnership level on a unified basis rather than on the basis of individual partner treatment. In addition, each partner is required to treat partnership items on his return consistently with the treatment of the items on the partnership return. If the treatment is inconsistent and the consistency requirement is requested to be waived, the partner must file a statement identifying the inconsistency. Unless the consistency requirement is waived, adjustments will be made to conform the partner's treatment of the

items with the treatment on the partnership return. The consistency rules do not apply to small partnerships, i.e., a partnership of ten or fewer partners who are individuals or estates, provided that each partner's share of any partnership item is the same as his distributive share of every other partnership item. A husband and wife are treated as one partner in a small partnership.

Partner's distributive share:

Each partner must thus include in his individual return his distributive share of each item of partnership income, gain, loss, deduction, or credit. The partner's distributive share is determined by the partnership agreement. If the agreement does not make such an allocation, or if the allocation does not have a "substantial economic effect," the partner's distributive share is determined in accordance with his interest in the partnership, taking into account all facts and circumstances.

Real estate subject to "at risk" rules:

Holding real property is an activity which is not exempt from the "at risk" loss deduction limitations. A taxpayer cannot deduct losses derived from an activity which exceed the amount at risk by the taxpayer. The amount at risk is the amount of money and property contributed by the taxpayer to the activity, and borrowed amount for which the taxpayer is personally liable or has pledged property, other than property used in the subject activity, as security for the loan. The amount of nonrecourse financing is not at risk. Qualified nonrecourse financing however is treated as an amount at risk. Generally, qualified nonrecourse financing is amounts borrowed from an institutional lender, government entity, or an amount insured by a government entity.

Partnership provisions:

This form contains the basic provisions of a general partnership agreement. The real estate activity of the partnership is principally reflected in the provisions dealing with the character of the business, the capital, and problems of management. Initially the partnership capital will consist of a contract to purchase real property which is to be contributed to the partnership by the partners. The partners will also contribute the cash required to close the contract. Additional funds, as required, will be provided equally by the partners.

All decisions with respect to management of the property require the consent of both partners. The partnership may be terminated by mutual consent. The death or retirement of a partner will terminate the partnership business, unless the remaining partner exercises an option to purchase the deceased or retiring partner's interest.

For further information, see Chapter 14.

FORM

AGREEMENT made February 1, 2002, between Harry James and John Gable, both of New York, New York.

1. *Name and business.* The parties hereby form a partnership under the name of Smith Realty Co. to own, build upon, alter, repair, rent, lease, and otherwise deal with real and personal property, of any kind or description, including the lands and premises known as 300 Penbrooke Avenue, Staten Island, New York (the "Property"). The principal office of the business shall be in New York, New York.

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2. *Term.* The partnership shall begin on February 1, 2002, and shall continue until terminated as herein provided.

3. *Capital.* (a) *Contract and closing costs.* The capital of the partnership shall consist initially of a contract to purchase the Property which the partners have entered into and which they agree to contribute to the partnership. The contract is dated December 20, 2001, and is to be closed March 20, 2002. A copy of the contract is attached as Exhibit A. The partners agree to contribute equally \$40,000 in cash required at the closing. Title to the Property shall be taken in the name of the partnership.

(b) *Additional contributions.* If at any time or times the partners determine that the partnership capital should be increased, the additional capital required shall be contributed by the partners equally.

(c) *Capital accounts.* A separate capital account shall be maintained for each partner. Neither partner shall withdraw any part of his capital account. If the capital account of a partner becomes impaired, his share of subsequent partnership profits shall be first credited to his capital account until that account has been restored, before such profits are credited to his income account.

4. *Profit and loss.* The net profits and losses of the partnership shall be divided and borne equally between the partners. A separate income account shall be maintained for each partner. Partnership profits and losses shall be charged or credited to the separate income account of each partner. If a partner has no credit balance in his income account, losses shall be charged to his capital account.

5. *Salaries and drawings.* Neither partner shall receive any salary for services rendered to the partnership. Each partner may, from time to time, withdraw the credit balance in his income account. No additional share of profits shall inure to either partner by reason of his capital or income account being in excess of the capital or income account of the other.

6. *Interest.* No interest shall be paid on the initial contributions to the capital of the partnership or on any subsequent contributions of capital.

7. *Management, duties, and restrictions.* (a) *Authority.* The consent of both partners shall be required with respect to the management, conduct, and operation of the partnership business and in all matters, including, but not limited to, full power to sell and convey the Property on such terms as they may determine, to lease the Property or any part of it on such terms and for such periods as they may determine, to mortgage the Property, whether the mortgage is a first or second mortgage lien, to make all agreements modifying any lease or mortgage, and to borrow or lend money on behalf of the partnership.

(b) *Competition.* Each partner may have other business interests and may engage in any other business or trade, profession, or employment whatsoever, for his own account, and shall not be required to devote his entire time to the business of the partnership.

8. *Banking.* All funds of the partnership shall be deposited in its name in any checking account or accounts as the partners shall designate. All withdrawals shall be made upon checks signed by either partner.

9. *Books.* The partnership books shall be maintained at its principal office, and each partner shall at all times have access thereto. The fiscal year of the partnership shall be the calendar year. The books shall be closed and balanced at the end of each fiscal year. An annual audit shall be made as of the closing date.

10. *Voluntary termination.* The partnership may be dissolved at any time by agreement of the partners, in which event the partners shall proceed with reasonable promptness to sell the real and personal property owned by the partnership and to liquidate its business. The partnership shall be dissolved also by the sale of all real property owned by it. Upon dissolution, the assets of the partnership business shall be used and distributed in the following order: (a) to pay or

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provide for the payment of all partnership liabilities and liquidating expenses and obligations; (b) to equalize the partners' income accounts; (c) to discharge the balance of the partners' income accounts; (d) to equalize the partners' capital accounts; and (e) to discharge the balance of the partners' capital accounts.

11. *Retirement.* (a) *Notice, purchase option.* Either partner shall have the right to retire from the partnership at the end of any fiscal year. Written notice of intention to retire shall be served upon the other partner at the office of the partnership at least three months before the end of the fiscal year. The retirement of either partner shall have no effect upon the continuance of the partnership business. The remaining partner shall have the right either to purchase the retiring partner's interest in the partnership or to terminate and liquidate the partnership business. If the remaining partner elects to purchase the interest of the retiring partner, he shall serve notice in writing of such election upon the retiring partner at the office of the partnership within two months after receipt of his notice of intention to retire.

(b) *Purchase price.* If the remaining partner elects to purchase the interest of the retiring partner, the purchase price and method of payment shall be the same as stated in Section 12 with reference to the purchase of a decedent's interest in the partnership.

(c) *Liquidation.* If the remaining partner does not elect to purchase the interest of the retiring partner, the partners shall proceed with reasonable promptness to sell the real and personal property owned by the partnership and to liquidate its business. The procedure as to liquidation and distribution of the assets of the partnership business shall be the same as stated in Section 10 with reference to voluntary termination.

12. *Death.* (a) *Purchase option.* Upon the death of either partner, the surviving partner shall have the right either to purchase the interest of the decedent in the partnership or to terminate and liquidate the partnership business. If the surviving partner elects to purchase the decedent's interest, he shall serve notice in writing of such election, within three months after the death of the decedent, upon the decedent's executor or administrator, or, if at the time of such election no legal representative has been appointed, upon any one of the decedent's known legal heirs at such heir's last known address.

(b) *Purchase price.* If the surviving partner elects to purchase the decedent's interest in the partnership, the purchase price shall be equal to the decedent's capital account at the date of his death plus his income account as at the end of the prior fiscal year, increased by his share of partnership profits or decreased by his share of partnership losses for the period from the beginning of the fiscal year in which his death occurred until the end of the calendar month in which his death occurred, and decreased by withdrawals charged to his income account during such period. The purchase price, with interest at 9 percent on each installment from the end of the calendar month in which the decedent's death occurred to the date of payment, shall be paid in four semiannual installments beginning six months after the end of the calendar month in which the decedent's death occurred.

(c) *Liquidation.* If the surviving partner does not elect to purchase the decedent's interest in the partnership, he shall proceed with reasonable promptness to sell the real and personal property owned by the partnership and to liquidate its business. The surviving partner and the estate of the deceased partner shall share equally in the profits and losses of the business during the period of liquidation, except that the decedent's estate shall not be liable for losses in excess of the decedent's interest in the partnership at the time of his death. No compensation shall be paid to the surviving partner for his services in liquidation. Except as otherwise stated in this agreement, the procedure for liquidation and distribution of the assets of the partnership shall be the same as stated in Section 10 with reference to voluntary termination.

13. *Arbitration.* Any controversy or claim arising out of or relating to this contract, or any breach thereof, shall be settled by arbitration in accordance with the governing rules of the American Arbitration Association. Judgment upon the award rendered may be entered in any court of competent jurisdiction.

14. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its

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subject matter. There are no other understandings or agreements between them.

15. *Notices.* All notices under this agreement shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

16. *Non-waiver.* No delay or failure by either party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

17. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

18. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New York.

19. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

20. *Binding effect.* Except as otherwise expressly provided herein, the provisions of this agreement shall be binding upon and inure to the benefit of each of the parties and their respective legal representatives, successors, and assigns.

In witness whereof the parties have signed this agreement.

Harry James

John Gable

A.5 General partnership--contribution of asset in kind

COMMENT

The contribution to a partnership of real property by one partner and cash by another presents a number of tax ramifications which must be clearly understood before an agreement can be drafted that will accurately accommodate the intention of the partners. Aside from the necessity of assigning a value to the real property to be contributed, the partners may find it desirable to make special provisions with respect to the allocation of depreciation between themselves and with respect to the distribution of gain or loss on any disposition of such property. Allocation of partnership items, however, must satisfy the requirement that they have substantial economic effect. Allocations lacking substantial economic effect or established primarily for tax avoidance purposes generally will not be recognized for tax purposes.

Tax basis of contributed property:

The tax aspects can be best presented by a simple illustration. Suppose in the formation of a 50-50 partnership, partner A contributes a building which has an adjusted tax basis to him of \$100,000, but has a value at the time of the contribution of \$150,000. Partner B is willing to accept the asset at the value of \$150,000, and makes a matching contribution of \$150,000 in cash. The statute provides that no gain or loss is to be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. It provides also (a) that the tax basis of the partnership interest acquired by the contributing partner is the adjusted tax basis of the contributed property, and (b) that the tax basis of a contributed asset in the hands of the partnership is the adjusted tax basis in the hands of the contributing partner. So far as the partnership is concerned, this will require

that cost recovery or depreciation and gain or loss be computed on the tax basis of \$100,000, although the partners as between themselves have agreed that the contributing partner shall be credited with \$150,000 as a capital contribution.

Economic effect of tax basis carryover:

In the computation of cost recovery in this example, the allowable tax basis will be \$100,000. Partner B's share of the cost recovery deduction will not be as large as it would have been if the partnership had itself purchased the asset for \$150,000. Should partner A compensate partner B for this "loss" of cost recovery allowances? The same type of problem arises on a sale. Suppose the asset is sold for \$160,000 at a time when its tax basis after cost recovery allowances is \$90,000 (\$100,000 basis to the partnership minus \$10,000 cost recovery allowance). How is the \$70,000 gain to be allocated between the partners? Generally, the first \$50,000 of gain should be reported by partner A, and the balance allocated between the partners in the ratio in which they share gains. Suppose, on the other hand, the asset is sold for \$80,000 at a time when its tax basis after cost recovery is \$90,000. Here, partner B's entire share of his "loss" is not deductible, since the partnership has sustained a loss of only \$10,000. Should partner A compensate partner B for the unavailable portion of the latter's tax loss? Similar problems exist where the asset has a tax basis in the hands of the contributing partner which is more than the value at which it is accepted as a capital contribution.

Allocation of gain on sale of property:

Income, gain, loss, and deductions for property contributed to the partnership by a partner is shared among the partners under a method which takes into account the difference between the basis of the property contributed to the partnership, i.e. the contributing partner's adjusted basis, and its fair market value at the time of contribution. For property contributed to a partnership after October 3, 1989, the contributing partner must recognize gain or loss, as the case may be, if within five years after the contribution the partnership makes a distribution of the contributed property to someone other than the contributing partner. The amount that must be recognized is the difference between the property's basis and its fair market value upon contribution of the property, had the property been sold by the partnership at its fair market value at the time of the distribution.

Inaccurate basis calculations:

It is conceivable that the basis of an asset may, upon examination by the Service, turn out to be different than that represented by the contributing partner, thus altering the cost recovery or depreciation deduction available to the partnership and gain or loss on any disposition. It may be wise to include an indemnification by the contributing partner to cover the possibility that the adjusted basis will be found to be less than represented. Another alternative is a provision that if the basis of the property turns out to be less than represented, any resulting increase in the taxable income of the partnership is to be allocated to the partner who contributed the property.

Alternate sale or lease of property to partnership:

If a partner sells property to the partnership instead of contributing it, he has taxable gain or loss. Normally the parties have it within their own control to determine which set of tax consequences will follow. The "sale" technique creates the simplest tax picture and may result in the most equitable tax distribution between the partners. However, where the contribution of real property to a partnership is utilized as a means of obtaining mortgage loans or other funds for further operations without incurring tax, the sale device may not be attractive. Another alternative is for the partner to retain title to the

property under a lease with the partnership, with rent approximating the cost recovery or depreciation. This, too, is a method for simplifying the tax structure. The partner's rent income would be offset by the cost recovery or depreciation, and the partnership would take a deduction for the rent.

Passive activity loss limitations:

Individuals, including partners, are limited in the tax use of losses, including expenses, from passive activities. Generally, passive activity losses can only offset income from the same or other passive activities. Unused losses are carried forward indefinitely to offset passive activity income in the following years, or until the activity is completely disposed of in a taxable disposition.

Generally speaking, rental real estate activity is considered to be a passive activity. *IRC § 469(c)(2)*. Therefore, deductions and credits from rental activities can only offset income from other passive activities. Such deductions and credits **cannot** be deducted from nonpassive income, such as wages, dividends, interest, etc. However, there are two major exceptions to this general rule.

First, beginning in 1994, certain eligible taxpayers who **materially** participate in rental real estate activities can deduct losses from such activities against nonpassive income. These eligible taxpayers include individuals and closely-held C corporations that meet special eligibility requirements. *IRC § 469(c)(7)*. Second, an individual who owns at least a 10-percent interest and **actively** participates in rental real estate activity is permitted to offset up to \$25,000 of passive activity losses against his nonpassive income. *IRC § 469(i)*.

Fiscal year and tax year:

This agreement provides that the partnership's taxable year will be the calendar year. A partner's income is his distributive share of the partnership income for the taxable year of the partnership ending with or within his own taxable year. A partnership's taxable year must be the calendar year unless the Service is satisfied that there is a business purpose for a different taxable year. The deferral of income to partners is not considered a business purpose. An election is available to a partnership to adopt or change to a taxable year with a limited deferral period. This election is only available if the deferral period of the taxable year elected is not longer than the shorter of three months or the deferral period of the taxable year being changed.

For further information, see Chapter 14.

FORM

AGREEMENT made January 2, 2002, among James Adams, Charles Stone, and George Brown.

1. *Name and business.* The parties hereby organize a partnership to own, build upon, alter, repair, rent, lease, subdivide, sell, and otherwise deal with real and personal property, particularly the real property to be contributed as capital, as described in paragraph 3.

2. *Term.* The partnership shall begin on January 2, 2002, and continue until December 31, 2012, unless sooner terminated by unanimous decision of the partners or by the sale of the real property to be contributed as capital, as described in paragraph 3.

3. *Capital.* (a) The original capital of the partnership shall consist of \$1,800,000 cash, to be contributed equally by

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Adams and Stone, and a fee interest in the land and a building at 2880 Cathedral Avenue, Washington, D. C. (the "property"), to be contributed by Brown, and to be deemed to have a value of \$900,000 for purposes of this agreement. The partners, by mutual agreement, may at the end of any partnership year transfer a portion of partnership profits to the capital of the partnership. No partner shall withdraw any part of his original or additional capital account without the written consent of the other partners. The capital accounts of the partners shall be maintained in the proportions in which they share in the partnership profits and losses.

(b) Brown warrants that he has full power to convey the property and that it is free and clear of all liens and encumbrances except those set forth in Schedule A annexed hereto and made a part hereof. The following items shall be apportioned between Brown and the partnership as of December 31, 1987: rents, interest on mortgages, premiums on existing transferable insurance policies, taxes, sewer rents, and water charges.

4. *Profit and loss.* (a) The net profits or net losses of the partnership shall be distributed or charged to the partners in equal proportions, and shall be credited or charged, as the case may be, to the drawing account of each partner.

(b) For tax purposes allocations with respect to the property shall follow *Section 704 of the Internal Revenue Code* and the "traditional method" in the regulations thereunder.

5. *Salaries and drawings.* No partner shall receive any salary for services rendered to the partnership. The partners shall have equal drawings in such amounts as they may agree upon. If at the end of any partnership year, there is a debit balance in the drawing account of any partner, such partner shall, within a reasonable time, clear such debit balance by a payment to the partnership.

6. *Interest.* No interest shall be paid to any partner on his original capital, his additional capital, or his credit balance in his drawing account.

7. *Management, duties, and restrictions.* Each partner shall have an equal voice in the management of the partnership. No partner shall, without the consent of the others, borrow or lend money on behalf of the partnership; enter into a contract to sell the property; sell, assign, or pledge his interest in the partnership; or execute any lease or mortgage with respect to the property. In all other matters relating to the business of the partnership, a decision of two of the partners shall be controlling.

8. *Banking.* All funds of the partnership shall be deposited in partnership bank accounts, as designated from time to time by the partners. All withdrawals from partnership accounts shall be made upon checks signed by two of the partners.

9. *Books.* The partnership books shall be maintained on the accrual basis, and shall be closed and balanced at the end of each calendar year.

10. *Retirement.* (a) *Notice, purchase option.* Any partner may retire from the partnership at the end of a calendar year, provided he has given two months' advance written notice of his intention to the other partners. A retirement shall cause a dissolution of the partnership, but the remaining partners shall have the right to continue the partnership business, provided the continuing partnership pays to the retiring partner the value of his interest in the partnership.

(b) *Valuation.* For this purpose, the value of the interest of a retiring partner shall be the amount of his capital account, plus or minus any credit or debit balance in his drawing account, all determined at the end of such calendar year in accordance with the accounting methods regularly used by the partnership.

(c) *Payment.* Payment of the amount due to the retiring partner shall be made in cash in two equal installments, the first within 60 days and the second within 120 days after the end of the calendar year. Upon payment, the retiring partner shall have no further interest in the partnership or in its business or assets.

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(d) *Liquidation.* If the continuing partnership does not elect to purchase the interest of the retiring partner, the partnership shall promptly sell the property and commence to wind up its affairs and shall distribute its assets in liquidation under the supervision of all of the partners. All profits and losses in liquidation shall be allocated equally to the partners. In liquidation, the partnership shall first pay all its debts, then pay credit balances in the drawing accounts of the partners, and finally distribute all other proceeds against the capital accounts of the partners.

11. *Death.* (a) *Purchase option.* The death of any partner shall cause a dissolution of the partnership, but the surviving partners shall have the right to continue the partnership business, provided the continuing partnership pays to the estate of the deceased partner the value of his interest in the partnership.

(b) *Valuation.* For this purpose, the value of the interest of a deceased partner shall be the amount of his capital account, plus or minus any credit or debit balance in his drawing account, all determined as at the end of the month in which his death occurs in accordance with the accounting methods regularly used by the partnership.

(c) *Payment.* Payment for the interest of a deceased partner shall be made to his estate in cash in three equal installments, the first within 60 days, the second within 120 days, and the third within 180 days after the end of the month in which death occurs. Upon such payment, the estate of the deceased partner shall have no further interest in the partnership or in its business or assets.

(d) *Liquidation.* If the continuing partnership does not elect to purchase the interest of the deceased partner, the partnership shall promptly sell the property and commence to wind up its affairs and shall distribute its assets in liquidation under the supervision of the surviving partners and a representative of the deceased partner's estate. All profits and losses in liquidation shall be allocated equally among the surviving partners and the deceased partner's estate. In liquidation, the partnership shall first pay all its debts, then pay credit balances in the partners' drawing accounts, and finally distribute all other proceeds against the partners' capital accounts.

12. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

13. *Notices.* All notices under this agreement shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

14. *Non-waiver.* No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

15. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

16. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of Maryland.

17. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

18. *Binding effect.* Except as otherwise expressly provided herein, the provisions of this agreement shall be binding upon and inure to the benefit of each of the parties and their respective legal representatives, successors, and assigns.

In witness whereof the parties have signed this agreement.

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James Adams

Charles Stone

George Brown

A.6 Limited partnership--small group of investors

COMMENT

The distinctive feature of a limited partnership is the restriction of the liability of the limited partners to the amount of their contributions to the capital of the partnership. Generally, a limited partnership may be formed by two or more persons to carry on any business which might be carried on by a general partnership. At least one of the partners must be a general partner. The partnership name must not contain the surname of a limited partner unless it is also the surname of a general partner or unless the partnership was conducted under that name prior to the time when the limited partner became associated with the firm. Violation of this provision will result in the named limited partner being held liable to partnership creditors as a general partner. The same consequence follows if the limited partner takes an active part in the control of the partnership business; a limited partner may contribute cash or property to the partnership, but he may not contribute services.

Limited partnership agreement:

The basic provisions of a general partnership agreement should be covered in a limited partnership agreement. In addition, the agreement may contain provisions regulating the assignment of a limited partner's interest in the partnership, the withdrawal or reduction of his contribution to capital, the priority of any limited partner in the distribution of profits or upon dissolution, and the admission of new limited partners. In this agreement limited partners have no priority as to distributions upon dissolution. Limited partners possess no right to withdraw any part of their contribution until termination of the partnership, and then only after all liabilities have been paid (except liabilities to partners for contributions) or until the partnership has sufficient assets to pay them. Death of a limited partner does not dissolve the partnership.

Passive activity loss limitation:

Individuals, including partners and limited partners, are limited in the tax use of losses, including expenses, from passive activities. Generally, passive activity losses can only offset income from the same or other passive activities. Unused losses are carried forward indefinitely to offset passive activity income in the following years, or until the activity is completely disposed of in a taxable disposition. Material participation by the taxpayer in the activity will take it out of the passive activity classification.

Generally speaking, rental real estate activity is considered to be a passive activity. *IRC § 469(c)(2)*. Therefore, deductions and credits from rental activities can only offset income from other passive activities. Such deductions and credits **cannot** be deducted from nonpassive income, such as wages, dividends, interest, etc. However, there are two major exceptions to this general rule.

First, beginning in 1994, certain eligible taxpayers who **materially** participate in rental real estate activities can deduct losses from such activities against nonpassive income. These eligible taxpayers include individuals and closely-held C corporations that meet special eligibility requirements. *IRC §*

469(c)(7). Second, an individual who owns at least a 10-percent interest and **actively** participates in rental real estate activity is permitted to offset up to \$25,000 of passive activity losses against his nonpassive income. *IRC § 469(i)*.

For further information, see Chapter 14.

FORM

AGREEMENT made as of the 25th day of August, 2002, by and among Sam Harris, residing at 100 Forest Avenue, New York, New York, John Baker, residing at 200 Fifth Avenue, Harrison, New Jersey, and Myron Lowe, residing at 60 Palm Drive, New Rochelle, New York (the "General Partners"), and Martin Brown, residing at 100 Gramercy Park, New York, New York, Edward Berger, residing at 80 Eastern Parkway Brooklyn, New York, Adam Paine, residing at 150 Eastern Road, Bayshore, New York, Gordon Gray, residing at 30 South Road, Great Neck, New York, and Mary Stern, residing at 80 Echo Bay Drive, New Rochelle, New York (the "Limited Partners").

The parties desire to form a limited partnership in accordance with the laws of the State of Georgia and acquire for the partnership the ownership of certain property situated in Atlanta, Georgia, and generally known as No. 1000 Palmetto Road (the "property"), which property is under contract of sale dated August 25, 2002, between Central Properties, Inc., as Seller, and Palmetto Road, Inc., nominee for the partnership, as Purchaser.

Now, therefore, it is mutually agreed as follows:

1. *Formation.* The parties by this agreement form a limited partnership pursuant to the laws of the State of Georgia.
2. *Name.* The partnership shall be conducted under the name of Palmetto Road Company.
3. *Purpose.* The purpose of the partnership is to acquire for investment the property situate in Atlanta, Georgia, and commonly known as No. 1000 Palmetto Road, and to own, manage, mortgage, lease, exchange, sell, or otherwise transfer or dispose of the property. The partnership is empowered to accept an assignment of the contract of sale for the property from Palmetto Road, Inc., its nominee, and to do all things necessary to acquire title to the property. The General Partners are directed and empowered to take any action on behalf of the partnership as may be necessary to accomplish the acquisition, and to repay out of partnership funds the sum of \$42,500 deposited by Palmetto Road, Inc., upon the signing of the aforementioned contract of sale, either to Palmetto Road, Inc., or to any partners who advanced funds to Palmetto Road, Inc., for the purpose of making the deposit or, in the discretion of the General Partners, to apply all advances made by any of the partners toward the capital contributions required to be made by them under paragraph 8.
4. *Term.* The term of the partnership shall be from August 25, 2002, to August 24, 2042. The partnership, however, shall be dissolved prior to such date upon: (a) any disposition by the partnership of its entire interest in all of the property described above, including any mortgage or leasehold interest which the partnership may acquire in exchange therefor; (b) the desire of a majority of General Partners to dissolve the partnership as set forth in paragraph 20; or (c) the death, retirement, resignation, bankruptcy, expulsion, or insanity of any General Partner as provided in paragraph 18.
5. *Principal office.* The principal office of the partnership shall be maintained c/o William Conner, Esq., Eastern National Bank Building, Atlanta, Georgia, or at any other place as the General Partners from time to time may determine.
6. *General partners.* Sam Harris, John Baker, and Myron Lowe shall be the General Partners.

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7. *Limited partners.* Martin Brown, Edward Berger, Adam Paine, Gordon Gray, and Mary Stern shall be the Limited Partners.

8. *Capital contributions.* Each partner shall contribute to the capital of the partnership the cash amount set opposite his or her respective name:

Partner	Contribution
Sam Harris	\$ 60,000
John Baker	30,000
Myron Lowe	30,000
Martin Brown	120,000
Edward Berger	90,000
Adam Paine	90,000
Gordon Gray	90,000
Mary Stern	90,000

9. *Profits, losses, and cash proceeds.* (a) *Percentage interest.* The net profits of the partnership, and net proceeds resulting from the sale, mortgage, refinancing, and condemnation of any property held by it shall be divided among, and any losses shall be borne by, each of the partners in the following proportions, subject, however, insofar as the Limited Partners are concerned, to the limitation of their liability to the amount of their individual investment, as hereinafter provided:

Partner	Percentage
Sam Harris	10
John Baker	5
Myron Lowe	5
Martin Brown	20
Edward Berger	15
Adam Paine	15
Gordon Gray	15
Mary Stern	15

(b) *Net profits defined.* The term "net profits" of the partnership shall mean net profits derived from the property owned by the partnership as ascertained through the use of generally accepted accounting practices. The following exceptions, however, shall apply: (a) depreciation of building, improvements, furniture, fixtures, furnishings, and equipment shall not be taken into account; (b) mortgage amortization paid by the partnership shall be considered a deduction; (c) all amounts expended by the partnership in the discretion of the General Partners for capital improvements shall be considered a deduction; and (d) if the General Partners shall so determine, a reasonable reserve shall be deducted to provide funds for improvements or for any other contingencies of the partnership.

(c) *Net profit distributions.* The net profits of the partnership shall be distributed quarterly or at other more frequent or

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less frequent intervals as the General Partners in their sole discretion may determine. Distribution shall commence three months after the acquisition by the partnership of the aforementioned property, or at such earlier or later date as the General Partners in their sole discretion may deem advisable.

(d) *Withdrawals.* A Limited Partner shall have the right to withdraw his capital contribution upon the termination of the partnership, provided, however, that no part of the capital contribution of any Limited Partner shall be withdrawn unless all liabilities of the partnership, except liabilities to partners on account of their contributions, have been paid or unless the partnership has assets sufficient to pay them. Except as otherwise provided in paragraph 21, no Limited Partner shall have the right to demand or receive property other than cash in return for his contribution. No Limited Partner shall have priority over any other Limited Partner either as to contribution to capital or as to compensation by way of income.

10. *Losses of limited partners.* Notwithstanding anything to the contrary in this agreement, the liability of any of the Limited Partners for the losses of the partnership shall in no event exceed in the aggregate the amount of his or her contribution to the capital of the partnership. All losses in excess of the contributed amount shall be borne solely by the General Partners in the proportion that their respective percentage shares of profits, as set forth in paragraph 9, bear to each other.

11. *General partners' fee.* At or prior to the acquisition of title by the partnership to the property, the partnership shall pay to the General Partners the aggregate sum of \$45,000 for their services in negotiating the contract for the purchase of the property. Such sum shall constitute full payment to the General Partners of their fee and all expenses and disbursements incurred by them in connection with the negotiations.

12. *Salaries, drawings, and interest on capital contributions.* Except as otherwise provided in paragraph 11 and in this paragraph 12, none of the partners, General or Limited, shall receive any salary or drawings for services rendered on behalf of the partnership in their capacity as partners, nor shall any partner receive any interest on his contributions to the capital of the partnership. Notwithstanding anything to the contrary in this agreement and in addition to the authorizations and consents herein contained, the partners consent to the employment by the partnership of Sam Harris and John Baker as Supervisory Managing Agents for the purpose of supervising the management of the partnership property. Sam Harris and John Baker shall be paid \$22,500 per year in the aggregate, payable monthly (or at less frequent intervals if the General Partners shall so determine) as and for their supervisory management fee. This sum shall include all traveling expenses incurred by them in the performance of their duties.

13. *Management, duties, and restrictions.* (a) *General partners.* The General Partners shall have equal rights in the management of the partnership business, and shall devote such time to the partnership as shall be reasonably required for its welfare and success. Without the consent of a majority of the General Partners, no General Partner shall, on behalf of the Partnership: borrow or lend money, or make, deliver, or accept any commercial paper or execute any mortgage, security interest, or bond, or lease, purchase, or contract to purchase or sell any property for or of the partnership; or assign, create a security interest in, or sell his interest as a General Partner in the partnership.

(b) *Limited partners.* No Limited Partner shall participate in the management of the partnership business.

(c) *Agents.* The Limited Partners hereby consent to the employment, when and if required, of any brokers, managing and other agents, accountants, and attorneys as the General Partners may from time to time determine. The fact that a General or Limited partner, or a member of such partner's family, is employed by, or directly or indirectly interested in or connected with, any person, firm, or corporation employed by the partnership to render or perform a service, or from which the partnership may purchase any property, shall not prohibit the General Partners from employing such person, firm, or corporation, or from otherwise dealing with him or it. Neither the partnership nor any of the partners herein shall have any rights in or to any income or profits derived therefrom as a consequence of the partnership relationship herein created.

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(d) *Other business ventures.* Any of the General or Limited Partners may engage in or possess an interest in other business ventures of every nature and description, independently or with others. Such other interest may include, but not be limited to, the ownership, financing, leasing, operation, management, or development of real property. Neither the partnership nor any of the partners shall have any rights by virtue of this agreement in and to any independent ventures or the income or profits derived therefrom.

14. *Banking.* All funds of the partnership shall be deposited in such bank account or accounts as the General Partners shall designate. Withdrawals from any such bank account or accounts shall be made upon such signature or signatures as the General Partners may designate.

15. *Conveyances.* Any deed, bill of sale, mortgage, security agreement, lease, contract of sale, or other commitment purporting to convey or encumber the interest of the partnership in all or any portion of any real or personal property at any time held in its name shall be signed by two of the General Partners. Notwithstanding anything contained in this agreement, occupancy leases for individual apartments may be signed by any one of the General Partners or by the resident Managing Agent. No person shall be required to inquire into the authority of any individual to sign any document pursuant to the provisions of this paragraph.

16. *Books.* The partnership shall maintain full and accurate books in its principal office or such other office as the General Partners shall designate for such purpose. All partners shall have the right to inspect and examine the books at reasonable times. The books shall be closed and balanced at the end of each calendar year. The accountants for the partnership shall prepare annual statements showing its profits and losses for the fiscal year and indicating each partner's share of profit or loss for income tax purposes, and shall distribute such statements to all the partners within a reasonable time after the close of each fiscal year.

17. *Assignability.* No Limited Partner shall have the right to substitute an assignee as contributor or substituted Limited Partner in his place. Any Limited Partner may assign his interest in the partnership without the consent of the General Partners, provided that the Limited Partner and his assignee shall execute such instruments as the General Partners may reasonably deem necessary to effectuate an assignment and shall furnish the General Partners with duplicate original copies thereof.

18. *Death, retirement, and resignation.* In the event of the death, retirement, resignation, bankruptcy, expulsion, or adjudication of insanity or incompetency of any General Partner, the partnership shall be dissolved and terminated. In the event, however, of the death, retirement, or insanity of a General Partner, the partnership may be continued if all of the surviving or remaining competent General Partners so elect. If the surviving or remaining competent General Partners shall determine to continue the partnership, the withdrawing General Partner or his personal representative shall become a Limited Partner in the partnership with the same relative percentage interest, as set forth in paragraph 9, in partnership profits, losses, and distributions of all kinds, including (but not limited to) liquidating distributions and distributions of proceeds from the sale or condemnation of partnership property and proceeds resulting from any mortgage or refinancing, as previously possessed by the General Partner in this partnership, subject, however, to the limitation of liability to an amount equal to the share of the partner in the total net assets of the partnership at the date that the partner became a Limited Partner under this paragraph. The percentage share of such partner in the total assets of the partnership shall be the same as his percentage share of partnership profits and losses as set forth in paragraph 9. The surviving or remaining competent General Partners shall determine whether to continue the partnership no later than 90 days following the death, retirement, or adjudication of insanity of any General Partner, and shall within such 90 days give written notice of such determination to the then Limited Partners.

19. *Death of limited partner.* The death of a Limited Partner shall not dissolve or terminate the partnership. In the event of death, the deceased Limited Partner's personal representative shall have all the rights of a Limited Partner in the partnership to the extent of the deceased's interest therein, subject to the terms and conditions of this agreement.

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20. *Termination prior to end of term.* A majority of the General Partners may terminate the partnership prior to the end of its term by giving at least 30 days' prior written notice to each of the Limited Partners.

21. *Distributions on termination.* In the event of the dissolution and termination of the partnership, the then General Partners shall proceed to the liquidation of the partnership. The proceeds of the liquidation shall be applied and distributed in the following order of priority:

(a) *Debts.* To the payment of the partnership's debts and liabilities (other than any loans or advances that may have been made by the partners to the partnership) and the expenses of liquidation.

(b) *Reserves.* To the setting up of all reserves which the General Partners may deem reasonably necessary for any contingent or unforeseen liabilities or obligations of the partnership or of the General Partners arising out of or in connection with the partnership. Any reserves shall be paid over by the General Partners to an attorney-at-law of the State of New York, as Escrowee, to be held by him for the purpose of disbursing the reserves in payment of any of the contingencies, and, at the expiration of the period as the General Partners shall deem advisable, to distribute the balance thereafter remaining in the manner hereinafter provided.

(c) *Partner loans.* To the repayment of all loans or advances that may have been made by any of the partners to the partnership, but if the amount available for such repayment shall be insufficient, then pro rata on account thereof.

(d) *Balance.* Any balance remaining shall be distributed among all General and Limited Partners, as follows:

(1) *Cash.* In the event that the partnership assets shall have been sold, the net proceeds shall be distributed to each partner in satisfaction of his interest in the partnership in the manner provided in paragraph 9.

(2) *In kind.* In lieu of sale, the partnership assets may be distributed in kind, each partner accepting an undivided interest in the partnership's assets subject to its liabilities in satisfaction of his interest in the partnership.

(e) *Valuation.* In the event of a liquidating distribution of the partnership's property in kind, the fair market value of such property shall be determined by averaging the appraisals of two appraisers selected by the Real Estate Board of the City of New York, New York, or any other comparable body, and each partner shall receive an undivided interest in the property equal to the portion of the proceeds to which he would be entitled under paragraph 9 if the property were sold.

22. *Procedure on termination.* A reasonable time shall be allowed for the orderly liquidation of the partnership's assets and the discharge of liabilities to creditors so as to enable the General Partners to minimize the normal losses attendant upon a liquidation. Each of the partners shall be furnished with a statement prepared by the partnership's then Certified Public Accountants, which shall set forth the assets and liabilities of the partnership as at the date of complete liquidation. Upon the General Partners complying with the distribution plan set forth in paragraph 21 (including payment over to the Attorney-Escrowee if there are sufficient funds), the Limited Partners shall cease to be Limited Partners, and the General Partners, as the sole remaining partners of the partnership, shall execute, acknowledge, and cause to be filed a Certificate of Cancellation of the Partnership.

23. *Limit on general partners' liability.* Anything in this agreement to the contrary notwithstanding, the General Partners shall not be personally liable for the return of the capital contributions of Limited Partners, or any portion thereof, it being expressly understood that any return shall be made solely from partnership assets.

24. *Opinion of counsel.* Any act or failure to act by any General Partner which may cause or result in loss or damage to the partnership, if pursuant to opinion of legal counsel employed by the General Partners on behalf of the partnership, shall not subject the General Partners to any liability.

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25. *Indemnity.* The partnership shall indemnify and hold harmless any General Partner from any loss or damage incurred by him by reason of any act performed by him for and on behalf of the partnership and in furtherance of its interests. The foregoing shall not relieve the General Partners of liability for gross negligence or willful malfeasance.

26. *Notices.* All notices provided for in this agreement shall be directed to the parties at the addresses herein set forth in this agreement and to the partnership at its principal office by Registered or Certified Mail.

27. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

28. *Non-waiver.* No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

29. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

30. *Governing law.* This agreement and the rights of the parties shall be construed in accordance with and governed by the laws of the State of Georgia.

31. *Counterparts.* This agreement may be executed in two or more counterparts, and all so executed shall constitute one agreement, binding on all the parties, notwithstanding that all the parties are not signatory to the original or the same counterpart.

32. *Binding effect.* The provisions of this agreement shall be binding upon and inure to the benefit of each of the parties and their respective estates, heirs, legatees, successors, and assigns.

In witness whereof the parties have executed this agreement as of the day and year first above written.

General Partners:

Sam Harris

John Baker

Myron Lowe

Limited Partners:

Martin Brown

Edward Berger

Adam Paine

Gordon Gray

Mary Stern

A.7 Limited partnership--provision for additional capital--hotel renovation

COMMENT

Insufficient capital can become a problem in any business venture. In the agreement illustrated here, a limited partnership is in the process of acquiring a hotel property which requires substantial alterations and improvements. The right to make these capital expenditures is vested in the general partner, together with the collateral right to demand additional proportionate capital contributions from the limited partners. If any of the limited partners fails to make his additional contribution, the general partner undertakes to provide all the additional financing. In that event, a priority is established in favor of the general partner, for the additional capital contributions, in the net profits of the partnership, in the proceeds of any mortgage refinancing, and in distributions from the proceeds of liquidation.

The requirement that all limited partners contribute their proportionate shares of additional capital is designed to preserve the initial ownership percentages among the various partners. Under the Uniform Limited Partnership Act, if a priority is to be given a limited partner over other limited partners in respect of income, return of contributions, or any other matter, that priority must be set forth in the filed certificate of limited partnership.

For further information, see Chapter 14.

FORM

AGREEMENT made November 1, 2002, among Sanford Corporation, a Delaware corporation with offices at 100 East 42d Street, New York, New York (the "General Partner"), and James Meyer, residing at 100 Central Park West, New York, New York, Perry Barnes, residing at 150 East 59th Street, New York, New York, and George Roberts, residing at 10 Willow Lane, Scarsdale, New York (the "Limited Partners").

Recitals

The General Partner on behalf of itself and of the Limited Partners has entered into a contract dated September 15, 2002, to acquire the premises known as the Skyline Hotel in New York, New York, together with certain furniture, furnishings, and personal property located in the premises ("property").

The parties desire to form a Limited Partnership under the laws of the State of New York for the purposes and on the terms and conditions set forth in this agreement.

The General Partner has simultaneously herewith assigned the purchase contract to the Limited Partnership organized pursuant to this agreement.

Now, therefore, it is mutually agreed as follows:

1. *Formation.* The parties hereby form a Limited Partnership pursuant to the provisions of Article 8 of the Partnership Law of the State of New York.

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2. *Name.* The Partnership shall be conducted under the name of Skyline Hotel Company.

3. *Purpose.* The purpose of the Partnership is to acquire pursuant to a certain contract of purchase dated September 15, 2002, and to hold for investment the premises known as the Skyline Hotel in New York, New York, and certain furniture, furnishings, and personal property located therein, and to own, manage, mortgage, create security interests in, lease, improve, exchange, sell, or otherwise transfer or dispose of such property.

4. *Term.* The term of the Partnership shall begin on November 1, 2002, and shall continue until November 1, 2037. The Partnership shall be dissolved prior to such date, however, if any of the following events shall occur: (a) any disposition by the Partnership of its entire interest in the real and personal property, including all mortgages or leasehold interests which it may acquire in exchange therefor; (b) the desire of the General Partner to dissolve the Partnership as set forth in paragraph 21; or (c) the bankruptcy, receivership, or liquidation of the General Partner as provided in paragraph 19.

5. *Principal office.* The principal office of the Partnership shall be maintained in care of Sanford Corporation, 100 East 42d Street, New York, New York, or at such other place as the General Partner from time to time may determine.

6. *General and limited partners.* Sanford Corporation shall be the General Partner. James Meyer, Perry Barnes, and George Roberts shall be the Limited Partners.

7. *Capital contribution of general partner.* The General Partner shall contribute to the capital of the Partnership the sum of \$600,000. The General Partner warrants and represents that it has full power and authority to enter into this agreement and to make its contribution to the capital of the Partnership, and that this agreement and its execution by the General Partner have been ratified, approved, and confirmed by resolution of its Board of Directors.

8. *Capital contributions of limited partners.* Each Limited Partner shall contribute to the capital of the Partnership the sum of \$200,000 in cash.

9. *Profits and losses.* Except as otherwise provided in paragraph 11(b), the net profits of the Partnership shall be divided and any losses shall be borne by each of the Partners in the following proportions (subject, however, insofar as the Limited Partners are concerned, to the limitation of their liability to the amount of their individual investment as hereinafter provided):

Partner	Percentage
Sanford Corporations	50%
James Meyer	16 2/3 %
Perry Barnes	16 2/3 %
George Roberts	16 2/3 %

10. *Losses of limited partners.* Notwithstanding anything to the contrary contained in this agreement, the liability of any Limited Partner for the losses of the Partnership shall in no event exceed in the aggregate the value of his original contributions to the Partnership's capital. The General Partner shall solely bear all losses in excess of the contributed amount.

11. *Alterations and additional capital contributions.* (a) *Proportionate contributions.* The Partnership shall cause all alterations, additions, improvements, repairs, and replacements to or of the Partnership property that the General Partner in its sole discretion shall deem advisable, notwithstanding the same may substantially alter the character or use of the premises. If in the sole judgment of the General Partner the Partnership requires additional capital contributions from

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the Partners for such work, the Limited Partners shall be notified in writing and shall have the option, to be exercised unanimously within 30 days after such notification, to make additional contributions in cash to the Partnership equal to 16 2/3 percent each of the estimated net cost to the Partnership of the work. The exercise of such option by a Limited Partner shall not be deemed effective unless all of the Limited Partners exercise the option in accordance with the terms of this paragraph. If the option is exercised by all of the Limited Partners, they shall make their additional capital contributions at such time or times as the General Partner shall direct, and the General Partner shall make an additional contribution in cash to the Partnership equal to 50 percent of the estimated net cost to the Partnership of such work, and in such event the Partners' shares of profits and losses shall remain unchanged, i.e., shall be in the proportions set forth in paragraph 9.

(b) *Contribution by general partner.* If any Limited Partner fails to exercise such option, the General Partner shall, in lieu of the foregoing, make an additional contribution of cash to the Partnership equal to the Partnership's entire estimated net cost of the work. In such event the net losses of the Partnership shall continue to be apportioned by the Partners in the proportions set forth in paragraph 9 (subject, however, insofar as the Limited Partners are concerned, to the limitation of their liability to the amount of their individual investment as hereinabove provided), but effective as of the date of the making of such additional capital contribution by the General Partner, the net profits of the Partnership shall be divided among the Partners as follows:

(1) *Preferred share of profits.* The General Partner shall first be entitled, before any allocation to the Limited Partners, to a portion of the net cash receipts of the Partnership from the operation of the Partnership property equal to 10 percent per annum of the amount of the additional capital contribution made by it to the Partnership pursuant to this paragraph 11(b), subject, however, to the following provisos: (a) in the event that the additional contribution made by the General Partner pursuant to this paragraph 11(b) is repaid in part or in whole to the General Partner from the proceeds of any mortgage refinancing or from the sale or condemnation of any partnership property, at any time or from time to time, as provided in paragraph 12(b), then, effective as of the date of such repayment or repayments, the preferred share of profits to which the General Partner shall be entitled pursuant to this subdivision (1) shall be reduced to an amount equal to 10 percent of the unreturned portion of the General Partner's additional capital contribution; and (b) if the entire additional contribution made by the General Partner pursuant to this paragraph 11(b) shall have been so repaid to the General Partner, then effective as of the date of the repayment the General Partner shall no longer be entitled to a preferred share of profits as provided in this subdivision (1), and all profits shall thereafter be divided among the General and Limited Partners in the proportions set forth in paragraph 9.

(2) *Balance of profits.* The balance of Partnership net profits over and above the amount allocable to the General Partner, pursuant to subdivision (1) above, shall be divided among the General and Limited Partners in the proportions set forth in paragraph 9.

(c) All additional capital contributions to the Partnership and the rights of the Partners and the Partnership with respect thereto shall be governed by the provisions of this agreement pertaining to original capital contributions to the Partnership.

12. *Partnership cash receipts.* (a) *Net cash receipts.* The net cash receipts of the Partnership derived from operation of the Partnership property, in excess of operating expenses and such reasonable reserves as may be established at the sole discretion of the General Partner for alterations, repairs, or other contingencies, shall be distributed to the Partners quarterly or at such other more frequent intervals as the General Partner shall determine. Distributions to the Partners of such net cash receipts shall be made to the Partners in the same proportions in which they then share profits pursuant to paragraph 9 or paragraph 11(b), as the case may be. No Partner shall be obligated to repay to the Partnership any such cash distributions received by him or by any other Partner.

(b) *Mortgage, sale, or condemnation proceeds.* Notwithstanding anything herein contained to the contrary, in the event that the Limited Partners are given the option of making additional contributions to the capital of the Partnership, as

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provided in paragraph 11(b), and fail to exercise such option, and if the General Partner then makes an additional capital contribution as provided for in paragraph 11(b), the net proceeds (after payment of all expenses) subsequently received by the Partnership from the refinancing of any mortgage constituting a lien against the Partnership property or from the sale or condemnation of any Partnership property shall be first applied to the repayment to the General Partner of the additional contribution made by it pursuant to paragraph 11(b), and shall be distributed to the General Partner accordingly. The Limited Partners shall have no right to such sale, mortgage, or condemnation proceeds or to the proceeds of any successive mortgage refinancing or sale or condemnation of Partnership property until the additional contribution of the General Partner shall have been repaid to it in full by the Partnership. All such distributions to the General Partner shall be charged against the General Partner's capital account, and the General Partner shall not be obligated to repay such distributions to the Partnership.

13. *Salaries, drawings, and interest on capital contributions.* None of the Partners (General or Limited) shall receive any salary or drawings for services rendered on behalf of the Partnership in their capacity as Partners, nor shall any Partner receive any interest on his contribution to the capital of the Partnership.

14. *Management, duties, and restrictions.* (a) *General partner.* The General Partner shall manage the Partnership business and shall devote such time to the Partnership as shall be reasonably required for its welfare and success. The General Partner shall have the right, in its discretion, on behalf of the Partnership, to borrow or lend money, to make, deliver, or accept any commercial paper and execute any mortgage, security agreement, bond, or lease, and to purchase or contract to purchase or sell or contract to sell any property for or of the Partnership.

(b) *Limited partners.* No Limited Partner shall participate in the management of the Partnership business. A Limited Partner shall have the right to withdraw his capital contribution upon the termination of the Partnership as provided herein. No part of the capital contribution of any Limited Partner shall be withdrawn, however, unless all liabilities of the Partnership (except liabilities to partners on account of their contributions) have been paid or unless the Partnership has assets sufficient to pay them. No Limited Partner shall have the right to demand or receive property other than cash in return for his contribution. No Limited Partner shall have priority over any other Limited Partner either as to contributions to capital or as to compensation by way of income.

(c) *Limited partners' consent.* The Limited Partners consent to any sale or other disposition, encumbrance, mortgage, security agreement or lease (or modification, cancellation, or replacement of any existing mortgage or lease) by the General Partner on behalf of the Partnership, of any or all of the Partnership's assets on such terms and conditions as the General Partner may determine in its sole discretion, and to the employment, when and if required, of such brokers, accountants, managing, and other agents and attorneys as the General Partner may from time to time determine. The fact that a Partner, General or Limited, or an officer, director, or shareholder of the General Partner, or a member of the family of a Limited Partner or of an officer, director, or shareholder of the General Partner, is employed by, or directly or indirectly interested in or connected with, any person, firm, or corporation employed by the Partnership to render or perform a service, or from which the Partnership may purchase any property, shall not prohibit the General Partner from employing such person, firm, or corporation, or from otherwise dealing with him or it, and neither the Partnership nor any of the Partners shall have any rights in or to any income or profits derived therefrom as a consequence of the Partnership relationship herein created.

(d) *Other activities.* Any General or Limited Partner, may engage in and possess an interest in other business ventures of every nature and description, independently or with others, including but not limited to the ownership, financing, leasing, operation, management, or development of real property. Neither the Partnership nor any of its Partners shall have any rights by virtue of this agreement in and to such independent ventures or the income or profits derived therefrom.

15. *Banking.* All funds of the Partnership shall be deposited in such bank account or accounts as the General Partner shall designate. Withdrawals from any such bank account or accounts shall be made upon such signature or signatures

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as the General Partner may designate.

16. *Conveyance.* Any deed, bill of sale, mortgage, security agreement, lease, contract of sale, or other commitment purporting to convey or encumber the interest of the Partnership in all or any portion of any real or personal property at any time held in its name, shall be signed by the General Partner, and no other signature shall be required. No person shall be required to inquire into the authority to sign any document pursuant to the provisions of this paragraph.

17. *Assignability.* With the consent of the General Partner only, any Limited Partner may assign his interest in the Partnership. No Limited Partner shall have the right to substitute an assignee as a contributor or substituted Limited Partner in his place.

18. *Power of attorney.* Each of the Limited Partners hereby irrevocably constitutes and appoints the General Partner his true and lawful attorney, in his name, place, and stead, to make, execute, acknowledge, and file:

- (a) A certificate of limited partnership under the laws of the State of New York;
- (b) Any certificate or other instrument which may be required to be filed by the Partnership under the laws of the State of New York or which the General Partner shall deem it advisable to file;
- (c) Any and all amendments or modifications of the instruments described in the preceding subdivisions (a) and (b); and
- (d) All documents which may be required to effectuate the dissolution and termination of the Partnership;

It is expressly understood and intended by each of the Limited Partners that the grant of the foregoing power of attorney is coupled with an interest.

19. *Bankruptcy, receivership, or liquidation of general partner.* In the event of the bankruptcy, receivership, or liquidation of the General Partner, the Partnership shall be dissolved and terminated.

20. *Death of limited partner.* The death of a Limited Partner shall not dissolve nor terminate the Partnership. In the event of such death, the personal representative of the deceased Limited Partner shall have all the rights of a Limited Partner in the Partnership to the extent of the deceased's interest therein, subject to the terms and conditions of this agreement.

21. *Termination prior to end of term.* The General Partner may, in its sole discretion, terminate the Partnership prior to the end of the partnership term by giving at least 30 days' prior written notice to each of the Limited Partners.

22. *Distributions on termination.* In the event of the dissolution and termination of the Partnership, the General Partner shall proceed to the liquidation of the Partnership. The proceeds of such liquidation shall be applied and distributed first in payment of Partnership liabilities, then to the repayment of the additional capital contribution (if any) made by the General Partner pursuant to paragraph 11(b) or so much thereof as shall not theretofore have been returned to the General Partner in accordance with the provisions of paragraph 12(b), and finally to each Partner in proportion to the percentages as set forth in paragraph 9. Anything in this agreement to the contrary notwithstanding, the General Partner shall not be personally liable for the return of the capital contributions of Limited Partners, or any portion thereof, it being expressly understood that any such return shall be made solely from Partnership assets.

23. *Notices.* All notices provided for in this agreement shall be directed to the parties at the addresses herein set forth and to the Partnership at its principal office by registered or certified mail.

24. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its

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subject matter. There are no other understandings or agreements between them.

25. *Non-waiver.* No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

26. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

27. *Governing law.* This agreement and the rights of the parties hereunder shall be construed in accordance with and governed by the laws of the State of New York.

28. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

29. *Binding effect.* The provisions of this agreement shall be binding upon and inure to the benefit of each of the parties and their respective estates, heirs, legatees, successors, and assigns.

In witness whereof the parties hereto have executed this agreement as of the day and year first above written.

Attest:

Secretary

General Partner:

Sanford Corporation

by _____

President

Limited Partners:

James Meyer

Perry Barnes

George Roberts

A.8 Syndication--limited partnership agreement--provision for continuance of partnership upon death of general partner

COMMENT

This form illustrates a limited partnership agreement which might be used by a substantial real estate syndication. Participating interests purchased by limited partners in a syndication have been recognized as "securities." This requires compliance with state and federal securities laws, which require filing statements, prospectus materials and other items.

Partnership vs. publicly traded partnership:

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A newly formed partnership that is publicly traded is generally treated as a corporation for tax purposes. Publicly traded means that the partnership interests either are traded on an established securities market, or are readily tradable on a secondary market or its substantial equivalent. If 90 percent or more of its gross income is qualifying passive-type income, including real property rents, and gains from the sale or other disposition of real property, the partnership is excluded from corporate tax treatment. Net income from a publicly traded partnership is not treated as passive income for purposes of the passive loss rules. Losses are not allowed against other passive income or even against income from another publicly traded partnership.

Parties who wish to avoid "publicly traded" status can include a prohibition against any transfer that would cause the partnership to become publicly traded.

"Association" tax status:

If the partnership were treated as a corporation in any taxable year, income and deductions of the partnership would be reflected only on its tax return rather than being passed through to the unit holders. In that event, the partnership would be required to pay income tax at corporate tax rates on its net income, thereby reducing the amount of cash available to be distributed to the unit holders and all or a portion of such distributions made to them could be treated as ordinary income regardless of the source from which they were generated. Depreciation and other "loss" items would be deducted at the corporate (partnership) level, rather than by the partners.

Partnership tax status:

A partnership is not subject to any federal income taxes. The partnership files federal partnership information tax returns reporting its operations on a cash basis for each calendar year. Each unit holder will be required to report on his own federal income tax return his share of partnership items of income, gain, loss, deduction, or credit and, accordingly, may be subject to tax on his distributive share of partnership income whether or not any cash distribution is made to him.

Passive activity limitations:

Generally speaking, rental real estate activity is considered to be a passive activity. *IRC § 469(c)(2)*. Therefore, deductions and credits from rental activities can only offset income from other passive activities. Such deductions and credits **cannot** be deducted from nonpassive income, such as wages, dividends, interest, etc. However, there are two major exceptions to this general rule.

First, certain eligible taxpayers who **materially** participate in rental real estate activities can deduct losses from such activities against nonpassive income. These eligible taxpayers include individuals and closely-held C corporations that meet special eligibility requirements. *IRC § 469(c)(7)*. Second, an individual who owns at least a 10-percent interest and **actively** participates in rental real estate activity is permitted to offset up to \$25,000 of passive activity losses against his nonpassive income. *IRC § 469(i)*.

Allocation of partnership tax items:

Items of partnership income, gain, loss, deductions, credits, or other items are allocated to a partner only if realized, paid, or incurred by the partnership during the portion of the year in which the partner is a member of the partnership and not retroactively to periods prior to entry. If any partner's interest in a partnership changes during the partnership tax year, each partner's share of partnership income, gain, loss, deduction, or credit is to be determined by using any method prescribed by regulations which takes

into account the varying interests of the partners in the partnership during the tax year. For partnerships using the cash method of accounting, specific cash method items are required to be assigned to each day in the period to which they are attributable. The assigned amounts are then apportioned among the partners in proportion to their interests in the partnership at the close of each day. This allocation is similar to the accrual method and applies specifically to interest, taxes, payments for services, or for the use of property and other items prescribed by regulation to avoid retroactive allocation.

Generally, allocation of partnership tax items among partners is controlled by the partnership agreement, provided that the allocation has substantial economic effect. If the allocation is set aside, a partner's share of partnership items will be determined in accordance with the partner's interest in the partnership.

Amortization of organization expenses:

Fees for the syndication of a partnership must be capitalized. Partnership organization fees must be capitalized and may be amortized over a five year period. Regulations provide that no deduction is allowed to a partnership or a partner for expenses to organize a partnership or to promote the sale, or to sell, any partnership interest. However, "organizational expenses" may be amortized under an exception which permits an election to amortize by the partnership. The election to amortize organizational expenses is made with the partnership tax return. The expenses are to be amortized on a straight-line basis over a period of not less than 60 months. "Organizational expenses" are defined as expenditures which meet each of the following tests: expenses which are

- (1) incident to the creation of the partnership;
- (2) chargeable to a capital account; and
- (3) of a character which would be amortized over the life of a partnership if the partnership had an ascertainable life.

Expenses connected with the following are not organizational expenses:

- (1) acquisition or transfer of assets;
- (2) admission or removal of partners other than at the time of organization of the partnership;
- (3) contracts relating to the operation of the partnership's business; and
- (4) syndication fees.

For further information, see Chapter 14.

FORM

PARTNERSHIP AGREEMENT made July 15, 2002, among John Baker, Marvin Harris, Alvin Johnson, William Minton, Oscar Kindler, and Donald Enright.

Recitals

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A contract of sale, dated March 15, 2002, was entered into between John Baker, Marvin Harris, and Alvin Johnson, as purchasers, and Central Realty Co., Inc., as seller (the "Purchase Agreement"), covering the sale of the improved real property situated in New York County known as the Blackacre Building (the "Real Property").

The Purchase Agreement provides, among other things, that contemporaneously with the acquisition of the fee title to the Real Property, the purchaser will enter into a Net Lease with the seller of the fee title as lessee, covering the entire Real Property for an initial term of 21 years with options in the lessee to renew for four additional terms of 21 years each, upon the terms more particularly provided in the form of Net Lease attached to the Purchase Agreement.

The parties desire to form a limited partnership for the purpose of acquiring the Real Property pursuant to the Purchase Agreement.

It is therefore agreed:

1. *Formation.* The parties hereby form a Limited Partnership (the "Partnership"), pursuant to the provisions of Article 8-A of the Partnership Law of the State of New York.
2. *Name.* The Partnership shall be conducted under the firm name and style of Blackacre Realty Company.
3. *Purpose.* The purpose of the Partnership is to acquire and hold the Real Property for investment and to lease the same to another for operation, and if future circumstances require it, to again lease the real property or operate the same on such terms and conditions as a majority of the General Partners shall determine.
4. *Term.* The term of the Partnership shall be from July 15, 2002, to December 31, 2052. The Partnership shall be dissolved and terminated prior to such date, however, if any of the following events shall occur:
 - (a) Any disposition by the Partnership of its entire interest in the Real Property, including any mortgage, leasehold, securities, or other interest which it may acquire upon a transfer of the Real Property.
 - (b) The death, retirement, or adjudication of bankruptcy, insanity, or incompetency of any General Partner, unless the remaining General Partners elect to continue the Partnership pursuant to the provisions of paragraph 20.
 - (c) The happening of the events described in paragraph 8(b) of this agreement.
 - (d) The decision of all of the General Partners to terminate the Partnership.
5. *Capital.* The capital of the Partnership shall be \$3,500,000, consisting of
 - (a) \$3,200,000 in cash; and
 - (b) Other property consisting of the Purchase Agreement at an agreed value of \$300,000.
6. *General partners and their contributions.* The following parties shall be the General Partners of the Partnership. The General Partners shall contribute to the partnership capital undivided interests aggregating 100 percent in the Purchase Agreement, in the amounts set forth alongside their respective names as follows:

John Baker	\$100,000
Marvin Harris	100,000

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Alvin Johnson 100,000

These contributions shall be accomplished by the execution and delivery by the General Partners, concurrently with the execution of this Partnership Agreement, of an instrument assigning to the Partnership their undivided 100 percent interest in the Purchase Agreement. The assignment shall include the interest of the General Partners in the \$125,000 which they paid on account of the purchase price under the Purchase Agreement. However, the Partnership shall reimburse the assignors for their payment under the Purchase Agreement by delivering to them a noninterest-bearing note or notes in the amount of \$125,000. Such note or notes shall be payable at the time and in the event of the closing of the Partnership's acquisition of the Real Property.

7. Original limited partners and their contributions. The following parties shall be the Original Limited Partners of the Partnership. The Limited Partners shall contribute to the partnership capital, in cash, concurrently with the execution of this Partnership Agreement, the amounts set forth alongside their respective names as follows:

William Minton \$10,000
 Oscar Kindler 5,000
 Donald Enright 10,000

8. Additional limited partners and their contributions. (a) *Admission of limited partners.* The General Partners are authorized to admit Additional Limited Partners to the Partnership, who shall contribute, in cash, to the partnership capital sums aggregating \$3,175,000. Upon the admission of such additional Limited Partners an amendment to the certificate of limited partnership of the Partnership, reflecting such admissions, shall be filed. The cash contributions of each additional Limited Partner shall be in the amount of \$5,000 or multiples thereof, or in lesser fractional amounts if the General Partners so determine. To accomplish the purposes of this paragraph, the General Partners are authorized to do all things necessary to effectuate the admission of such Additional Limited Partners. Each Additional Limited Partner shall become signatory to this agreement by executing a conformed counterpart of the agreement at the foot thereof, and each Additional Limited Partner shall be deemed to have adopted and agreed to be bound by all of the provisions of this agreement. However, each executed counterpart shall not become binding and effective until it has been attested by the signature of one of the General Partners. The original of this agreement, executed by the General Partners and the Original Limited Partners, and the duly executed and attested counterparts, taken together, shall constitute a single instrument.

(b) *Preconditions.* If for any reason whatsoever (1) additional contributions to the Partnership of \$3,175,000 are not made by Additional Limited Partners by October 15, 1987, or any adjourned date for the closing of title to the Real Property, or (2) the acquisition of the Real Property shall not close by October 15, 1987, or any adjourned date for the closing of title to the Real Property, then the cash contributions of the Original Limited Partners and the Proposed Limited Partners shall be repaid to them without interest; and the Partnership shall pay over to the General Partners, as their interests may appear, the deposit of \$125,000 under the Purchase Agreement, in the event that the deposit is returnable to the Partnership by the seller on the occasion of the termination of the Partnership in the circumstances described in this subparagraph. Upon such payments being made, this Partnership Agreement shall be of no further force and effect, and the Partnership shall terminate, with the authority in the General Partners, or any of them, to execute a Certificate of Cancellation of the Partnership, as well as any and all other documents required to effectuate the Partnership dissolution.

9. Acquisition of real property, etc. Upon the admission of Additional Limited Partners whose cash contributions to the Partnership aggregate \$3,175,000, the Partnership shall proceed to acquire fee title to the Real Property and enter into the Net Lease pursuant to the terms of the Purchase Agreement, and the General Partners shall take all steps which they shall deem necessary or proper to effectuate such transactions. Any of the General Partners, acting on behalf of the Partnership, may execute any or all of the instruments required to accomplish the foregoing.

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10. *Principal office.* The principal office of the Partnership shall be maintained at 100 East 42d Street, New York, New York, or at such other place or places as the General Partners may from time to time determine, notice of which shall be given to the Limited Partners.

11. *Profits and losses.* (a) *Allocation.* The net profits receipts of the Partnership shall be apportioned among the General Partners and the Limited Partners (collectively the "Partners"), and net losses shall be borne by them pro rata in accordance with the amounts of their respective original cash and agreed value of other property contributions to the Partnership capital, as the case may be. In any event, however, the liability of any Limited Partner (except one who is also a General Partner) for the losses of the Partnership shall be limited to the actual cash or property originally contributed by him to the Partnership capital.

12. *Distributions.* (a) *Time.* The net cash receipts of the Partnership, apportioned in the manner provided in paragraph 11, shall be distributed at reasonable intervals as determined by the General Partners in their absolute discretion.

(b) *Net cash receipts defined.* The term "net cash receipts of the Partnership" shall mean net profits derived from the ownership of the Real Property as ascertained through the use of generally accepted accounting practices, except that (1) depreciation of buildings, improvements, and personalty shall not be considered as a deduction, (2) mortgage amortization shall be considered as a deduction, (3) all amounts expended by the Partnership in the discretion of the General Partners for capital improvements shall be considered a deduction, and (4) if the General Partners shall so determine, a reasonable reserve shall be deducted for working capital needs or to provide funds for improvements or for any other contingencies of the Partnership.

(c) *Effect.* The foregoing provisions for the apportionment of net cash receipts shall remain effective irrespective of whether all or any portion of the Partners' capital contributions shall have been returned to them pursuant to the provisions of this paragraph.

(d) *Refinance proceeds.* In the event that moneys shall be available for distribution among the Partners as a return of capital by reason of mortgage refinancing, all such moneys shall be divided among the General Partners and Limited Partners, pro rata, in accordance with their respective original cash and agreed value of other property contributions to the Partnership capital, as the case may be.

(e) The respective amounts of the Partners' contributions to the Partnership capital in cash or the agreed value of other property may be returned to them, in whole or in part, in cash, at any time in the absolute discretion of the General Partners. Such returns of contributions shall be pro rata to all Partners in accordance with the amounts of their respective cash or agreed value of other property contributions to Partnership capital, as the case may be. No Partner shall have the right to demand or receive property other than cash in return for his contribution.

13. *Advances.* If any Partner shall, in excess of his contribution to the capital of the Partnership, advance any moneys to the Partnership, the amount of any such advance shall not be an increase of his capital contribution or entitle him to any increase in his share of the distributions of the Partnership. The amount of any such advance shall be an obligation of the Partnership to the Partner and, unless otherwise provided and agreed, shall be repaid to him without interest, except that such advances shall be payable or collectible only out of the Partnership assets, and the General Partners shall not be personally obligated to repay any part thereof.

14. *Books, records, and reports.* (a) *Maintenance.* At all times during the continuance of the Partnership, the General Partners shall keep or cause to be kept complete and true books of account, in which shall be entered fully and accurately each transaction of the Partnership. The books of account, together with a certified copy of the certificate of limited partnership and all amendments thereto, shall at all times be maintained at the Partnership's principal office and shall be open to the reasonable inspection of the Partners or their duly authorized representatives.

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(b) *Annual statements.* Annual statements of Partnership gross receipts and operating expense, as prepared by the Partnership's accountants, shall be transmitted to each of the Partners. Within a reasonable period after the close of each year, a report shall be transmitted to each Partner indicating his share of the Partnership's profits or loss for such year for federal income tax purposes.

15. *Bank accounts.* All funds of the Partnership shall be deposited in the Partnership name, in such bank account or accounts as the General Partners shall designate. Withdrawals from any bank account or accounts shall be made upon such signature or signatures as the General Partners may designate.

16. *Powers and rights of general partners.* (a) *Management.* Except as otherwise provided in subparagraph (b), the General Partners shall have equal rights in the management and conduct of the Partnership business.

(b) *Authority.* A majority of the General Partners in their absolute discretion shall have the power on behalf of the Partnership:

(1) to sell, exchange, or convey title to, and to grant an option for the sale of all or any portion of the Real Property, including any mortgage or leasehold interest or other property which may be acquired by the Partnership upon a transfer of the Real Property; to lease all or any portion of the Real Property without limit as to the term, whether or not such term (including renewal terms) shall extend beyond the date of the termination of the Partnership and whether or not the space so leased is to be occupied by the lessee or, in turn, subleased in whole or in part to others; to borrow money and as security therefor to mortgage all or any part of the Real Property, and to prepay, in whole or in part, refinance, recast, increase, modify, consolidate, correlate, or extend all mortgages affecting the Real Property; all of the foregoing at the price, rental, or amount, for cash, securities, or other property and upon such terms as they deem proper;

(2) to place record title to the Real Property in the name or names of a nominee or nominees for the purpose of mortgage financing or any other convenience or benefit of the Partnership;

(3) to employ from time to time persons, firms, or corporations for the operation and management of the Real Property, including, without limitation, a supervisory managing agent, a building management agent, accountants, and attorneys on such terms and for such compensation as they shall determine;

(4) to change and reorganize the Partnership into any other legal form; and

(5) to execute, acknowledge, and deliver any and all instruments to effectuate the foregoing.

By way of extension of the foregoing and not in limitation thereof, the General Partners shall possess all of the powers and rights of partners in a partnership without limited partners under the Partnership Law of the State of New York. However, whenever a decision shall have been made by a majority of the General Partners in respect of any of the foregoing matters, such majority decisions shall be binding upon all General Partners, and any action taken thereunder shall constitute the act of all General Partners.

(c) *Approval of sale.* Notwithstanding the unqualified power and right of a majority of the General Partners to sell, exchange, or convey title to the Real Property, or any part thereof, the General Partners represent that it is not their intention to sell, exchange, or convey the Real Property unless written approval of a majority in interest of the Limited Partners is first obtained. Each of the Limited Partners agrees that such written approval, if given, shall be irrevocable and upon receipt by the General Partners of such approval of a majority in interest of the Limited Partners to any such sale, the express irrevocable approval and consent of all Limited Partners shall be deemed conclusively to have been given to the General Partners. Each of the Limited Partners hereby irrevocably constitutes and appoints the General Partners, or any one of them, jointly and severally, his true and lawful attorney, in his name, place, and stead, in such event, to execute his consent to confirm and adopt such unanimous approval. The foregoing power of attorney is

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coupled with an interest and shall survive delivery of an assignment of limited partnership interest in the same manner as in paragraph 23 provided. A transfer of record title to a nominee for the Partnership for the purpose of mortgage financing or any other convenience or benefit of the Partnership shall not be construed as a sale, exchange, or conveyance within the meaning of this subparagraph (c) or of paragraph 4(a) hereof. Nothing herein contained shall require any assignee or grantee to investigate the General Partners' authority to sell, exchange, or convey all or any portion of the Real Property or any other property of the Partnership, or to grant any option therefor, nor require any assignee or grantee to inquire as to whether the approval of the Limited Partners for any sale, exchange, or conveyance, if executed by a majority of the General Partners, shall bind the Partnership.

(d) *Other activities.* The General Partners shall devote so much of their time as they in their absolute discretion deem necessary to the affairs of the Partnership business, and they shall receive no compensation therefor from the Partnership. Any General or Limited Partner may engage in or possess an interest in other business ventures of every nature and description, independently or with others. Such other activities may include, but shall not be limited to, the ownership, financing, leasing, operation, management, syndication, brokerage, and development of real property. Neither the Partnership nor the Partners shall have any right by virtue of this agreement in and to such independent ventures or to the income or profits derived therefrom. The fact that a General or Limited Partner, or a member of his family, is employed by, or is directly or indirectly interested in or connected with, any person, firm, or corporation employed by the Partnership to render or perform a service, or from whom or which the Partnership may buy merchandise or other property, or to or from whom or which the Partnership shall lease the Real Property, shall not prohibit the General Partners from executing a lease with or employing such person, firm, or corporation or from otherwise dealing with him or it. Neither the Partnership nor any of the Partners, as such, shall have any rights in or to any income or profits derived therefrom.

(e) *Reliance on counsel.* Any act or failure to act by a General Partner, the effect of which may cause or result in loss or damage to the Partnership, if pursuant to opinion of legal counsel employed by the General Partners on behalf of the Partnership, shall not subject the General Partners to any liability.

17. *Activities of limited partners.* The Limited Partners shall take no part in, or interfere in any manner with, the conduct or control of the Partnership business or the sale, leasing, or refinancing of its assets, and shall have no right or authority to act for or bind the Partnership.

18. *Substituted limited partners.* (a) *Consent.* Anything in this agreement to the contrary notwithstanding, no assignee of the whole or any portion of a Limited Partner's interest in the Partnership shall have the right to become a Substituted Limited Partner in place of his assignor, unless (1) his assignor shall designate such intention in the instrument of assignment, and (2) the written consent of all the General Partners to such substitution shall be obtained. The General Partners shall have the sole and absolute discretion to grant or deny such substitution. Their failure or refusal to grant consent, however, shall not affect the validity of any such instrument as an assignment of the right to receive Partnership distributions applicable to such interest under this agreement, provided such instrument is in form satisfactory to the General Partners, a duly executed and acknowledged counterpart is filed with the Partnership, and the terms thereof are not in contravention of the provisions of subparagraph (c) of this paragraph 18. In no event shall the consent of any other Limited Partner be required to effectuate such substitution.

(b) *Preconditions.* Notwithstanding the granting of consent by the General Partners, the admission of an assignee as a Substituted Limited Partner shall be further conditioned on (1) the assignment instrument being in form and substance satisfactory to the General Partners, (2) the assignor and assignee named in the assignment executing and acknowledging such other instrument or instruments as the General Partners may deem necessary or desirable to effectuate the admission, (3) the assignee's written acceptance and adoption of all of the terms and provisions of this agreement, as the same may have been amended, and (4) the assignee paying or obligating himself to pay, as the General Partners may determine, all reasonable expenses connected with the admission.

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(c) In no event shall a limited partnership interest, or any portion thereof, be assigned or transferred to a minor or incompetent. Any such attempted assignment or transfer shall be void and ineffectual and shall not bind the Partnership.

19. *Death of limited partner.* The death of a Limited Partner shall not dissolve or terminate the Partnership. In the event of death the personal representative of the deceased Limited Partner shall have all the rights of a Limited Partner in the Partnership to the extent of the deceased's interest therein, subject to the terms and conditions of this agreement; and his estate shall be liable for all his liabilities as a Limited Partner.

20. *Right of surviving or remaining general partner to continue business of partnership.* (a) *Election.* In the event of the death, retirement, or adjudication of bankruptcy, insanity, or incompetency of any of the General Partners, such retiring partner, or personal representative of the deceased partner, or the trustee of the bankrupt partner, or the committee or other representative of the insane or incompetent partner, as the case may be (the "Withdrawing General Partner"), the surviving or remaining General Partners, as the case may be (the "Remaining General Partners," which shall denote the singular if there is only one remaining or surviving General Partner), acting unanimously, shall have the right, but not the obligation, to elect to continue the business of the Partnership for the balance of the term as specified in paragraph 4. The election may be exercised by notice to the Limited Partners stating in substance that the Remaining General Partners have elected to continue the business of the Partnership.

(b) *Purchase options.* In the event that the election is exercised upon the death or adjudication of insanity or incompetency of a General Partner, the Remaining General Partners shall have the option to purchase (pro rata, or as they may otherwise agree among themselves) the entire interest of the Withdrawing General Partner for a cash price equal to the original contribution of the Withdrawing General Partner plus his proportionate share of mortgage amortization payments made by the Partnership less any distributions of capital made to him from the proceeds of any mortgage refinancing.

(c) *Bankruptcy or retirement.* In the event that the election is exercised upon the adjudication of bankruptcy or retirement of a General Partner, the Remaining General Partners shall have the option to purchase (pro rata, or as they may otherwise agree among themselves) the entire interest of the Withdrawing General Partner for a cash price equal to the original contribution of such Withdrawing General Partner, less all distributions of capital theretofore made to him from the proceeds of any mortgage refinancing.

(d) *Exercise of purchase option.* Any of the foregoing options may be exercised by notice thereof to the Withdrawing General Partner, within 60 days after the remaining General Partners shall have elected to continue the business of the Partnership or the appointment of the legal representative of the deceased, bankrupt, insane, or incompetent General Partner, as the case may be, whichever is the later. Until such option is exercised and payment made thereunder, the Withdrawing General Partner shall be entitled to receive distributions applicable to his interest.

(e) *Limited partner alternative.* In the event the Remaining General Partners do not exercise their option to purchase, the Withdrawing General Partner shall become a Limited Partner of the Partnership with the same interest in the Partnership capital and profits as the Withdrawing General Partner had.

21. *Distribution on dissolution.* (a) *Liquidation priority.* Upon the dissolution and termination of the Partnership, the then General Partners shall proceed to the liquidation of the Partnership. The proceeds of liquidation shall be applied and distributed in the following order of priority:

(1) To the payment of the Partnership's debts and liabilities (other than any loans or advances that may have been made by any of the Partners to the Partnership) and the expenses of liquidation.

(2) To the setting up of any reserves which the General Partners may deem reasonably necessary for any contingent or unforeseen liabilities or obligations of the Partnership or of the General Partners, arising out of or in connection with the

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Partnership. The General Partners shall pay over the reserves to a New York State attorney-at-law, as escrowee, to be held by him for the purpose of disbursing them in payment of any of the contingencies. At the expiration of a period that the General Partners shall deem advisable, the escrowee shall distribute the balance remaining in the manner provided in subparagraphs (3) and (4) of this paragraph 21.

(3) To the repayment of all loans or advances that any of the Partners may have made to the Partnership, but if the amount available for repayment shall be insufficient, then pro rata on account thereof.

(4) Any balance then remaining shall be distributed among all General and Limited Partners, pro rata, in accordance with the amounts of their respective original contributions to the Partnership capital.

(b) *Liquidation period.* A reasonable time shall be allowed for the orderly liquidation of the Partnership assets and the discharge of liabilities to creditors so as to enable the General Partners to minimize the normal losses attendant upon a liquidation.

(c) *Financial statement, termination.* Each of the Partners shall be furnished with a statement prepared by the Partnership's then accountants, which shall set forth the Partnership assets and liabilities as at the date of complete liquidation. Upon the General Partners complying with the distribution plan (including payment over to the attorney escrowee if there are sufficient funds therefor), the Limited Partners shall cease to be such, and the General Partners, as the sole remaining partners of the Partnership, shall execute, acknowledge and cause to be filed a certificate of cancellation of the Partnership.

(d) *Return of capital contribution.* The General Partners shall not be personally liable for the return of the capital contributions of Limited Partners, or any portion thereof. Any such return shall be made solely from Partnership assets.

22. *Withdrawal by limited partners.* No Limited Partner shall at any time withdraw from the Partnership, except as hereinbefore provided.

23. *Power of attorney.* (a) *Partnership documents.* In addition to the powers of attorney contained in paragraph 16, each of the Limited Partners irrevocably constitutes and appoints the General Partners, or any one of them, jointly and severally, his true and lawful attorney, in his name, place, and stead, to make, execute, acknowledge, and file:

- (1) a certificate of limited partnership under the laws of the State of New York;
- (2) any certificate or other instrument which may be required to be filed by the Partnership under the laws of the State of New York or which the General Partners shall deem it advisable to file;
- (3) any and all amendments or modifications of the instruments described in the preceding subdivisions (1) and (2); and
- (4) all documents which may be required to effectuate the dissolution and termination of the Partnership;

It is expressly intended by each of the Limited Partners that the foregoing power of attorney is coupled with an interest.

(b) *Survival.* The foregoing power of attorney, as well as the powers contained in paragraph 16, shall survive the delivery of an assignment by any of the Limited Partners of the whole or any portion of his limited partnership interest. Where, however, the General Partners have approved an assignee of a limited partnership interest as a Substituted Limited Partner, then the foregoing power of attorney of the assignor Limited Partner shall survive the delivery of the assignment for the sole purpose of enabling the General Partners to execute, acknowledge, and file any and all instruments necessary to effectuate the substitution.

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(c) *Substitute limited partners.* A similar power of attorney shall be one of the instruments which the General Partners, under para graph 18, shall require an assignee of a Limited Partner to execute as a condition of his admission as a substituted Limited Partner.

(d) *Tax election.* In the discretion of the General Partners, the Partnership may, but shall not be obliged to, make or revoke the election referred to in *Section 754 of the Internal Revenue Code of 1954* or any similar provision enacted in lieu of Section 754. Each of the Partners shall supply to the Partnership the information necessary, properly to give effect to such election.

(e) *Disability.* This power of attorney, and any other power of attorney granted by this agreement, shall not be affected by the subsequent disability or incompetence of the principal.

24. *Acknowledgment of limited partners.* (a) *Other instruments.* Each of the Additional Limited Partners acknowledges that statements contained in this agreement as to the contents of any agreement or other instrument are not necessarily complete. In each instance reference is made to the copies of such instruments which have been available for inspection by the Additional Limited Partners as hereinafter set forth.

(b) *Prospectus.* Each of the Additional Limited Partners further acknowledges that prior to the date of execution of a counterpart of this agreement he received and examined a copy of the Prospectus filed with the Securities and Exchange Commission, as amended to the execution date.

(c) *Inspection.* True copies of the Purchase Agreements and exhibits annexed thereto, the Registration Statement filed with the Securities and Exchange Commission, and all other instruments related to this transaction shall be available for inspection by each of the Additional Limited Partners prior to the submission of a counterpart hereof for his signature. Such availability for inspection shall be at the Partnership's principal office.

25. *Notice.* All notices under this agreement shall be in writing, and shall be given to the parties at the addresses herein set forth and to the Partnership at its principal office, or at such other address as any of the parties may hereafter specify in the same manner.

26. *General partners' option.* If all the General Partners deem it to be in the best interests of the Partnership, they may treat an assignee, who has not become a Substituted Limited Partner, as a Substituted Limited Partner in the place and stead of his assignor.

27. *Captions.* Paragraph titles or captions contained in this agreement are inserted only as a matter of convenience and for reference, and in no way define, limit, extend, or describe the scope of this agreement or the intent of any provision hereof.

28. *Variations in pronouns.* All pronouns and variations thereof shall be deemed to refer to the masculine, feminine, singular, or plural as the identity of the person or persons may require.

29. *Arbitration.* Any dispute or controversy arising under, out of, in connection with, or in relation to this agreement, and any amendment thereof, or the breach thereof, or in connection with the formation, operation, or dissolution of the Partnership, shall be determined and settled by arbitration in New York City in accordance with the rules of the American Arbitration Association. Any award rendered therein shall be final and binding on each and all of the Partners, and judgment may be entered thereon in any court of competent jurisdiction.

30. *Conversion.* Notwithstanding the foregoing, nothing in paragraph 29 shall affect the right of any Partner to bring an action for conversion in the event of violation of the trust provisions of Section 352-h of the General Business Law of the State of New York.

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31. *Agreement in counterparts.* This agreement may be executed in several counterparts, and all so executed shall constitute one agreement, binding on all the parties, notwithstanding that all the parties are not signatory to the original or the same counterpart.

32. *Partners' representation.* Each of the Partners represents and warrants that he is over the age of 21 years, and that the residence address set forth opposite or below his name, as the case may be, at the end of this agreement is his bona fide residence.

33. *Cash contributions.* At the election of the General Partners, cash contributions by Limited Partners to the Partnership capital may be in the form of cash, bank draft, certified check, or uncertified check subject to collection.

34. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

35. *Non-waiver.* No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

36. *Governing law.* This agreement and the rights of the parties hereunder shall be construed in accordance with and governed by the laws of the State of New York.

37. *Binding effect.* Except as otherwise expressly provided herein, the provisions of this agreement shall be binding upon and inure to the benefit of each of the parties and their respective personal representatives, successors, and assigns.

In witness whereof the parties have executed this agreement.

General Part-
ners

John Baker	68 Greenwich Avenue New York, New York
Marvin Harris	14 Fifth Avenue New York, New York
Alvin Johnson	15 Center Avenue Larchmont, New York

Limited Part-
ners

William Minton	300 Fifth Avenue New York, New York
Oscar Kindler	10 Oak Lane Hartsdale, New York
Donald Enright	210 Main Street Hicksville, New York

Additional Limited Partner

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Confirmed, Approved, and Adopted:

(1) _____

(Additional Limited Partner--Signature)

(2) _____

(Print residence address here)

(3) Capital Contributions \$ _____

(If by check, subject to collection)

(4) _____

(Additional Limited Partner--Print full name here)

(Agreement Authentic Only if Signed by a General Partner)

Attested and Accepted on _____, 2002.

General Partner _____

A.9 Limited partnership--corporate general partner--sale of limited partnership units to the public--detailed provisions concerning the general partner's fees, powers, and duties

COMMENT

One of the principal features of this limited partnership agreement is that a corporation is the sole general partner. The Uniform Limited Partnership Act ("ULPA") has been modified in several states to specifically permit a corporation to act as general partner in a partnership. A major benefit of this arrangement is to permit the possibility of limited liability for the persons holding shares in the corporate general partner, as well as limited liability for the limited partners. There is some conflict of authority, however, as to whether a limited partner, who is also a director, officer and/or principal shareholder of the corporate general partner, exercises sufficient "control" so as to be personally liable as a general partner under the ULPA. Local law on these issues should be consulted.

Publicly traded partnerships taxed as corporations:

A partnership first publicly traded after December 17, 1987 is generally treated as a corporation for tax purposes. A partnership is publicly traded if its partnership interests are either traded on an established securities market, or readily tradable on a secondary market or the substantial equivalent of a secondary market. An exception to corporate tax treatment applies to certain partnerships if 90 percent or more of

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their gross income is qualifying passive-type income, including real property rents, and gains from the sale or other disposition of real property.

Net income from a publicly traded partnership is not treated as passive income for purposes of the passive loss rules. Each partner in a publicly traded partnership treats loss, if any, from the partnership as separate from income and loss from any other publicly traded partnership, and separate from any income or loss from passive activities. Under the passive loss rules net income from publicly traded partnerships is treated as portfolio income.

Parties who wish to avoid "publicly traded" status can include a prohibition against any transfer that would cause the partnership to become publicly traded.

For further information, see Chapter 14.

FORM

This PARTNERSHIP AGREEMENT ("Partnership Agreement") entered into as of September 2, 2002, by and between NWP Management Corp., a Delaware corporation ("General Partner"), as General Partner, and Arthur D. Smith, as the original Limited Partner, all of whom hereby form a limited partnership pursuant to the Uniform Limited Partnership Act of the State of California, upon the following terms and conditions:

1. Name and Place of Business

The name of the Partnership is New World Property Investors. Its principal place of business is 10946 Victory Boulevard, Van Nuys, California, or such other place or places as the General Partner may hereafter determine.

2. Definitions and Glossary of Terms

2.1 The following terms used in this Partnership Agreement shall (unless otherwise expressly provided herein or unless the context otherwise requires) have the following respective meanings:

2.1.1 "Acquisition Fees" shall mean the total of all fees and commissions paid by any person to any person, including any Sponsor, in connection with the selection, purchase, or initial operation of any Property by the Partnership, whether designated as real estate commission, selection fee, management fee, nonrecurring start-up fee, development fee, construction fee, or any fee of a similar nature, however designated, but not any loan fee ("points"), independent appraisal fees, engineering fees or architectural fees in connection with the selection, purchase or initial operation of any Property by the Partnership.

2.1.2 "Adjusted Cash From Operations" shall mean the excess of cash revenue from operation of Partnership Property (including lease payments on net leases) over cash disbursements without deduction for depreciation and amortization of intangibles such as organization, underwriting and debt placement costs but after a reasonable allowance for cash reserves for repairs, replacements, contingencies and anticipated obligations (including debt service), as determined by the General Partner. Adjusted Cash from Operations shall not include Cash From Sales or Refinancings, Cash From

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Initial Financings, or Cash From Property Reserve Account.

2.1.3 "Adjusted Invested Capital" of a Holder shall be the Original Invested Capital paid for or attributable to his Units reduced by the total of cash distributed to him and prior Holders of his Units from Cash From Sales or Refinancings and from Cash From Property Reserve Account (to the extent such cash distributed came from Net Proceeds).

2.1.4 "Affiliate" shall refer to: (i) any person directly or indirectly controlling, controlled by or under common control with another person, (ii) a person owning or controlling 10 percent or more of the outstanding voting securities of such other person, (iii) any officer, director or partner of such person, and (iv) if such other person is an officer, director or partner, any company for which such person acts in any such capacity.

2.1.5 "Assignee" shall mean a person who has acquired a beneficial interest in one or more Units from a third party but who is neither a substituted Limited Partner nor an Assignee of Record.

2.1.6 "Assignee of Record" shall mean an Assignee who has acquired a beneficial interest in one or more Units whose ownership of such Units has been recorded on the books of the Partnership and which ownership is the subject of a written instrument of assignment, the effective date of which assignment has passed.

2.1.7 "Cash From Initial Financing" shall mean the net cash realized by the Partnership during that portion of the term of the Partnership ending 24 months after the effective date of the Prospectus from the initial financing of any Partnership Property purchased for all cash.

2.1.8 "Cash From Property Reserve Account" shall mean that portion of the Net Proceeds not utilized in the acquisition of Partnership Properties including cash maintained according to the provisions of Paragraph 3.2.

2.1.9 "Cash From Sales or Refinancing" shall mean the net cash realized by the Partnership from the sale, refinancing or other disposition of any Partnership Property after retirement of applicable mortgage debt and all expenses related to the transaction; however, Cash From Sales or Refinancing shall not include Cash From Initial Financing or Cash From Property Reserve Account.

2.1.10 "Closing Date" shall mean such date designated by the General Partner, but not later than November 12, 2002.

2.1.11 "Code" shall mean the Internal Revenue Code of 1986, as amended, or corresponding provisions of subsequent revenue laws.

2.1.12 "Cost of Partnership Property" with respect to each Partnership Property means the total consideration paid for federal income tax purposes by the Partnership in connection with the purchase of such Property, whether paid to the seller, the General Partner or any other person, either in cash or by way of promissory notes, including payments for Acquisition Fees paid by the Partnership, if any, and financing charges. Reference to "Cost Of All Partnership Properties" shall be the total of such consideration paid by the Partnership for all Partnership Properties.

2.1.13 "Distributions" shall refer to any cash or other property distributed to Holders and the General Partner arising from their interests in the Partnership, but shall not include any payments to the General Partner under the provisions of Paragraph 9 or Paragraph 10.

2.1.14 "General Partner" shall refer to NWP Management Corp., a Delaware corporation, or to any other person or corporation who succeeds it in such capacity.

2.1.15 "Gross Proceeds" shall mean the aggregate total of the Original Invested Capital of the original and all of the additional Limited Partners.

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2.1.16 "Gross Revenues" shall mean revenues from the operation of real property owned by the Partnership other than from security deposits paid by lessees thereof. The term "Gross Revenues" shall not include revenues from sale, refinancing or other disposition of Partnership Properties.

2.1.17 "Holders" shall refer to owners of Units who are either Partners or Assignees of Record, and reference to a "Holder" shall be to any one of them. The General Partner shall be considered to be a Holder.

2.1.18 "Limited Partners" shall refer to the original Limited Partner, and to any other persons who are admitted to the Partnership as additional or substituted Limited Partners. Reference to a "Limited Partner" shall refer to any one of them.

2.1.19 "Majority Vote" shall mean the vote of Limited Partners who own more than 50 percent of the Total Outstanding Units.

2.1.20 "Net Income" or "Net Loss" shall mean the net income or net loss of the Partnership, as determined in accordance with the cash method of accounting.

2.1.21 "Net Proceeds" shall mean the total Gross Proceeds less expenses incurred and to be paid by the Partnership in organizing the Partnership and in offering Units to the public.

2.1.22 "Original Invested Capital" shall mean the amount in cash contributed by the original and each additional Limited Partner to the capital of the Partnership for his Units, which amount shall be attributed to such Units in the hands of a subsequent Holder.

2.1.23 "Partners" shall refer collectively to the General Partner and to the Limited Partners, and reference to a "Partner" shall be to any one of the Partners.

2.1.24 "Partnership" shall refer to the Limited Partnership created under this Partnership Agreement.

2.1.25 "Partnership Properties" or "Properties" shall refer to all properties or any interest therein acquired directly or indirectly by the Partnership, in whole or in part, with Net Proceeds or Cash From Initial Financing. Reference to "Partnership Property" or "Property" shall be to any one of them.

2.1.26 "Prospectus" shall mean the final prospectus in the registration of Units filed with the Securities and Exchange Commission on Form S-11, as amended.

2.1.27 "Sponsor" shall mean any person directly or indirectly instrumental in organizing, wholly or in part, the Partnership or who will manage or participate in the management of the Partnership including the General Partner and its Affiliates, but excluding (i) any nonaffiliated person whose only relationship with the Partnership or the General Partner is that of an independent property manager whose only compensation from the Partnership is as such, and (ii) nonaffiliated third parties such as attorneys, accountants, and underwriters whose only compensation from the Partnership is for professional services rendered in connection with the offering of Units or the operations of the Partnership.

2.1.28 "Subordinated Incentive Fee" shall refer to the fee payable to the General Partner and its Affiliates under the provisions of Paragraph 9.5.1 of this Partnership Agreement.

2.1.29 "Total Outstanding Units" shall mean all Units issued at or before the Closing Date.

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2.1.30 A "Unit" shall represent a capital contribution of \$500 to the Partnership and shall entitle the Holder thereof to an interest in the Net Income, Net Loss, and Distributions of the Partnership, without regard to capital accounts.

3. Business and Purpose

3.1 The primary purpose (character of business) of the Partnership is to invest in, hold and manage income-producing real estate which is improved or which will be improved within a reasonable period after acquisition, with emphasis planned to be upon the acquisition of existing apartment complexes, shopping centers, industrial buildings and commercial properties located in the United States. The Partnership may enter into ventures, partnerships, and other business arrangements with respect to real estate deemed prudent by the General Partner in order to achieve successful operations for the Partnership; subject, however, to the provisions of Paragraph 15.3.8.

3.2 For the Partnership Properties, the Partnership shall initially endeavor to maintain a cash reserve for normal repairs, replacements, contingencies and accruals required by mortgages for insurance, real estate taxes and related items in an amount equal to at least five percent in the aggregate of the Gross Proceeds applicable to the acquisition of such Properties. Upon the disposition of each Partnership Property, any cash reserve for that Property need not be maintained thereafter, but may be applied as reserves for other Properties. Any cash reserve used as aforesaid need not be restored and if restored, shall be restored from cash generated from Partnership Properties.

3.3 Subject to the provisions of Paragraphs 11.10 and 11.11, during that part of the Partnership term which ends 24 months after the effective date of the Prospectus, the Partnership may obtain initial financing on any Partnership Property purchased for all cash, and may reinvest all proceeds therefrom. The Partnership may also reinvest proceeds from any financing effected during the period commencing 24 months and ending 60 months after the Closing Date. Thereafter, proceeds from any financing or refinancing shall not be reinvested but shall be available for and used in Distributions.

4. Term

The Partnership commenced September 2, 2002, and shall continue until December 31, 2026, unless sooner terminated in accordance with the provisions of this Agreement.

5. General Partner

5.1 NWP Management Corp., as the General Partner, has contributed \$500 in cash to the Partnership. The General Partner shall on the Closing Date contribute additional cash in the sum of \$100,000 as a Limited Partner, and shall receive 200 Units for such additional cash contributions, and at all times during the existence of the Partnership, have a present and continuing interest in Net Income, Net Loss and Distributions according to the provisions of Paragraph 11.

5.2 In the event that, immediately prior to the dissolution of the Partnership referred to in Paragraph 19.2, the General Partner shall have a deficiency, if any, in its capital account, and if the assets available for distribution upon the dissolution and termination of the Partnership are insufficient to allow Distributions to the Holders of Units of amounts

equal to the then balances in their capital accounts, then, the General Partner shall contribute in cash to the capital of the Partnership an amount equal to whichever is less of (a) the deficiency in the General Partner's capital account, or (b) the amount needed so that the Distributions may be made to the Holders of Units is an amount equal to the then balances in their respective capital accounts.

6. Original and Additional Limited Partners

6.1 The original Limited Partner has contributed the sum of \$2,500 to the capital of the Partnership, and has received five Units for such contribution.

6.2 The Partnership intends to sell and issue not less than 6,200 nor more than 20,000 additional Units, and to admit as additional Limited Partners the persons who contribute cash to the Partnership capital for such Units.

6.3 Each person who acquires any such additional Units shall become a Limited Partner in the Partnership at such time as he has: (i) purchased five or more Units, (ii) contributed the sum of \$500 in cash for each Unit purchased, and (iii) executed and filed with the Partnership a written instrument which sets forth an intention to become a Limited Partner and requests admission to the Partnership in that capacity, together with such other instruments as the General Partner may deem necessary or desirable to effect such admission, including the written acceptance and adoption of such person of the provisions of this Partnership Agreement, and the execution, acknowledgement and delivery to the General Partner of a special power of attorney, the form, style and content of which are more fully described in Paragraph 20.

6.4 The General Partner shall in timely fashion amend (but not later than the last day of the calendar month following the date of acceptance of the additional Limited Partner's subscription) this Partnership Agreement and any separate certificate of limited partnership filed for record to reflect the admission of a person as an additional Limited Partner.

6.5 The Partnership shall not issue any additional Units after the Closing Date.

6.6 All Original Invested Capital of Holders shall be received by the Partnership in trust, and shall be deposited in an escrow account in any branch of the Bank of America National Trust and Savings Association or in any other banking institution designated by the General Partner as escrow holder for the Original Invested Capital. Upon receipt of a minimum of \$3,000,000 in Original Invested Capital from purchasers of Units, the Partnership shall admit such purchasers into the Partnership as additional Limited Partners not later than 15 days after the receipt of such minimum. At the time the purchaser is admitted as a Limited Partner, the escrow holder shall transfer such person's Original Invested Capital to the Partnership. If the \$3,000,000 minimum amount is not obtained within 180 days from the effective date of the Prospectus, all Original Invested Capital shall be promptly refunded to the purchasers with any interest earned thereon.

7. Status of Limited Partners

Limited Partners shall not be bound by, or be personally liable for, the expenses, liabilities or obligations of the Partnership.

8. Status of Units

Each Unit shall be fully paid and nonassessable.

9. Compensation to General Partner and its Affiliates

9.1 The General Partner and its Affiliates shall receive compensation only as specified by this Partnership Agreement.

9.2 *Limitation on Compensation*

9.2.1 The aggregate amount of the Acquisition Fees shall not exceed the lesser of: (i) 15 percent of Gross Proceeds, (ii) the normal and competitive rate for similar services in the locations where the services are performed, or (iii) 3 percent of the Cost of all Partnership Properties.

9.2.2 The amount of the Acquisition Fees with respect to a particular Partnership Property shall not exceed the lesser of: (i) 15 percent of that portion of the Gross Proceeds applicable to the Partnership Property which is the subject of the acquisition, (ii) the normal and competitive rate for similar services in the location where the services are performed, or (iii) 3 percent of the Cost of such Partnership Property.

9.2.3 The Partnership shall pay no Acquisition Fee to any of its Affiliates, nor shall any of its Affiliates receive a fee, commission, or other benefit from any person, upon any reinvestment of the Cash From Sales or Refinancing of Property by the Partnership other than any Acquisition Fees in connection with the investment of Cash From Initial Financing.

9.2.4 Except as set forth in Paragraph 9, no other real estate commission, property purchase fee, or finder's fee shall be paid or payable by the Partnership to the General Partner or to any other person in connection with the acquisition of specific real properties. However, if such commissions or fees exceed the limitations in this Paragraph 9.2, the General Partner may cause Acquisition Fees to be paid to other persons, without cost to the Partnership.

9.3 *Acquisition Stage*

9.3.1 *Acquisition fee.* The General Partner or its Affiliates or any person shall receive an Acquisition Fee not greater than 15 percent of that portion of the Gross Proceeds applicable to each Partnership Property purchased through the services of the General Partner or its Affiliates. Such fee shall be paid by the seller of the Partnership Property acquired and not by the Partnership.

9.4 *Operating Stage (Operating Compensation)*

9.4.1 *Property management fee.* The General Partner or an Affiliate shall be entitled to a Property Management Fee for services in providing continuing professional property management or supervision of professional property managers of the Partnership Properties. Such fee shall be paid monthly and shall be equal to 5 percent of Gross Revenues for the preceding month (but not to exceed rates prevailing for comparable services in the localities where the Properties are located). In the event the General Partner retains third parties to perform a portion or all of the services set forth below, it shall be solely responsible for all fees charged by such persons and shall pay such fees without cost to the Partnership. Property management services shall include, but not be limited to: (i) review of the maintenance, repair, remodeling and refurbishing of all Partnership Properties, (ii) review of rental schedules and recommendations with respect to changes

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thereto, (iii) supervision of on-site property managers and other employees together with the establishment of procedures regarding the management of Partnership Properties, (iv) preparation and review of rental surveys, (v) preparation and review of historical and projected performance, (vi) preparation and review of leases, management agreements and maintenance agreements, and (vii) review of replacement reserves and working capital and recommendations with respect to changes thereto. Property management services to be rendered by the General Partner or by third parties retained by it do not include the leasing or releasing of Partnership Properties or the salaries of on-site property managers for which separate fees may be paid.

9.5. *Liquidating Stage (Final Compensation)*

9.5.1 *Subordinated incentive fee.* The General Partner shall be entitled to receive the Subordinated Incentive Fee as compensation for the services rendered in: evaluating and selecting Properties for the Partnership; making decisions as to the nature and terms of the acquisition and disposition of such Properties; selecting, retaining, and supervising consultants, contractors, architects, engineers, lenders, borrowers, and others; and otherwise generally managing the Partnership's day-to-day operations. The Subordinated Incentive Fee shall be an amount equal to 15 percent of the remaining Cash from Sales or Refinancings in excess of the Cost of All Partnership properties, and shall be paid when such Cash From Sales or Refinancings is distributed. Payment of 50 percent thereof, however, shall be computed on the remainder after the Partnership has distributed to Holders an aggregate amount in cash which is equal to (i) the total of Original Invested Capital, and (ii) a sum equal to 6 percent per year cumulative on their Adjusted Invested Capital, commencing with the third full fiscal quarter following the Closing Date. Payment of 50 percent thereof shall be computed on the remainder after the Partnership has distributed to Holders an aggregate amount in cash which is equal to (i) the total of Original Invested Capital, and (ii) a sum equal to 10 percent per year cumulative on their Adjusted Invested Capital, commencing with the third full fiscal quarter following the Closing Date.

9.6 If the General Partner is expelled from the Partnership, such Partner shall be entitled to interest on all loans so made subject to the provisions of this Partnership Agreement.

9.7 Should the General Partner be expelled from the Partnership any portion of the Acquisition Fee, Property Management Fee, Subordinated Incentive Fee, or any other fee or commission payable according to the provisions of this Paragraph 9 which is then accrued and due, but not yet paid, shall be paid by the Partnership to the General Partner in cash within 30 days of the date of expulsion as stated in the written notice of expulsion.

10. Partnership Expenses

10.1 Reimbursement (other than for organization and offering expenses) to the General Partner or its Affiliates shall not be made, except for reimbursement of the actual cost to the General Partner or its Affiliates of goods and materials used for or by the Partnership. Reimbursement of the actual costs to the General Partner and its Affiliates of travel expenses shall be limited as follows: the amount of such reimbursement plus the amount of Acquisition Fees paid to any party in connection with the acquisition of Partnership Properties and the amounts payable to the General Partner under Paragraph 11.4 shall not exceed the lesser of (a) 12 percent of the Gross Proceeds of the offering (or, if less, the real estate commissions or Acquisition Fees customarily charged in arm's length transactions by others in the same geographical location for comparable property to that acquired by the Partnership), or (b) 10 percent of the total amount of Adjusted Cash From Operations. In addition, such reimbursement as to expenses relating to the acquisition of the Partnership Properties shall not be made if and to the extent that such expenses, when combined with the Acquisition Fees payable to any party in connection with the acquisition of the Partnership Properties, exceed 6 percent of the Cost of all Partnership Properties acquired. The reimbursement for expenses provided for in this Paragraph 10.1 shall be made to the General Partner regardless of whether any Distributions are made to the Limited Partners under the

provisions of Paragraph 11.4.

10.2 The General Partner shall pay: (i) salaries and other compensation of its officers and directors incidental to the organization of the Partnership, the sale of Units and the acquisition of Partnership Properties, (ii) expenses incurred by the General Partner or its Affiliates in connection with the administration of the Partnership, including the overhead expenses of the General Partner or its Affiliates, (iii) expenses incidental to the organization of the Partnership and marketing of Units (exclusive of sales commissions payable in connection with the sale of Units to those persons who are admitted to the Partnership as additional Limited Partners therein), which expenses are in excess of 2.25 percent of Gross Proceeds, (iv) expenses related to the performance of those services for which the General Partner or its Affiliates are entitled to compensation by way of the Acquisition Fee, Property Management Fee and Subordinated Incentive Fee, and (v) all other expenses which are unrelated to the business of the Partnership.

10.3 Subject to Paragraphs 10.1 and 10.2, the Partnership shall pay all of its expenses. Such expenses may include, but shall not be limited to: (i) all costs of personnel employed by the Partnership and involved in its business, including persons who may also be officers or employees of the General Partner; (ii) all costs of borrowed money, taxes and assessments on Partnership Properties and other taxes applicable to the Partnership; (iii) legal, audit, accounting, brokerage and other fees; (iv) printing, engraving and other expenses and taxes incurred in connection with the issuance, distribution, transfer, registration and recording of documents evidencing ownership of an interest in the Partnership or in connection with its business; (v) fees and expenses paid to independent contractors, mortgage bankers, brokers and servicers, leasing agents, consultants, on-site managers, real estate brokers, insurance brokers and other agents; (vi) expenses in connection with the disposition, replacement, alteration, repair, remodeling, refurbishment, leasing, refinancing and operation of Partnership Properties (including the costs and expenses of foreclosures, insurance premiums, real estate brokerage and leasing commissions and of maintenance of such Property); (vii) the cost of insurance as required in connection with the business of the Partnership; (viii) expenses of organizing, revising, amending, converting, modifying or terminating the Partnership; (ix) expenses in connection with Distributions made by the Partnership to, and communications and bookkeeping and clerical work necessary in maintaining relations with Unit Holders, including the cost of printing and mailing to such persons certificates for Units and reports of meetings of the Partnership, and of preparation of proxy statements and solicitations of proxies in connection therewith; (x) expenses in connection with preparing and mailing reports required to be furnished to Unit Holders for investor, tax reporting or other purposes, or which reports the General Partner deems the furnishing thereof to Unit Holders to be in the best interests of the Partnership; (xi) costs of any accounting, statistical or bookkeeping equipment necessary for the maintenance of the books and records of the Partnership; and (xii) the cost of preparation and dissemination of the informational material and documentation relating to potential sale, refinancing or other disposition of Partnership Property.

11. Allocation of Income, Loss, and Distributions

11.1 That portion of Net Income, Net Loss and Distributions of the Partnership allocated to the Unit Holders shall be apportioned among the Holders, in the ratio in which the number of Units owned by each of them on the last day of each calendar quarter bears to the total number of Units owned by all of them as of that date, without regard to capital accounts or the number of days during such quarter in which a person was a Holder.

11.2 *Allocation of net loss.* Except as provided in Section 11.9 of this Partnership Agreement, Net Loss shall be allocated as follows:

11.2.1 One percent shall be allocated to the General Partner.

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11.2.2 Ninety-nine percent shall be allocated to the Unit Holders.

11.3 *Allocation of net income.* Net Income shall be allocated as follows:

11.3.1 One percent shall be allocated to the General Partner.

11.3.2 Ninety-nine percent shall be allocated to the Unit Holders.

11.4 *Distribution of adjusted cash from operations.* Adjusted Cash From Operations shall be distributed as follows:

11.4.1 One percent shall be distributed to the General Partner.

11.4.2 Ninety-nine percent shall be distributed to the Unit Holders.

11.5 *Distributions of cash from sales and refinancings and cash from property reserve account.* Cash From Sales and Refinancings and Cash From Property Reserve Account shall be distributed in the following order of priority (for purposes of this Paragraph 11.5, Adjusted Invested Capital shall not be reduced by the amount of Distributions of Cash From Sales and Refinancings and Cash From Property Reserve Account that is applied toward the preference to Unit Holders pursuant to Paragraph 11.5.1(i)):

11.5.1 First, to the Unit Holders, in an amount equal to: (i) the amount, when added to all prior Distributions to the Unit Holders, that shall be equal to 6 percent per annum cumulative on their Adjusted Invested Capital commencing with the third full fiscal quarter following the Closing Date, and (ii) the Original Invested Capital.

11.5.2 Second, to the General Partner, in an amount equal to the initial portion of the Subordinated Incentive Fee it is entitled to under Paragraph 9.5.1.

11.5.3 Third, to the Unit Holders, in an amount equal to 4 percent per annum cumulative on their Adjusted Invested Capital commencing with the third full fiscal quarter following the Closing Date.

11.5.4 Fourth, to the General Partner, in an amount equal to the remaining portion of the Subordinated Incentive Fee it is entitled to under Paragraph 9.5.1.

11.5.5 Fifth, with respect to the remainder, 1 percent to the General Partner and 99 percent thereof to the Unit Holders.

11.6 The Partnership may be restricted from making Distributions under the terms of notes, mortgages or other types of debt obligation which it may issue or assume in conjunction with borrowed funds, and Distributions may also be restricted or suspended in circumstances when the General Partner determines, in its absolute discretion, that such action is in the best interests of the Partnership.

11.7 The methods hereinabove set forth by which Distributions and allocations of Net Income and Net Loss are made and apportioned are hereby expressly consented to by each Partner as an express condition to becoming a Partner.

11.8 All Distributions are subject to the payment of Partnership expenses, and to the maintenance of reasonable reserves for alterations, repairs, improvements, maintenance, and replacement of furniture and fixtures.

11.9 To the extent that the Partnership shall be entitled to any deduction for federal income tax purposes as a result of any interest in Net Income and Net Loss granted to the General Partner, such deduction shall be allocated for federal income tax purposes to the General Partner.

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11.10 During the first 60 months after the Closing Date, the General Partner shall also distribute after the completion of each calendar year such amounts of Cash From Sales or Refinancings (when considered with prior distributions of Adjusted Cash From Operations) sufficient to allow a Holder in a 28 percent federal, income tax bracket to pay the income taxes due with respect to Net Income derived by him from the operations of the Partnership.

11.11 In the event that any portion of the Net Proceeds are not invested or committed for investment within 24 months from the effective date of the Prospectus (except for any amounts utilized to pay Partnership operating expenses, including amounts set aside for reserves as set forth in Paragraph 3.2 of this Partnership Agreement), such portion of the Net Proceeds shall be distributed to the Unit Holders by the Partnership as a return of capital. For the purposes of this Paragraph 11.11, funds will be deemed to have been committed to investment and will not be returned to the Unit Holders to the extent written agreements in principle or letters of understanding were at any time executed, regardless of whether any such investment may or may not be consummated, and to the extent any funds have been reserved to make contingent payments in connection with any Property, regardless of whether any such payments may or may not be made.

12. Assignment of Partnership Units

12.1 Holders shall have the right to assign five or more whole Units (or, if fewer, the number of Units owned by the Partner) by a written instrument of assignment. The terms of such instrument shall not be in contravention of any provision of this Partnership Agreement, and the instrument shall have been duly executed by the assignor of such Units. A Limited Partner shall within 30 days after assignment notify the General Partner of any assignment of a beneficial interest in any Units which occurs without a transfer of record ownership.

12.2 An Assignee of Record shall be entitled to receive distributions of cash or other property from the Partnership attributable to the Units acquired by reason of such assignment from and after the effective date of the assignment of such Units to him. Anything herein to the contrary notwithstanding, however, the Partnership and the General Partner shall be entitled to treat the assignor of such Units as the absolute owner thereof in all respects, and shall incur no liability for allocations of Net Income, Net Loss, or Distributions, or transmittal of reports and notices required to be given to Holders hereunder which are made in good faith to such assignor until such time as the written instrument of assignment has been received by the Partnership and recorded on its books and the effective date of the assignment has passed. Provided the Partnership has actual notice of an assignment of Units, the effective date of such assignment on which the Assignee shall be deemed as Assignee of Record shall be the first day of the month set forth on the written instrument of assignment.

12.3 Except as provided in this Paragraph 12.3, no assignment of any Units by a Holder may be made if the Units sought to be assigned, when added to the total of all other Units assigned within the period of 12 consecutive months prior to the proposed date of assignment would, in the opinion of counsel for the Partnership, result in the termination of the Partnership under Section 708 of the Code. Such assignment may be made, however, if, upon the application and at the expense of the Holder desiring to assign his Units in the Partnership, the Internal Revenue Service shall have granted to the transferring Holder and the Partnership a private ruling that the proposed assignment will not cause such termination.

12.4 No assignment, sale, transfer, exchange or other disposition of any Units in the Partnership may be made except in compliance with the then applicable rules of any other applicable governmental authority.

12.5 Any assignment, sale, exchange, or other transfer in contravention of any provision of this Paragraph 12 shall be void and ineffectual, and shall not bind or be recognized by the Partnership.

13. Substituted Limited Partners

13.1 No Assignee shall have the right to become a substituted Limited Partner in place of his assignor unless all of the following conditions are first satisfied:

13.1.1 A duly executed and acknowledged written instrument of assignment shall have been filed with the Partnership. Such instrument shall specify the number of Units being assigned and set forth the intention of the assignor that the Assignee succeed to the assignor's interest as a substituted Limited Partner in his place;

13.1.2 The assignor and Assignee shall have executed and acknowledged such other instruments as the General Partner may deem necessary or desirable to effect such substitution, including the written acceptance and adoption by the Assignee of the provisions of this Partnership Agreement, as the same may be amended and his execution, acknowledgement and delivery to the General Partner of a special power of attorney, the form and content of which are described herein;

13.1.3 The written consent of the General Partner to such substitution shall have been obtained, the granting or denial of which shall be within its absolute discretion;

13.1.4 A transfer fee shall have been paid to the Partnership which is sufficient to cover all reasonable expenses connected with such substitution; and

13.1.5 The provisions of Paragraphs 12.3 and 12.4 of this Partnership Agreement are complied with.

13.2 By executing or adopting this Partnership Agreement, each Limited Partner hereby consents to the admission of additional or substituted Limited Partners by the General Partner and to any Assignee of his Units becoming a substituted Limited Partner.

13.3 The General Partner shall cause the Partnership Agreement or any separate certificate of limited partnership to be amended to reflect the substitution of Limited Partners at least once in each calendar quarter.

14. Books, Records, Accountings and Reports

14.1 The Partnership's books and records, the Partnership Agreement and all amendments thereto, all separate certificates of limited partnership, and copies of each appraisal on Partnership Property shall be maintained at the Partnership's principal office or such other place as the General Partner may determine. All such materials shall be open to inspection and examination of Limited Partners or their duly authorized representatives at all reasonable times. Upon written request, a Limited Partner or his duly authorized representative shall be provided with a copy of the certificate or certificates of limited partnership containing the most recent listing of Partners' names, addresses and capital contributions. Each appraisal on Partnership Property shall be maintained by the General Partner and available for such inspection and examination by any Limited Partner or his duly authorized representative for a period of at least five years following the date of acquisition of the Property subject to such appraisal.

14.2 The General Partner shall have prepared at least annually, at Partnership expense, financial statements (balance

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sheet, statement of income or loss, partners' equity, and changes in financial position) prepared in accordance with generally accepted accounting principles and accompanied by a report thereon containing an opinion of an independent certified public accounting firm. Copies of such statements and report shall be distributed to each Limited Partner within 90 days after the close of each taxable year of the Partnership.

14.3 The General Partner shall have prepared at least annually, at Partnership expense: (i) a statement of cash flow, (ii) Partnership information necessary in the preparation of the Limited Partners' federal income tax returns, (iii) a report of the Partnership business, (iv) a statement as to the compensation received by the General Partner during the year from the Partnership, setting forth the services rendered or to be rendered by the General Partner and the amount of fees received, and (v) a report identifying distributions from: (a) Adjusted Cash From Operations of that year, (b) Adjusted Cash From Operations of prior years, (c) Cash From Sales or Refinancings, and (d) Cash From Property Reserve Accounts and other sources. Copies of such report shall be distributed to each Limited Partner within 90 days after the close of each taxable year of the Partnership provided, however, all Partnership information necessary in the preparation of the Limited Partners' federal income tax returns shall be distributed to each Limited Partner within 45 days, but not later than 75 days, after the close of each taxable year of the Partnership.

14.4 The General Partner shall have prepared quarterly, at Partnership expense, commencing with the first calendar quarter after the Closing Date: (i) a statement as to the compensation received by the General Partner during such quarter from the Partnership, setting forth the services rendered or to be rendered by the General Partner and the amount of fees received, and (ii) other relevant information. Copies of such statements shall be distributed to each Limited Partner within 60 days after the end of each quarterly period.

14.5 Until such time as the Partnership is registered under Section 12(g) of the Securities Exchange Act of 1934, the General Partner shall have prepared, at Partnership expense, a semi-annual report covering the first six months of Partnership operations in each calendar year, commencing with the first six-month period after the Closing Date and semi-annually thereafter, unaudited financial statements (balance sheet, statement of income or loss for said first six-month period and statement of Adjusted Cash From Operations for said first six-month period), and a statement of other pertinent information regarding the Partnership and its activities during the six-month period covered by the report. Copies of such statements and other pertinent information shall be distributed to each Limited Partner within 60 days after the close of the six-month period covered by the Partnership report.

14.6 At such time as the Partnership is registered under Section 12(g) of the Securities Exchange Act of 1934, the General Partner shall have prepared, at Partnership expense, a quarterly report covering the first three quarterly calendar year periods of Partnership operations in each calendar year, commencing with the first quarterly period required after Section 12(g) registration is effective, unaudited financial statements (balance sheet, statement of income or loss for said quarterly period and Statement of Adjusted Cash From Operations for said quarterly period) and a statement of other pertinent information regarding the Partnership and its activities during the quarterly period covered by the report. Copies of such statements and other pertinent information shall be distributed to each Limited Partner within 60 days after the close of the quarterly period covered by the report of the Partnership.

14.7 The General Partner shall have prepared, at Partnership expense, no later than the end of each quarter in which Partnership Properties are acquired, a notice which shall describe therein: (i) each real property so acquired, (ii) the geographic area in which such Property is located, and (iii) such other relevant information with respect to the acquisition of such Property as the General Partner deems appropriate (including by way of illustration the date and appraised value of the real property, its purchase price, including the terms of purchase, the total cash expended by the Partnership for the property, and the amount of Net Proceeds remaining uncommitted, in terms of dollars and percentage of Gross Proceeds). Copies of such notice shall be distributed to each Limited Partner within 60 days after the end of such quarter. If deemed appropriate by the General Partner, such notice may be prepared and distributed to each Limited Partner more frequently than quarterly.

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14.8 The General Partner, at Partnership expense, shall cause income tax returns for the Partnership to be prepared and timely filed with the appropriate authorities.

14.9 The General Partner, at Partnership expense, shall cause to be prepared and timely filed, with appropriate federal and state regulatory and administrative bodies, all reports required to be filed with such entities under then current applicable laws, rules and regulations. Such reports shall be prepared on the accounting or reporting basis required by such regulatory bodies. Any Limited Partner shall be provided with a copy of any such report upon request without expense to him.

14.10 The General Partner, at Partnership expense, shall maintain for a period of at least four years a record of the information obtained to indicate that a Limited Partner meets with the suitability standards set forth in the Prospectus.

15. Rights, Authority, Powers, Responsibilities and Duties of the General Partner

15.1 The General Partner shall have all authority, rights and powers conferred by law and those required or appropriate to the management of the Partnership business which, by way of illustration but not by way of limitation, shall, subject only to the provisions of Paragraph 15.3, include the right, authority and power:

15.1.1 To acquire, develop, hold and dispose of real property, interests therein or appurtenances thereto, as well as personal or mixed property connected therewith, including the purchase, lease, development, improvement, maintenance, exchange, trade or sale of such properties, at such price, rental or amount, for cash, securities (in compliance with appropriate securities regulations), or other property, and upon terms as the General Partner deems, in its sole discretion, to be in the best interests of the Partnership;

15.1.2 To borrow money and, if security is required therefor, to mortgage or subject any Partnership investment to any other security device, to obtain replacements of any mortgage or other security device, and to prepay, in whole or in part, refinance, increase, modify, consolidate or extend any mortgage or other security device, all of the foregoing at such terms and in such amounts as the General Partner, in its sole discretion, deems to be in the best interests of the Partnership;

15.1.3 To place record title to, or the right to use, Partnership assets in, the name or names of a nominee or nominees, trustee or trustees for any purpose convenient or beneficial to the Partnership;

15.1.4 To acquire and enter into any contract of insurance which the General Partner deems necessary or appropriate for the protection of the Partnership and the General Partner for the conservation of Partnership assets, or for any purpose convenient or beneficial to the Partnership;

15.1.5 To employ persons in the operation and management of the business of the Partnership including, but not limited to, supervisory managing agents, building management agents, insurance brokers, real estate brokers and loan brokers, on such terms and for such compensation as the General Partner shall determine, subject, however, to the limitations with respect thereto as set forth in Paragraph 9, and also subject to the following provisos: agreements with the General Partner or its Affiliates for the services set forth in Paragraph 9 shall contain the terms and limitations as to fees and expenses as set forth therein, and any such agreement shall be terminated immediately upon the Partnership's dissolution under Paragraph 19.1;

15.1.6 To prepare or cause to be prepared reports, statements, and other relevant information for distribution to Holders, including annual and quarterly interim reports;

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15.1.7 To open accounts and deposit and maintain funds in the name of the Partnership in banks or savings and loan associations, provided, however, that the Partnership funds shall not be commingled with the funds of any other person;

15.1.8 To cause the Partnership to make or revoke any of the elections referred to in *Sections 108, 754, or 1017 of the Internal Revenue Code of 1954*, or any similar provisions enacted in lieu thereof;

15.1.9 To select as its accounting year a calendar year or such fiscal year as approved by the Internal Revenue Service;

15.1.10 To determine the appropriate accounting method or methods to be used by the Partnership (the Partnership intends initially to utilize the accrual method of accounting in maintaining its books and records);

15.1.11 To offer and sell Units in the Partnership to the public directly or through any licensed Affiliate of the General Partner and to employ personnel, agents and dealers for such purpose;

15.1.12 To amend this Partnership Agreement to reflect the addition or substitution of Limited Partners or the reduction of capital accounts upon the return of capital to Partners;

15.1.13 To require in all Partnership obligations that the General Partner shall not have any personal liability thereon but that the person or entity contracting with the Partnership is to look solely to the Partnership and its assets for satisfaction. In the event that any such obligations have personal liability, the General Partner may require their satisfaction prior to contracts without such personal liability;

15.1.14 To execute, acknowledge, and deliver any and all instruments to effectuate the foregoing, and to take all such action in connection therewith as the General Partner shall deem necessary or appropriate;

15.1.15 To reinvest all Cash From Initial Financing; and

15.1.16 To purchase Property in its own name or in the name of a nominee, a trust or a corporate "nominee" or otherwise (and assume loans in connection therewith), and temporarily hold title thereto for the purpose of facilitating the acquisition of such Property or the borrowing of money or obtaining of financing for the Partnership, or completion of construction of the Property, or any other purpose related to the business of the Partnership. The Partnership, however, shall not purchase the Property for a price greater than the cost thereof to the General Partner, except for compensation in accordance with Paragraph 9 of this Partnership Agreement. In addition, there shall be no difference in interest rates of the loans secured by the Property at the times acquired by the General Partner and by the Partnership, nor any other benefit arising out of such transaction of the General Partner apart from the compensation otherwise permitted by this Partnership Agreement.

15.2 The General Partner shall, except as otherwise provided in this Partnership Agreement, have all the rights and powers and shall be subject to all the restrictions and liabilities of a partner in a partnership without limited partners.

15.3 Neither the General Partner nor any Affiliate shall have the authority to:

15.3.1 Enter into contracts with the Partnership which would bind the Partnership after the expulsion, adjudication of bankruptcy or insolvency of the General Partner, or continue the business with Partnership assets after the occurrence of such event;

15.3.2 Grant to it or any Affiliate an exclusive listing for the sale of Partnership assets, including Partnership Properties;

15.3.3 Sell substantially all of the assets of the Partnership in a single sale, or in multiple sales in the same 12-month

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period, except in the orderly liquidation and winding up of the business of the Partnership upon its termination and dissolution;

15.3.4 Pledge or encumber substantially all of the assets of the Partnership at one time, other than in connection with the acquisition or improvement of assets or the refinancing of previous obligations;

15.3.5 Alter the primary purpose of the Partnership as set forth in Paragraph 3;

15.3.6 Receive from the Partnership a rebate or give-up or participate in any reciprocal business arrangements which would enable it or an Affiliate to do so;

15.3.7 Sell or lease property to any entity in which the General Partner or any Affiliate has an interest;

15.3.8 Cause the Partnership to invest in any program, partnership or other venture unless: (i) it is a general partnership or a joint venture; (ii) the other partner or joint owner is not the General Partner or an Affiliate; (iii) such general partnership or venture owns and operates a particular property and the Partnership acquires the controlling interest in such venture or general partnership; (iv) the Partnership, as a result of such joint ownership or partnership ownership of a property, is not charged directly or indirectly, more than once for the same service; and (v) the agreement of partnership or joint venture does not authorize the Partnership to do anything as a Partner or joint venturer with respect to the property which the Partnership, or the General Partner, could not do directly because of the policies set forth in this Partnership Agreement; and (vi) the General Partner and its Affiliates are prohibited from receiving any compensation, fees or expenses which are not permitted to be paid under the terms of this Partnership Agreement.

15.3.9 Purchase or lease real property from the Partnership, or sell or lease real property to it;

15.3.10 Purchase Partnership Property without first having obtained an appraisal with respect to the value thereof, rendered by an independent appraiser who is a member of a nationally recognized society of appraisers, which provides that the Cost of such Partnership Property and all Acquisition Fees paid with respect to such Property by any person equals or is less than the appraised value;

15.3.11 Cause the Partnership to exchange Units for real property;

15.3.12 Make long-term secured loans to the Partnership, and on short-term unsecured loans made to the Partnership, receive interest or other financing charges or fees in excess of those amounts which would be charged by third party financing institutions on comparable loans for the same purpose in the same geographic area but in no event in excess of 2 percent above the prime rate of the Chemical Bank, New York, N. Y.;

15.3.13 Cause the Partnership to finance the purchase of Partnership Property by use of a wrap-around note and mortgage ("all-inclusive" note and deed of trust) unless: (i) neither the General Partner nor any Affiliate thereof shall receive interest in excess of that payable to the lender on such underlying encumbrances; (ii) all payments on the underlying obligation shall be made by the Partnership or, in the alternative, payments by the Partnership on the wrap-around note are made to a third party collecting agent which in turn disburses such payment, first to the holder of such underlying obligation, and thereafter to the holder of the wrap-around note; and (iii) the Partnership receives credit on its all-inclusive note for payments made directly on the underlying obligations;

15.3.14 Redeem or repurchase Units on behalf of the Partnership;

15.3.15 Do any act in contravention of this Partnership Agreement or which would make it impossible to carry on the ordinary business of the Partnership;

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15.3.16 Confess a judgment against the Partnership in connection with any threatened or pending legal action;

15.3.17 Possess any Partnership property or assign its rights in specific Partnership property for other than a Partnership purpose;

15.3.18 Admit a person as a General Partner except with the consent of the Limited Partners as provided for in this Partnership Agreement;

15.3.19 Perform any act (other than an act required by this Agreement or any act taken in good faith reliance upon counsel's opinion) which would, at the time such act occurred, subject any Limited Partner to liability as a general partner in any jurisdiction;

15.2.20 Reinvest any Adjusted Cash From Operations, or after five years from the Closing Date, Cash From Sales or Refinancings;

15.3.21 Invest any Gross Proceeds in nonincome-producing Properties except in amounts and upon terms which can be financed by the Partnership's Gross Proceeds or Adjusted Cash From Operations.

15.3.22 Receive any insurance brokerage fee or write any insurance policy covering the General Partner on any of the Partnership Properties;

15.3.23 Employ, or permit to employ, the funds or assets of the Partnership in any manner except for its exclusive benefit;

15.3.24 Incur any nonrecourse indebtedness wherein the lender will have or acquire, at any time as a result of making the loan, any direct or indirect interest in the Partnership's profit, capital or property other than as a secured creditor;

15.3.25 Incur aggregate borrowings of the Partnership in excess of 80 percent of the purchase price of all Partnership Properties on a combined basis. Purchase price for purposes of this subparagraph 15.3.25 shall mean the sum of the price paid for a property by the Partnership, including Acquisition Fees plus all costs of improvements, if any, reasonably and properly allocable to all the Partnership Properties made at the time of the acquisition or within 60 days thereafter, but does not include loan points, prepaid interest, or other prepaid expenses;

15.3.26 Commingle the Partnership funds with those of any other person or entity;

15.3.27 Cause the Partnership to enter into any transactions with any other partnership in which the General Partner or any Affiliates have an interest, including, but not limited to, any transaction involving the sale, lease or purchase of any property to or from the Partnership, or the lending of any moneys or other property to or from the Partnership;

15.3.28 Receive any commission or fee for the placement of mortgage loans or trust deed loans on the Partnership Property or otherwise act as a finance broker on its behalf;

15.3.29 Directly or indirectly pay or award any finder's fees, commissions, or other compensation to any person engaged by a potential investor for investment advice as an inducement to such advisor to advise the purchaser regarding the purchase of Units. The General Partner, however, shall not be prohibited from paying the normal sales commissions payable to a registered broker-dealer or other properly licensed person for selling Units;

15.3.30 Operate the Partnership in such a manner as to have the Partnership classified as an "investment company" for purposes of the Investment Company Act of 1940;

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15.3.31 Invest any Gross Proceeds in junior mortgages, deeds of trust, or other similar obligations;

15.3.32 Incur short term borrowings, except for Partnership short term construction loans, repairs, replacements of working capital;

15.3.33 Use any Gross Proceeds to prepay interest on Partnership mortgages, deeds of trust or other similar obligations. The General Partner, however, may cause the Partnership to pay "points" to prospective lenders as a condition to obtaining financing;

15.3.34 Cause the Partnership to enter into any agreements with the General Partner or its Affiliates which shall not be subject to termination without penalty by either party upon not more than 60 days' written notice;

15.3.35 Cause the Partnership to enter into any contracts with the General Partner or with any Affiliate to construct or develop Partnership Properties or to render any services in connection with such construction or development; or

15.3.36 Cause the Partnership to enter into any contracts to construct or develop Partnership Property without such contract being guaranteed at the price contracted by an adequate completion bond or other satisfactory arrangements.

15.4 Within 90 days after the Limited Partners have voted to remove the General Partner, the General Partner shall have prepared, at Partnership expense, a financial statement (balance sheet, statement of income or loss, partners' equity, and changes in financial position) prepared in accordance with generally accepted accounting principles and accompanied by a report thereon containing an opinion of a recognized independent certified public accounting firm. The General Partner shall cause such statement to be mailed to the Limited Partners as soon as possible after its receipt.

15.5 The General Partner or any Affiliate may acquire and resell Units from time to time on its or their own behalf and for its or their own benefit.

15.6 The General Partner shall have the duty and responsibility to provide continuing administrative and executive support, advice, consultation, analysis and supervision with respect to the functions of the Partnership as an owner of Partnership Property, including decisions regarding adjustments to rental schedules, the sale or refinancing or other disposition of property, and compliance with federal, state and local regulatory requirements and procedures.

16. Rights, Powers and Voting Rights of the Limited Partners

16.1 Limited Partners shall take no part in or interfere in any manner with the control, conduct or operation of the Partnership, and shall have no right or authority to act for or bind the Partnership.

16.2 Limited Partners shall have the right, by Majority Vote, to vote only upon the following matters affecting the basic structure of the Partnership;

16.2.1 Removal of the General Partner;

16.2.2 Election of a successor General Partner;

16.2.3 Termination and dissolution of the Partnership;

16.2.4 Amendment of the Partnership Agreement, provided such amendment is not for the purpose of reflecting the

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addition or substitution of Limited Partners or the reduction of capital accounts upon the return of capital to Partners;

16.2.5 The sale of all or substantially all of the Partnership assets in a single sale, or in multiple sales in the same 12-month period, except in the liquidation and winding up of the Partnership business upon its termination and dissolution;

16.2.6 The pledge or encumbrance of all or substantially all of the Partnership assets at one time, other than in connection with the acquisition or improvement of assets, initial financing of a Partnership Property, or the refinancing of previous obligations; and

16.2.7 The extension of the term of the Partnership.

16.3 In any such vote each Holder shall be entitled to cast one vote for each Unit which he owns, and the procedures set forth in Paragraph 16.5 of this Partnership Agreement shall be applicable.

16.4 The General Partner may at any time call a meeting of the Limited Partners or for a vote, without a meeting, of the Limited Partners on matters which they are entitled to vote, and shall call for such meeting or vote following receipt of written request therefor of Limited Partners holding 10 percent or more of the Units held by all Limited Partners as of the date of receipt of such written request ("notice date"). Within ten days of such notice date, the General Partner shall notify all Limited Partners of record as of the notice date as to the time and place of the Partnership meeting, if called, and the general nature of the business to be transacted thereat, or if no such meeting has been called, of the matter or matters to be voted upon and the date upon which the votes will be counted. Any Partnership meeting or the date upon which such votes, without a meeting, will be counted (regardless of whether the General Partner has called for such meeting or vote upon the request of Limited Partners or has initiated such event without such request) shall be no less than 15 nor more than 60 days following mailing of the notice thereof by the General Partner. All expenses of the voting and such notification shall be borne by the Partnership.

16.5 A Limited Partner shall be entitled to cast one vote for each unit which he owns: (i) at a meeting, in person, by written proxy or by a signed writing directing the manner in which he desires that his vote be cast; or (ii) without a meeting, by a signed writing directing the manner in which he desires that his vote be cast. The General Partner must receive such writing prior to the meeting, or, if there is no meeting, prior to the date upon which the votes of the Limited Partners are to be counted. Only the votes of Limited Partners of record on the notice date, whether at a meeting or otherwise, shall be counted. The General Partner shall not be entitled to vote. The laws of the State of California pertaining to the validity and use of corporate proxies shall govern the validity and use of proxies given by Limited Partners.

16.6 No Limited Partner shall have the right or power to: (i) withdraw or reduce his contribution to the capital of the Partnership except as a result of its dissolution or as otherwise provided by law, (ii) bring an action for partition against the Partnership, (iii) cause the termination and dissolution of the Partnership by court decree or otherwise, except as set forth in this Partnership Agreement, or (iv) demand or receive property other than cash in return for his contribution. No Limited Partner shall have priority over any other Limited Partner either as to the return of contributions of capital or as to Net Income, Net Loss or Distributions. Other than upon the termination and dissolution of the Partnership as provided by this Partnership Agreement, there has been no time agreed upon when the contribution of each Limited Partner may be returned.

16.7 In addition to any amendments otherwise authorized herein, the General Partner may amend this Agreement from time to time, without the consent of any Limited Partner, (i) to add to the representations, duties, or obligations of the General Partner or its Affiliates or surrender any right or power granted to the General Partner or its Affiliates herein, for the benefit of the Limited Partners; (ii) to cure any ambiguity, to correct or supplement any provision herein which may be inconsistent with any other provision herein, or to make any other provisions with respect to matters or

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questions arising under this Agreement which will not be inconsistent with the provisions of this Agreement; and (iii) to delete or add any provision of this Agreement required to be so deleted or added by the Staff of the Securities and Exchange Commission or by a State "Blue Sky" Commissioner or similar such official, which addition or deletion is deemed by such Commissioner or official to be for the benefit or protection of the Limited Partners. Notwithstanding anything to the contrary contained in this Partnership Agreement, this Agreement may not be amended without the consent of the Partners to be adversely affected by an amendment that:

16.7.1 Converts a Limited Partner into a general partner;

16.7.2 Modifies the limited liability of a Limited Partner;

16.7.3 Alters the interest of the General or Limited Partners in Net Income or Net Loss or Distributions from the Partnership; or

16.7.4 Affects the status of the Partnership as a partnership for federal income tax purposes;

17. Expulsion, Bankruptcy or Dissolution of the General Partner

17.1 The General Partner may be expelled from the Partnership upon a Majority Vote.

17.2 Written notice of the expulsion of the General Partner shall be served upon it either by certified or by registered mail, return receipt requested, or by personal service. Such notice shall set forth the date upon which the expulsion is to become effective.

17.3 Upon the retirement, expulsion, adjudication of bankruptcy or dissolution of the General Partner ("Terminated Partner"), the Partnership shall purchase the Terminated Partner's interest in the Net Income, Net Loss and Distributions of the Partnership for a purchase price determined according to the provisions of Paragraph 17.4.

17.4 The Terminated Partner shall receive from the new general partner or partners ("acquiring partner") the fair market value of its interest in the Partnership, determined by agreement between the Terminated Partner and the acquiring partner, or if they cannot agree, by arbitration in accordance with the then current rules of the American Arbitration Association. For this purpose, the fair market value of the interest of the Terminated Partner shall be deemed to be the amount it would receive upon the Partnership's dissolution and termination under Paragraph 19.2, assuming such dissolution or termination occurred on the date of the dissolving event and that the Partnership assets were sold for their then fair market value without compulsion of the Partnership to sell such assets. Payment shall be made by a promissory note bearing 8 percent simple interest per year on such note's unpaid principal amount, secured by the acquiring partner's assignment to the Terminated Partner of the Partnership's future Distributions to the acquiring partner. The principal amount, together with accrued interest, shall be payable at the times and in the amounts equal to 75 percent of such Distributions until such time as the principal amount, together with accrued interest, is paid in full, but shall become due and payable in full by the acquiring partner at such time as the Partnership is finally wound up and liquidated. If the Terminated Partner requests, however, the sale and payment shall be made, to the extent required, on terms and conditions that will allow such sale to qualify for the installment method as provided in *Section 453 of the Internal Revenue Code*. The Terminated Partner shall be required to sell, and the acquiring partner shall be required to purchase, the Terminated Partner's interest in the Partnership no later than the 60th day after the occurrence of one of the events specified in Paragraph 19.1, or the election of a new General Partner under Paragraph 16.2, whichever occurs later.

18. Certain Transactions

The General Partner, any Holder, any Affiliates, any shareholder, officer, director or employee thereof, or any person owning a legal or beneficial interest therein, may engage in or possess an interest in any other business or venture of every nature and description, independently or with others including, but not limited to, the ownership, financing, leasing, operation, management, brokerage and development of real property.

19. Termination and Dissolution of the Partnership

19.1 The Partnership shall be terminated and dissolved upon the earlier to occur of the following:

19.1.1 The General Partner's retirement (provided there has been 90 days prior written notice to the Limited Partners), expulsion, adjudication of bankruptcy, insolvency, dissolution or other cessation to exist as a legal entity, unless the General Partner in place thereof within 120 days of the date of such event by Majority Vote elects to continue the business of the Partnership. Expenses incurred in the reformation, or attempted reformation, of the Partnership shall be deemed expenses of the Partnership;

19.1.2 A Majority Vote in favor of the Partnership's dissolution and termination;

19.1.3 The expiration of the term of the Partnership; or

19.1.4 The disposition of all interests in the Partnership's real property and other assets (other than cash and cash equivalents).

19.2 Upon a dissolution and termination of the Partnership for any reason, the General Partner shall take full account of the Partnership assets and liabilities, shall liquidate the assets as promptly as is consistent with obtaining the fair value thereof, and shall apply and distribute the proceeds therefrom in the following order.

19.2.1 To the payment of the Partnership's creditors, but excluding secured creditors whose obligations will be assumed or otherwise transferred on the liquidation of Partnership assets;

19.2.2 To the repayment of all outstanding loans made by the General Partner to the Partnership; and

19.2.3 To the General Partner and Holders pursuant to the provisions of Paragraph 11.5, of this Partnership Agreement.

20. Special Power of Attorney

20.1 Concurrently with the execution of written acceptance and adoption of the provisions of this Partnership Agreement, each Limited Partner shall execute, acknowledge, and deliver to the General Partner a special power of attorney in form acceptable to the General Partner. Each such special power of attorney shall constitute and appoint the General Partner as the attorney-in-fact for the Limited Partner, with power and authority to act in his name and on his

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behalf to execute, acknowledge, and swear to in the execution, acknowledgement, and filing of documents. Such powers shall include, by way of illustration but not of limitation, the following:

20.1.1 The Partnership Agreement, all separate certificates of limited partnership, as well as all amendments to the foregoing which, under the laws of the State of California or of any other state, are required to be filed or which the General Partner deems to be advisable to file;

20.1.2 Any other instrument or document which the Partnership may be required to file under the laws of any state or by any governmental agency, or which the General Partner deems advisable to file; and

20.1.3 Any instrument or document which may be required to effect the continuation of the Partnership, the admission of an additional or substituted Limited Partner, or the dissolution and termination of the Partnership (provided such continuation, admission or dissolution and termination are in accordance with the terms of this Partnership Agreement), or to reflect any reductions in amount of contributions of Partners.

20.2 The special power of attorney to be concurrently granted by each Limited Partner:

20.2.1 Is a special power of attorney coupled with an interest, is irrevocable, shall survive the death or legal incapacity of the granting Limited Partner, and is limited to those matters herein set forth;

20.2.2 May be exercised by the General Partner acting alone for each Limited Partner by a facsimile signature of the General Partner or by any one of its officers, or by listing all of the Limited Partners executing any instrument with a signature of the General Partner or one of its officers acting as its attorney-in-fact; and

20.3.3 Shall survive an assignment by a Limited Partner of all or any portion of his Units except that, where the Assignee of the Units owned by a Limited Partner has been approved by the General Partner for admission to the Partnership as a substituted Limited Partner, the special power of attorney shall survive such assignment for the sole purpose of enabling the General Partner to execute, acknowledge and file any instrument or document necessary to effect such substitution.

21. Indemnification

21.1 The Partnership, its receiver or its trustee, shall indemnify, save harmless and pay all judgments and claims against the General Partner, from any liability or damage incurred by reason of any act performed or omitted to be performed by them in connection with the business of the Partnership, including attorneys' fees incurred by them in connection with the defense of any action based on any such act or omission, which attorneys' fees may be paid as incurred, including all such liabilities under Federal and State Securities Acts (including the Securities Act of 1933) as permitted by law. If a claim for indemnification (other than for expenses incurred in a successful defense) is asserted against the Partnership by the General Partner under this Partnership Agreement or otherwise, the Partnership will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy and will be governed by the final adjudication of such issue.

21.2 In the event of any action by a Holder against the General Partner including a Partnership derivative suit, the Partnership shall indemnify, save harmless and pay all expenses of the General Partner including attorneys' fees incurred in the defense of said action, if (a) the General Partner is successful in said action, or (b) in the opinion of the Partnership's counsel the matter has been settled by controlling precedent, or (c) if the matter has not been settled by

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controlling precedent, it will be submitted to a court of appropriate jurisdiction as to whether such indemnification by the Partnership is against public policy and all parties will be governed by the final adjudication of such issue.

21.3 Notwithstanding the provisions of Paragraph 21.1 and 21.2, the General Partner shall not be relieved from any liability imposed by law, including liability for fraud, bad faith, willful neglect or negligence. All judgments against the Partnership and the General Partner, wherein the General Partner is entitled to indemnification, must first be satisfied from Partnership assets before the General Partner is responsible for these obligations.

21.4 The General Partner shall have the right and authority to require in all Partnership contracts that it will not be personally liable thereon and that the person or entity contracting with the Partnership is to look solely to the Partnership and its assets for satisfaction.

22. Miscellaneous

22.1 This Partnership Agreement may be executed in several counterparts and all so executed shall constitute one Partnership Agreement, binding on all of the parties hereto, notwithstanding that all of the parties are not signatory to the original or the same counterpart.

22.2 The terms and provisions of this Partnership Agreement shall be binding upon and shall inure to the benefit of each of the Partners and their respective legal representatives, successors, and assigns.

22.3 In the event any sentence or paragraph of this Partnership Agreement is declared by a court of competent jurisdiction to be void, such sentence or paragraph shall be deemed severed from the remainder of the Partnership Agreement and the balance of the Partnership Agreement shall remain in effect.

22.4 All notices under this Partnership Agreement shall be in writing and shall be given to the Holder entitled thereto, by personal service or by mail, posted to the address maintained by the Partnership for such person or at such other address as he may specify in writing.

22.5 Paragraph titles or captions contained in this Partnership Agreement are inserted only as a matter of convenience and for reference. Such titles and captions in no way define, limit, extend or describe the scope of this Partnership Agreement nor the intent of any provision hereof.

22.6 Whenever required by the context hereof, the singular shall include the plural, and vice-versa; the masculine gender shall include the feminine and neuter genders, and vice-versa; and the word "person" shall include a corporation, partnership, firm or other form of association.

22.7 The name and address of the General Partner is:

NWP Management Corp.
10946 Victory Boulevard
Van Nuys, California

22.8 The names, addresses and capital contributions of the Limited Partners are set forth on Exhibit I attached hereto, which exhibit shall be maintained at the principal place of business of the Partnership.

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22.9 This Partnership Agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

22.10 No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

22.11 This Partnership Agreement shall be construed in accordance with and governed by the laws of the State of California.

General Partner

NWP Management Corp.

Frank Martin Executive Vice President

Original Limited Partner

Arthur D. Smith

A.10 Single Member Limited Liability Company Agreement

COMMENT

This form illustrates a limited liability company agreement that might be used by a single owner to own an interest in a specific project. Single member LLCs are treated as disregarded entities for federal income tax purposes, with the result that the Federal income tax consequences of the LLC's business and operations are reported directly on the Federal income tax returns of its owner, unless the entity files an election to be treated as a corporation. A single member LLC is a technique used by individual owners of real estate or other businesses to insulate themselves from liabilities with respect to the underlying business or property without the tax implications of a regular corporation or a subchapter S corporation.

For further information, see Chapters 14, 15, and 17.

FORM

LIMITED LIABILITY COMPANY AGREEMENT

This Limited Liability Company Agreement is made as of August 1, 2002 by Pemburn Development Company, Inc. (the "Member") to serve as the limited liability company agreement under the Act (hereinafter defined) for the limited liability company specified herein. NOW, THEREFORE, intending to be legally bound hereby, the Member agrees as follows:

1. *Definitions.* Unless the context otherwise requires, the terms defined in this Section 1 shall, for the purposes of this Agreement, have the meanings herein specified.

"Act" means the New York Limited Liability Company Law, Chapter 34 of the Consolidated Laws of New York, and any successor statute, as amended from time to time.

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"Agreement" means this Limited Liability Company Agreement, as amended, modified, supplemented or restated from time to time.

"Certificate" means the Articles of Organization of the Company and any and all amendments thereto and restatements thereof filed on behalf of the Company with the office of the Department of State of the State of New York pursuant to the Act.

"Company" means S & J Renovations, LLC, the New York limited liability company of such name which has been formed under the Act.

"Person" means any individual, corporation, association, partnership (general or limited), joint venture, trust, estate, limited liability company, or other legal entity or organization.

2. *Organization.* The Member heretofore has authorized the organization of the Company as a limited liability company under and pursuant to the provisions of the Act and the Member agrees that the rights, duties and liabilities of the Member shall be as provided in the Act, except as otherwise provided herein.

3. *Purpose.* The Company is formed for the object and purpose of acquiring the property known as the Coventry Inn and renovating, owning, redeveloping, operating, financing, leasing and selling it for any lawful use or purpose (together, the land and improvements are collectively referred to herein as the "Project"), and engaging in any and all activities necessary, convenient, desirable or incidental to the foregoing.

4. *Term.* The existence of the Company commenced on the date the Certificate was filed in the office of the Department of State of the State of New York and shall continue perpetually until the Company is dissolved in accordance with the provisions of this Agreement. The existence of the Company as a separate legal entity shall continue until cancellation of the Certificate in the manner required by the Act.

5. *Registered Office and Principal Office.* The registered office of the Company in the State of New York and the principal office of the Company shall be located at 38 Any Street, Town, NY 11111, or at such other location as may be determined by the Member. The Company may also have such other offices at such other locations as may from time to time be deemed advisable by the Member.

6. *Management.* Management of the business and affairs of the Company shall be vested in the Member. The Member shall have all rights and powers and shall make all decisions affecting the Company in furtherance of the Company's purposes. The Member may appoint such officers and agents of the Company as the Member deems appropriate to carry out and execute the decisions and instructions of the Member in the operations of the business of the Company. Such officers and agents shall have such duties and powers as are from time to time specified by the Member and they may be removed or discharged by the Member at any time with or without cause. If the Member does not specify the duties and powers of an officer, such officer shall be deemed to have the duties and powers of an officer of a New York business corporation with the same title. The Member shall make such tax elections as are deemed desirable in the sole discretion of the Member.

7. *Distributions.* Distributions shall be made to the Member (in cash or in property) at the times and in the amounts determined by the Member and as permitted by applicable law.

8. *Other Interests of the Member.* The Member may engage in or possess an interest in other business ventures of any nature or description, independently or with others, similar or dissimilar to the business of the Company, and the Company shall have no rights by virtue of this Agreement in and to such independent ventures or the income or profits derived therefrom, and the pursuit of any such venture, even if competitive with the business of the Company, shall not be deemed wrongful or improper. The Member shall not be obligated to present any particular investment opportunity

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to the Company even if such opportunity is of a character that, if presented to the Company, could be taken by the Company, and the Member shall have the right to take for the Member's own account (individually or as a partner or fiduciary) or to recommend to others any such particular investment opportunity.

9. *Transfer of Membership Interest; Admission of Additional Members.*

(a) *Transfers of Membership Interest.* The Member's membership interest in the Company shall be freely transferable by the Member or by operation of law. The Member may transfer all or a portion of the Member's economic interest in the Company without transferring management power and without the transferee becoming a member of the Company. If a transferee is to become a member of the Company, the requirements of Section 9(b) must be complied with, unless the transferee will then be the sole member of the Company, in which case references herein to the Member shall refer to such transferee.

(b) *Admission of Additional Members.* Additional members of the Company may be admitted on such terms as the Member may approve or upon the transfer of the Member's entire interest in the Company (including transfer upon the Member's death); provided that if, upon such admission, there will be more than one member of the Company, this Agreement must be amended and restated to reflect the relative rights, duties and obligations of the Member and such additional members and the admission of such additional members shall not become effective until this Agreement is so amended and restated.

10. *Liability of Member.* The Member shall have no liability for the obligations or liabilities of the Company except to the extent required by the Act.

11. *Indemnification.* The Company shall indemnify the Member and those authorized officers, agents and employees of the Company identified in writing by the Member as entitled to be indemnified under this section for all costs, losses, liabilities and damages paid or accrued by the Member (whether as a member, officer, agent or employee of the Company) or any such officer, agent or employee in connection with the business of the Company, to the fullest extent provided or allowed by the laws of the State of New York. In addition, the Company may advance costs of defense of any proceeding to the Member or any such officer, agent or employee upon receipt by the Company of an undertaking by or on behalf of such person to repay such amount if it shall ultimately be determined that the person is not entitled to be indemnified by the Company.

12. *Dissolution.*

(a) *Events of Dissolution.* The Company shall be dissolved and its affairs wound up upon the first to occur of the following:

(i) the happening of any event specified as a dissolution event in the Certificate;

(ii) at any time at which there are no Members;

(iii) the written direction or determination of the Member; or

(iv) the entry of a decree of judicial dissolution of the Company under Section 702 of the Act.

(b) *Distributions upon Dissolution.* Upon the dissolution of the Company, the assets of the Company shall be liquidated in such manner as the Member shall determine, and the proceeds of such liquidation and the remaining assets of the Company shall be used first to discharge, or make provision for the Company's payment of, obligations to creditors, including the Member to the extent permitted by

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applicable law. Any remaining proceeds and assets shall be distributed to the Member.

(c) *Certificate of Cancellation*. Following the dissolution and the winding up of the Company, the Company shall file in the office of the Department of State articles of dissolution containing the information required by the Act.

13. *Miscellaneous*.

(a) *Controlling Law*. This Agreement and all questions relating to its validity, interpretation, performance and enforcement shall be governed by and construed in accordance with the laws of the State of New York.

(b) *Entire Agreement*. This Agreement represents the entire limited liability company agreement of the Company within the meaning of the Act.

(c) *Amendments or Modifications*. This Agreement may be amended or modified from time to time by an agreement in writing signed by the Member.

(d) *Rights of Creditors and Third Parties*. This Agreement is entered into by the Member solely to govern the operation of the Company. This Agreement is expressly not intended for the benefit of any creditor of the Company or any other Person other than Persons to be indemnified pursuant to Section 11 and the heirs, personal representatives, successors and assigns of the Member or of such indemnified Persons. Except to the extent provided by applicable law, no creditor or third party shall have any rights under this Agreement.

IN WITNESS WHEREOF, the undersigned has executed this Agreement as of the date first above written.

Pemburn Development Company, Inc.

By:

Name:

Title: A.11 Limited Liability Company Agreement--Multiple Members

COMMENT

This form illustrates a multi-member limited liability company agreement that will be managed by one of the members. The agreement is suitable for the ownership and operation of real estate or an operating business and contemplates a pro rata sharing of contributions, profits and losses. Management of the company is vested in the members and determined on the basis of majority vote. An alternative management structure would be to identify a single member as manager or identify a non-member third party as manager, in which case the manager would typically be required to provide an annual operating and capital budget, be given broad discretion to operate within those budgets, and be required to obtain approval of a majority or supermajority of the members for extraordinary items, such as a sale of the business.

For further information, see Chapters 14, 15, and 17.

FORM

LIMITED LIABILITY COMPANY AGREEMENT

This Limited Liability Company Agreement is made as of August 1, 2002 by and among Member, Incorporated, John Jones, and Sally Smith to serve as the limited liability company agreement under the Act (hereinafter defined) for the limited liability company specified herein.

NOW, THEREFORE, in consideration of the agreements and obligations set forth herein and for other good and valuable consideration, and intending to be legally bound hereby, the parties hereto agree_____ as follows:

1. *Definitions.* Unless the context otherwise requires, the terms defined in this Section 1 shall, for the purposes of this Agreement, have the meanings herein specified.

"Act" means the Delaware Limited Liability Company Act of 1994, 6 *Del. C.* § 18-101, *et seq.*, and any successor statute, as amended from time to time.

"Affiliate" means, as to any Person, any other Person that directly or indirectly, through one or more intermediaries controls, is controlled by or is under common control with such Person or, if such Person is an individual, the Immediate Family of such Person or trusts solely for the benefit of such Immediate Family. As used in this definition, the term "control" means the possession, directly or indirectly, or as trustee or executor, of the power to direct or cause the direction of the management and policies of a Person, whether through ownership of voting securities, as trustee or executor, by contract or credit arrangement or otherwise.

"Agreement" means this Limited Liability Company Agreement, as amended, modified, supplemented or restated from time to time.

"Capital Account" means, with respect to any Member, the account maintained for such Member in accordance with the provisions of Section 8 hereof.

"Capital Contribution" means, with respect to each Member, the aggregate amount of cash and the agreed value of any property or services contributed to the Company pursuant to Section 7 hereof. In the case of a Member that acquires an Interest in the Company by virtue of an assignment or transfer in accordance with the terms of this Agreement, "Capital Contribution" means the *pro rata* Capital Contribution of such Member's predecessor proportionate to the acquired Interest.

"Certificate" means the Certificate of Formation of the Company and any and all amendments thereto and restatements thereof filed on behalf of the Company with the office of the Secretary of State of the State of Delaware pursuant to the Act.

"Claim" has the meaning set forth in Section 18(b) hereof.

"Code" means the Internal Revenue Code of 1986, as amended from time to time, or any corresponding federal tax statute enacted after the date of this Agreement. A reference to a specific section of the Code refers not only to such specific section but also to any corresponding provision of any federal tax statute enacted after the date of this Agreement that is applicable to the transaction or event in question, as such specific section or corresponding provision is in effect on the date of application of the provisions of this Agreement containing such reference.

"Company" means Real Estate Associates, LLC, the Delaware limited liability company of such name which has been formed under the Act.

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"Covered Person" means a Member, any Affiliate of a Member, any officer, director, shareholder, partner, employee, representative or agent of a Member, or their respective Affiliates, or any officer, employee or agent of the Company or its Affiliates.

"Damages" has the meaning set forth in Section 18(a) hereof.

"Fiscal Year" means [(a) the period commencing upon the formation of the Company and ending on such date as the Members shall determine, (b) any subsequent twelve (12) month or 52/53 week period ending on such date as the Members shall determine, or (c) any portion of the period described in clause (b) of this sentence] [the calendar year or any portion thereof] for which the Company is required to allocate Net Income and Net Loss and other items pursuant to Section 9 hereof.

"Immediate Family" means, with respect to any individual, such individual's parents, spouse, issue and adopted children, or any of them.

"Indemnified Party" has the meaning set forth in Section 18(b) hereof.

"Initial Members" means Member, Incorporated, John Jones and Sally Smith.

"Interest" means a Member's interest in the Company, including, without limitation, such Member's share of the profits and losses of the Company and such Member's right to receive distributions (liquidating or otherwise), allocations and information and such Member's right to consent to or approve actions by the Company, all in accordance with the provisions of this Agreement and the Act.

"Laws" means:

(a) all constitutions, treaties, laws, statutes, codes, ordinances, orders, decrees, rules, regulations and municipal by-laws, whether domestic, foreign or international;

(b) all judgments, orders, writs, injunctions, decisions, rulings, decrees and awards of any governmental body;

(c) all policies, practices and guidelines of any governmental body; and

(d) any amendment, modification, re-enactment, restatement or extension of the foregoing, in each case binding on or affecting the party or Person referred to in the context in which such word is used; and

"Law" shall mean any one of them.

"Majority Vote" means the written approval of, or the affirmative vote by, Members holding a majority of the Percentage Interests.

"Member" means each Initial Member and any Person admitted as an additional Member or a substitute Member pursuant to the provisions of this Agreement, in such Person's capacity as, and so long as such Person is, a member of the Company, and "Members" means two or more of such Persons when acting in their capacities as members of the Company. For purposes of the Act, the Members shall constitute one class or group of members. Schedule A hereto shall list the Members and shall be revised from time to time to reflect changes in the Members.

"Net Income" or "Net Loss" means, for each Fiscal Year or other period, an amount equal to the Company's taxable income or loss for such year or period, other than items of income or loss specially allocated pursuant to this Agreement, as determined by the Company's accountants in accordance with Section 703(a) of the Code (for this

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purpose, all items of income, gain, loss or deduction required to be stated separately pursuant to Section 703(a)(1) of the Code shall be included in Net Income or Net Loss), with the adjustments required to comply with the Capital Account maintenance rules of *Treasury Regulation Section 1.704-1(b)*, including the rules relating to (i) revaluations in the case of distributions of Company property in kind and the optional revaluation of Company property and (ii) utilizing "book" depreciation, cost recovery or amortization as determined under *Treasury Regulation Section 1.704-1(b)(2)(iv)(g)(3)* if there is a difference between the fair market value of contributed or revalued property and the adjusted tax basis of such property. The Members shall cause the Company to revalue property as required or permitted under the applicable Treasury Regulations.

"Notice" has the meaning set forth in Section 18(b) hereof.

"Percentage Interest" means the interest of a Member, expressed as a portion of one hundred percent, as shown on Schedule A hereto, which reflects the Member's ownership interest in the Company.

"Person" means any natural person, corporation, association, partnership (general or limited), limited liability company, joint venture, trust, estate, unincorporated association, or other legal entity or organization.

"Regulatory Allocations" means allocations of Net Income and Net Loss (or items thereof) and Company indebtedness in accordance with the following:

(a) The non-recourse deductions of the Company (within the meaning of *Treasury Regulation Section 1.704-2(b)(1)* and (c)) shall be allocated among the Members in accordance with their respective Percentage Interests.

(b) Net Income or Net Loss (or items thereof) shall be allocated in a manner consistent with the requirements of *Treasury Regulation Section 1.704-2(e)*, including, without limitation, those provisions relating to allocations of income and deductions attributable to non-recourse debt and partner non-recourse debt. Allocations that would conform to those required by a "minimum gain chargeback" (as defined in *Treasury Regulation Section 1.704-2(f)*) in addition to the requirements of *Treasury Regulation Section 1.704-1(b)(2)(ii)(d)*, relating to a "qualified income offset," and *Treasury Regulation Section 1.704-2(i)(4)*, relating to the chargeback on account of a decrease in minimum gain attributable to partner non-recourse debt, shall be made in a manner, at a time, and in the amounts consistent with those provisions.

(c) The "excess non-recourse indebtedness" of the Company (within the meaning of *Treasury Regulation Section 1.752-3(a)(3)*) shall be allocated among the Members in accordance with their respective Percentage Interests.

(d) Items of income, gain, loss and deduction shall, solely for federal income tax purposes, be allocated among the Members in a manner that takes into account the difference between the income tax basis of any Company property contributed by a Member to the Company and its value for purposes of this Agreement, as required by Section 704(c) of the Code, both determined immediately after its contribution to the Company. The Members, in their absolute discretion, may elect to account for the book-tax variation using any method permitted under the applicable Treasury Regulations.

"Tax Matters Member" has the meaning set forth in Section 16 hereof.

"Tax Payment Loan" has the meaning set forth in Section 10(c) hereof.

"Treasury Regulations" means the income tax regulations, including temporary regulations, promulgated under the

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Code, as such regulations may be amended from time to time (including corresponding provisions of succeeding regulations that are applicable to the transaction or event in question).

"Voting Rights" means the number of votes of each Member (as set forth in Section 12(b) hereof) for purposes of voting on any matter arising under this Agreement. "Withholding Tax Act" has the meaning set forth in Section 10(c) hereof.

2. *Organization.* The Members heretofore have authorized the organization of the Company as a limited liability company under and pursuant to the provisions of the Act and agree that the rights, duties and liabilities of the Members shall be as provided in the Act, except as otherwise provided herein. Sally Smith, as an authorized person within the meaning of the Act, is hereby authorized and directed to execute, deliver and file the Certificate.

3. *Name.* The name of the Company is Real Estate Associates LLC. The business of the Company may be conducted upon compliance with all applicable Laws under any other name designated by the Members.

4. *Purpose.* The Company is formed for the object and purpose of, and the nature of the business to be conducted and promoted by the Company is, the development of the Pleasant Street Inn, and engaging in any lawful act or activity for which limited liability companies may be formed under the Act and engaging in any and all activities necessary, convenient, desirable or incidental to the foregoing.

5. *Term.* The existence of the Company shall commence on the date the Certificate is filed in the office of the Secretary of State of the State of Delaware and shall continue perpetually until the Company is dissolved in accordance with the provisions of this Agreement. The existence of the Company as a separate legal entity shall continue until cancellation of the Certificate in the manner required by the Act.

6. *Registered Office and Principal Office.* The registered office of the Company in the State of Delaware shall be located at 21 Dover Street, Dover, Delaware and the principal office of the Company shall be located at 21 Pleasant Street, Ispwich, NY 55555, or at such other locations as, from time to time, may be determined by the Members. The Company may also have such other offices at such other locations as, from time to time, may be deemed advisable by the Members.

7. *Company Capital and Initial Percentage Interests.*

(a) The initial Capital Contribution which each member has made or is deemed to have made to the Company is set forth opposite each Member's name on Schedule A hereto.

(b) No Member shall be required to lend any funds to the Company or to contribute any capital to the Company in excess of the amount that is initially credited to such Member's Capital Account. No Member shall have any obligation to eliminate a deficit balance in such Member's Capital Account at any time or to bring such Member's Capital Account into any particular parity with any other Member's Capital Account at any time.

(c) No interest shall be paid on or with respect to the Capital Contribution or Capital Account of any Member.

(d) Although the Company may make distributions to the Members from time to time as a return of their Capital Contributions, no Member shall have the right to resign, withdraw or otherwise dissociate from the Company (whether voluntary or involuntary) or demand a return of any of such Member's Capital Contribution or Capital Account or the fair value of such Member's interest in the Company, except upon dissolution and winding up of the Company. Any attempted resignation, withdrawal or other dissociation in violation of this Agreement shall be null and void *ab initio*.

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8. *Capital Accounts.* A separate Capital Account shall be established and maintained for each Member under this Agreement. The Capital Account of each Member shall be credited with the cash and the agreed value of any property (net of liabilities assumed by the Company and liabilities to which such property is subject) or services contributed to the Company by such Member, plus all income, gain, or Net Income of the Company allocated to such Member pursuant to Section 9 (including Net Income and income and gain exempt from tax), and shall be debited with the sum of (i) all Net Losses or deductions of the Company allocated to such Member pursuant to Section 9, (ii) such Member's distributive share of expenditures of the Company described in Section 705(a)(2)(B) of the Code (or treated as so described under *Treasury Regulation Section 1.704-1(b)(2)(iv)(i)*), and (iii) all cash and the fair market value of any property (net of liabilities assumed by such Member and the liabilities to which such property is subject) distributed by the Company to such Member pursuant to Section 10. The amount of the Capital Account of a Member shall be determined in accordance with the rules set forth in *Treasury Regulation 1.704-1(b)*. Any references in any Section or subsection of this Agreement to the Capital Account of a Member shall be deemed to refer to such Capital Account as the same may be credited or debited from time to time as set forth above. It is the intention of the Members to satisfy the capital account maintenance requirements of *Treasury Regulation Section 1.704-1(b)(2)(iv)*, and the foregoing provisions defining Capital Accounts are intended to comply with such provisions.

9. *Allocation of Net Income or Net Loss.*

(a) *Allocation of Net Income or Net Loss Generally.* Except as otherwise provided in this Section 9, Net Income or Net Loss, and all tax credits of the Company for each fiscal period, shall be allocated among the Members in accordance with their respective Percentage Interests.

(b) *Regulatory Allocations.* Net Income and Net Loss (and items thereof) and Company indebtedness shall be specially allocated in accordance with the Regulatory Allocations, to the extent applicable, and Regulatory Allocations of Net Income and Net Loss (and items thereof) shall be made prior to other allocations of Net Income or Net Loss under this Agreement.

(c) *Allocations and Distributions with Respect to Percentage Interests Transferred.* If a Percentage Interest is transferred, there shall be allocated to each Member who held the transferred Percentage Interest during the Fiscal Year of transfer the product of (a) the Net Income or Net Loss allocable to such transferred Percentage Interest for such Fiscal Year and (b) a fraction, the numerator of which is the number of days such Member held the transferred Percentage Interest during such Fiscal Year and the denominator of which is the total number of days in such Fiscal Year; *provided, however*, that the Company shall allocate the Net Income or Net Loss by closing the Company's books immediately after the transfer of any Percentage Interest if requested by the transferor or transferee of the Percentage Interest within forty-five (45) days after the close of the taxable year in which the transfer occurred. Either allocation shall be made without regard to the date, amount or recipient of any distributions which may have been made with respect to any such transferred Percentage Interest.

10. *Distributions.*

(a) Subject to Sections 10(b) and 10(c), distributions of cash and/or other assets or property of the Company, from whatever source (including, without limitation, net proceeds of Company operations and sale, financing or refinancing of Company assets) shall be made to the Members in accordance with their respective Percentage Interests at such times, and in such amounts, as the Members shall determine. In making such determination, the Members may set aside funds and establish reserves for such items as the Members shall determine, including, without limitation, working capital, maintenance of bonding capacity, capital expenditures, acquisition of other assets by the Company and the satisfaction of liabilities (including, without limitation, contingent liabilities) as they may come due.

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(b) With respect to any Fiscal Year of the Company in which Members are allocated taxable income for federal income tax purposes (and for this purpose all items of income, gain, loss or deduction required to be separately stated pursuant to Section 703 of the Code shall be included in this calculation of taxable income (other than the amount, if any, by which capital losses exceed capital gains)), the Company shall attempt to distribute to the Members, within 90 days after the close of such Fiscal Year, no less than the amount determined by multiplying the Company's taxable income (computed as set forth in this sentence) by the highest composite federal, state and local income tax rate applicable to any Member. Nothing herein shall require the Company to borrow money or reduce its cash flow so as to restrict its ability to operate the day-to-day activities of the business in order to make such distributions.

(c) Unless treated as a Tax Payment Loan (as hereinafter defined), any amount paid by the Company for or with respect to any Member on account of any withholding tax or other tax payable with respect to the income, profits or distributions of the Company pursuant to the Code, the Treasury Regulations, or any foreign, state or local statute, regulation or ordinance requiring such payment (each a "Withholding Tax Act") shall be treated as a distribution to such Member for all purposes of this Agreement. To the extent that the amount required to be remitted by the Company under a Withholding Tax Act exceeds the amount then otherwise distributable to such Member, the excess shall constitute a loan from the Company to such Member (a "Tax Payment Loan") which shall be payable upon demand and shall bear interest, from the date that the Company makes the payment to the relevant taxing authority, at the applicable federal short-term rate under Section 1274(d) of the Code, compounded semiannually. So long as any Tax Payment Loan or the interest thereon remains unpaid, the Company shall make future distributions due to such Member under this Agreement by applying the amount of any such distribution first to the payment of any unpaid interest on all Tax Payment Loans of such Member and then to the repayment of the principal of all Tax Payment Loans of such Member. The Members shall take all actions necessary to enable the Company to comply with the provisions of any Withholding Tax Act applicable to the Company and to carry out the provisions of this subsection.

11. *Other Interests of Members.* Any Member or Affiliate thereof may engage in or possess an interest in other business ventures of any nature or description, independently or with others, similar or dissimilar to the business of the Company, and the Company and the Members shall have no rights by virtue of this Agreement in and to such independent ventures or the income or profits derived therefrom, and the pursuit of any such venture, even if competitive with the business of the Company, shall not be deemed wrongful or improper. No Member or Affiliate thereof shall be obligated to present any particular investment opportunity to the Company even if such opportunity is of a character that, if presented to the Company, could be taken by the Company, and any Member or Affiliate thereof shall have the right to take for its own account (individually or as a partner or fiduciary) or to recommend to others any such particular investment opportunity.

12. *Control and Management.*

(a) *Power and Authority of the Members.* Management of the business and affairs of the Company shall be vested in the Members. Any decision, determination or other action to be made or taken by the Members shall be made or taken upon the affirmative vote of Members holding a majority of the Voting Rights. The Members shall have all rights and powers and shall make all decisions affecting the Company in furtherance of the Company's purposes, including, but not limited to, the following:

(i) to appoint a President, one or more Vice Presidents, a Secretary, a Treasurer and such other officers of the Company as the Members deem appropriate to carry out and execute the decisions and instructions of the Members in the day to day operations of the business of the Company. Such officers shall have such duties and powers as are from time to time

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specified by the Members and they may be removed by the Members at any time with or without cause;

(ii) to retain all or any part of the Company's assets as long as the Members deem advisable, and to invest, reinvest and keep invested all or any part thereof, without being restricted in any way with respect to the type of assets retained or invested in or with respect to the portion of the assets devoted to any investment;

(iii) to purchase, lease or otherwise acquire the ownership, use or benefit of assets, properties, rights or privileges, real or personal, tangible or intangible, of any kind or description, whether income producing or not;

(iv) to sell, pledge, mortgage, lease without limit of time, exchange, or to grant options for the purchase, lease or exchange of any Company assets, on such terms and conditions as the Members may determine;

(v) to institute any legal action or proceeding on behalf of the Company;

(vi) to assign, transfer, pledge, compromise or release any claims or debts due the Company;

(vii) to make, execute or deliver any assignment for the benefit of creditors or any confession of judgment, mortgage, deed, guarantee, indemnity or surety bond;

(viii) to vote at any election or meeting of any corporation, partnership, limited liability company, joint venture or other entity, in person or by proxy, to appoint agents to do so in the place and stead of the Members, and to exercise all rights (including without limitation approval and consent rights) that the Company may have with respect to such entity, whether pursuant to applicable Law, governing documents, contracts or otherwise;

(ix) to borrow money for any purpose that the Members consider to be for the benefit of the Company or to facilitate its administration, and to mortgage or pledge Company assets to secure the repayment thereof;

(x) to retain and pay custodians, accountants, counsel and other agents and to incur any other expenses which are reasonably related to the operation of the Company;

(xi) to enter into agreements with, and to fix and adjust the compensation of, employees of the Company; and

(xii) to invest in time deposits and savings accounts and to maintain banking accounts in any institutions determined by the Members.

(b) *Voting.* Each Member shall have that number of Voting Rights as equals such Member's Percentage Interest in the Company stated without a percentage symbol (e.g., a Member who has a 10% Percentage Interest in the Company would have 10 Voting Rights). Except as otherwise expressly provided to the contrary in this Agreement, the affirmative vote of Members holding a majority of the Voting Rights shall be required for the approval of any matter requiring the approval of Members. Members may vote in person or by proxy at a meeting of Members (which may be held by conference telephone), or by consent in writing without a meeting signed by a Member or Members holding a majority of the Voting

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Rights.

(c) *Binding Effect of Actions.* Each Member shall be bound by, and hereby consents to, any and all actions taken and decisions made by the Members in accordance with the terms of this Agreement. Any person designated by the Members, including a Member so designated, shall have the authority to bind the Company. Any act taken by, or any document executed by, Members holding the number of Voting Rights needed to approve such action, or the execution of such document, shall be binding on the Company with the same force and effect as if such action, or the execution of such document, were approved by a vote of the Members. Except as provided in this Section 12(c), no Member shall have authority to bind the Company.

(d) *Business Combination.* Notwithstanding any other provision of this Agreement, unless approved by Members holding a majority of the Voting Rights, the Company may not (i) engage in a merger or consolidation with or into any corporation, partnership, limited liability company or any other entity, whether or not the Company shall be the surviving entity of such merger or consolidation; or (ii) sell all or substantially all of its assets to any Person; or (iii) engage in any similar business combination.

13. *Transfers of Interests; Admission of Additional Members.*

(a) *Restrictions on Transfer.* Except as otherwise provided in this Agreement, no Interest of a Member may be sold, assigned, transferred, given, bequeathed, donated, mortgaged, pledged, attached, levied upon, seized by or for creditors, or otherwise encumbered or disposed of, whether by act of the Member or by operation of Law (any of the foregoing being a "Transfer"), without the prior written consent of Members (other than the Member whose Interest is involved) holding a majority of the remaining Voting Rights (i.e., excluding the Voting Rights of the Member whose Interest is involved), which consent may be withheld for any reason or for no reason. Any attempted Transfer by a Person of a Member's Interest, or any part thereof, other than in accordance with this Agreement shall be, and is hereby declared, null and void *ab initio*.

(b) *Admission of Additional Members.* Additional members may be admitted only with the consent of a majority in interest of the Members.

14. *Dissolution.*

(a) *Events of Dissolution.* The Company shall be dissolved and its affairs wound up upon, but only upon, the first to occur of the following:

(i) the written consent of Members holding at least 80% of the Voting Rights;

(ii) the termination of the membership of the last remaining Member; provided that the Company shall not be dissolved and its affairs shall not be wound up if (i) within 30 days after the occurrence of the event that terminated the continued membership of the last remaining Member, the personal representative of the last remaining Member agrees in writing to continue the Company and to the admission of the personal representative of such Member or its nominee or designee to the Company as a Member, effective as of the occurrence of the event that terminated the continued membership of the last remaining Member [Note: The Agreement may provide that the personal representative of the last remaining Member shall be obligated to agree in writing to continue the Company and to the admission of the personal representative of such Member or its nominee or designee to the Company as a Member, effective as of the occurrence of the event that terminated the

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continued membership of the last remaining Member] [or, (ii) a Member is admitted to the limited liability Company in the manner provided for in this Agreement, effective as of the occurrence of the event that terminated the continued membership of the last remaining Member, within 30 days after the occurrence of the event that terminated the continued membership of the last remaining Member, pursuant to Section 14(a)(ii) of this Agreement

(iii) the entry of a decree of judicial dissolution of the Company under Section 18-802 of the Act.

(b) *Distributions upon Dissolution.* In the event of a dissolution of the Company, the assets of the Company shall be liquidated in such manner as the Members shall determine and, after Company obligations to third parties have been discharged or provided for in accordance with applicable Law, the net proceeds of such liquidation shall be distributed as follows:

(i) First, among the Members, if any, who have made unrepaid loans or advances to the Company, an amount up to the aggregate amount of such unrepaid loans and advances, in proportion to the amount of such loans and advances and the unpaid interest thereon;

(ii) Second, among the Members, an amount up to the aggregate amount of their unrepaid Capital Contributions, in proportion to the amounts of such unrepaid Capital Contributions; and

(iii) Third, among the Members in accordance with their respective Percentage Interests. A reasonable time shall be allowed for such liquidation in order to minimize the losses normally attendant upon a liquidation.

(c) *Statement of Assets.* In connection with the Company's liquidation, the Company's accountants shall compile and furnish to each Member a statement setting forth the assets and liabilities of the Company as of the date of complete liquidation.

(d) *Certificate of Cancellation.* Upon the dissolution and the completion of winding up of the Company, the Members shall file in the office of the Secretary of State a certificate of cancellation containing the information required by the Act.

15. *Books and Records.*

(a) The Members shall cause to be kept full and accurate books and records of the Company. A separate Capital Account shall be established for each Member on the books of the Company. The Company shall maintain the following records, among others:

(i) A current list of the full name and last known business address of each Member.

(ii) A copy of the Certificate and all amendments thereto, together with executed copies of any powers of attorney pursuant to which the Certificate and such amendments have been executed.

(iii) Copies of the Company's federal, foreign, state and local income tax returns and reports, if any, for the three (3) most recent years.

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(iv) Copies of this Agreement and all amendments thereto.

(v) Any financial statements of the Company for the three (3) most recent Fiscal Years. All books and records of the Company shall be kept at the Company's principal office and shall be available at such location at reasonable times for inspection and copying by the Members or their duly authorized representatives. The books will be kept on an accrual basis. All information needed by the Members and other Persons who were Members during the applicable calendar year for income tax purposes shall be prepared by the Company's accountants and furnished to each such Person after the end of each calendar year of the Company.

(b) The books will be closed and balanced at the end of each Fiscal Year. The Members shall cause to be made available to each Member, upon written request, within 120 days after the close of each Fiscal Year, copies of the Company's annual financial statements, including a written balance sheet and statement of income or loss. Such financial statements will also indicate the Members' share of the Net Income and Net Loss and other relevant fiscal items of the Company for such year. The Members shall arrange for the preparation of all tax returns required to be filed for the Company. Each Member shall be entitled to receive, upon written request, copies of all federal, state and local income tax returns and information returns, if any, which the Company is required to file.

16. *Tax Matters.*

(a) *Tax Elections.*

(i) The Members shall cause the Company to make the election under Section 754 of the Code to adjust the basis of the Company's property in the case of a transfer of a Percentage Interest by sale or exchange or upon the death of a Member, if the transferee becomes a substitute Member, and the transferee requests that the Company make the election, in writing, not later than thirty (30) days after the close of the Fiscal Year in which the event giving rise to the adjustment for which an election is needed occurs. The Members may also, in their discretion, cause the Company to make an election at any time without a request to do so.

(ii) The Company shall take any action necessary to be taxed as a "partnership" for federal and state income tax purposes and neither the Company nor any Member shall take any action that would result in the Company being taxed as other than a "partnership" for federal income tax purposes, including (but not limited to) electing to be taxed as other than a "partnership" by filing Form 8832, "Entity Classification Election."

(iii) All other tax elections on behalf of the Company may be made or rescinded in the discretion of the Members.

(b) *Tax Matters Member.* Sally Smith or such other Member as may be designated by the Members from time to time shall act on behalf of the Company as the "tax matters member" within the meaning of Section 6231(a)(7) of the Code.

17. *Liability of Members.* The Members shall have no liability for the obligations or liabilities of the Company except to the extent required by the Act.

18. *Indemnification.*

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(a) *Indemnification of Covered Persons.* To the extent permitted by Law, the Company shall indemnify, defend and hold harmless each Covered Person from and against any and all debts, losses, claims, damages, costs, demands, fines, judgments, contracts (implied and expressed, written and unwritten), penalties, obligations, payments, liabilities of every type and nature (whether known or unknown, fixed or contingent), including, without limitation, those arising out of any lawsuit, action or proceeding (whether brought by or on behalf of a party to this Agreement or by any third party), together with any reasonable costs and expenses (including, without limitation, reasonable attorneys' fees, out-of-pocket expenses and other reasonable costs and expenses incurred in investigating, preparing or defending any pending or threatened lawsuit, action or proceeding) incurred in connection with the foregoing (collectively "Damages") suffered or sustained by such Covered Person by reason of any act, omission or alleged act or omission by such Covered Person arising out of such Covered Person's activities taken primarily on behalf of the Company, or at the request or with the approval of the Company, or primarily in furtherance of the interests of the Company. Notwithstanding the foregoing, indemnification shall not be available under this Section 18(a) where the acts, omissions or alleged acts or omissions upon which an actual or threatened action, proceeding or claim is based constituted willful misconduct or gross negligence.

(b) *Indemnification Procedure.* A party seeking indemnification from the Company pursuant to Section 18(a) hereof (an "Indemnified Party") shall give prompt notice to the Company of the assertion of any claim, including any claim brought by a third party, in respect of which indemnity may be sought hereunder (a "Claim") and shall give the Company such information with respect thereto as the Company may reasonably request, but no failure to give such notice shall relieve the Company of any liability hereunder except to the extent the Company has suffered actual prejudice thereby. The Company shall have the right, exercisable by written notice (the "Notice") to the Indemnified Party (which Notice shall state that the Company expressly agrees that as between the Company and the Indemnified Party, the Company shall be solely obligated to satisfy and discharge the Claim) within thirty (30) days of receipt of notice from the Indemnified Party of the commencement of or assertion of any Claim, to assume the defense of such Claim, using counsel selected by the Company and reasonably acceptable to the Indemnified Party; *provided* that the Company shall not have the right to assume the defense of a Claim (A) seeking an injunction, restraining order, declaratory relief or other nonmonetary relief against the Indemnified Party (whether or not the Company is also named as a party) or (B) if the named parties to any such action (including any impleaded parties) includes both the Indemnified Party and the Company and the Indemnified Party shall have been advised by counsel that there are one or more legal or equitable defenses available to the Indemnified Party which are different from those available to the Company; in which case such Indemnified Party shall have the right to participate in the defense of a Claim of the type set forth in clause (A) and/or (B) above and all Damages in connection therewith shall be reimbursed by the Company to the extent provided in Section 18(a). In addition, if the Company fails to give the Indemnified Party the Notice complying with the provisions stated above within the stated time period, the Indemnified Party shall have the right to assume control of the defense of the Claim and all Damages in connection therewith shall be reimbursed by the Company to the extent provided in Section 18(a) upon demand of the Indemnified Party. In any event, no party assuming the defense of any Claim shall have the right to compromise or settle any claim for non-monetary relief against the other party or any claim for monetary relief against another party without such party's consent (which consent shall not be unreasonably withheld or denied) unless such monetary relief is paid in full by the settling party.

If at any time after the Company assumes the defense of a Claim any of the conditions set forth above are no longer satisfied, the Indemnified Party shall have the same rights as if clause (A) or (B) in the preceding paragraph had been satisfied and the Company never assumed the defense of such Claim.

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The Company or the Indemnified Party, as the case may be, shall in any event have the right to participate, at its own expense, in the defense of any Claim which the other is defending.

The Company, if it has assumed the defense of any Claim in accordance with the terms hereof, shall have the right, upon five (5) business days prior written notice to the Indemnified Party, to consent to the entry of judgment with respect to, or otherwise settle, such Claim unless (i) the Claim involves equitable or other non-monetary damages or (ii) in the reasonable judgment of the Indemnified Party such settlement would have a continuing material adverse effect on the Indemnified Party's business (including any material impairment of its relationships with customers and suppliers). In the case of (i) and (ii) above, such settlement may be made only with the written consent of the Indemnified Party, which consent shall not be unreasonably withheld or delayed. If the Indemnified Party otherwise assumes the defense of a Claim, it shall have the right to settle such Claim only with the consent of the Company.

Whether or not the Company chooses to defend or prosecute any Claim involving a third party, all the parties hereto shall cooperate in the defense or prosecution thereof and shall furnish such records, information and testimony, and attend such conferences, discovery proceedings, hearings, trials and appeals as may be reasonably requested in connection therewith.

(c) *Right to Advancement of Expenses.* To the fullest extent permitted by applicable Law, expenses (including legal fees) incurred by a Covered Person in defending any claim, demand, action, suit or proceeding shall, from time to time, be advanced by the Company prior to the final disposition of such claim, demand, action, suit or proceeding upon receipt by the Company of an undertaking by or on behalf of the Covered Person to repay such amount if it shall be determined that the Covered Person is not entitled to be indemnified as authorized in Section 18(a) hereof.

(d) *Insurance.* The Company may purchase and maintain insurance, to the extent and in such amounts as the Members shall deem reasonable, on behalf of Covered Persons and such other Persons as the Members shall determine, against any liability that may be asserted against or expenses that may be incurred by any such Person in connection with the activities of the Company or such indemnitees, regardless of whether the Company would have the power to indemnify such Person against such liability under the provisions of this Agreement. The Company may enter into indemnity contracts with Covered Persons and such other Persons as the Members shall determine and adopt written procedures pursuant to which arrangements are made for the advancement of expenses and the funding of obligations under this Section 18 and containing such other procedures regarding indemnification as are appropriate.

(e) *Non-Exclusivity of Rights.* The rights conferred on any Person by this Section 18 shall not be exclusive of any other rights which such Person may have or hereafter acquire under any statute, provision of the Certificate, agreement, vote of Members or otherwise.

(f) *Amendment or Repeal.* Any repeal or modification of this Section 18 shall not adversely affect any right or protection hereunder of any Person in respect of any act or omission occurring prior to the time of such repeal or modification.

(g) *Changes in Law.* References in this Section 18 to Law shall be to such Law as it existed on the date this Agreement was executed or as such Law thereafter may be changed; provided that (i) in the case of any change which limits the indemnification rights or the rights to advancement of expenses which the Company may provide, the rights to indemnification and to the advancement of expenses provided in this Section 18 shall continue as theretofore agreed upon to the extent permitted by Law; and (ii) if such change permits the Company without the requirement of any further action by the Members to provide

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broader indemnification rights or rights to the advancement of expenses than the Company was permitted to provide prior to such change, then the rights to indemnification and the advancement of expenses shall be so broadened to the extent permitted by Law.

(h) *Applicability.* The provisions of this Section 18 shall be applicable to all actions, suits or proceedings commenced after its adoption, whether such arise out of acts or omissions which occurred prior or subsequent to such adoption and shall continue as to a Person who has ceased to be a Covered Person, and shall inure to the benefit of the heirs, personal representatives, successors and assigns of such Person.

19. *Miscellaneous.*

(a) *Indulgences, Etc.* Neither the failure nor any delay on the part of any party to exercise any right, remedy, power or privilege under this Agreement shall operate as a waiver thereof, nor shall any single or partial exercise of any right, remedy, power or privilege preclude any other or further exercise of the same or of any other right, remedy, power or privilege, nor shall any waiver of any right, remedy, power or privilege with respect to any occurrence be construed as a waiver of such right, remedy, power or privilege with respect to any other occurrence. No waiver shall be effective unless it is in writing and is signed by the party asserted to have granted such waiver.

(b) *Controlling Law.* This Agreement and all questions relating to its validity, interpretation, performance and enforcement (including, without limitation, provisions concerning limitations of actions), shall be governed by and construed in accordance with the Laws of the State of Delaware.

(c) *Notices.* All notices, requests, demands and other communications required or permitted under this Agreement shall be in writing and shall be deemed to have been duly given, made and received only when delivered (personally, by reputable courier service such as Federal Express, or by other messenger) or when deposited in the United States mails, registered or certified mail, postage prepaid, return receipt requested, addressed as set forth below:

If to the Company:

Real Estate Associates LLC
21 Pleasant Street
Ipswich, NY 55555

If to a Member:

to the address appearing for such Member on Schedule A hereto.

Any party may alter the address to which communications to such party are to be sent by giving notice of such change of address to the other parties in conformity with the provisions of this paragraph for the giving of notice, whereupon Schedule A shall be amended to reflect such change.

(d) *Binding Nature of Agreement; No Assignment.* This Agreement shall be binding upon and inure to the benefit of the parties and their respective successors and assigns except that no party may assign or transfer any of its rights or obligations under this Agreement except as provided herein.

(e) *Execution in Counterparts.* This Agreement may be executed in any number of counterparts, each of which shall be deemed to be an original as against any party whose signature appears thereon, and all of

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which shall together constitute one and the same instrument. If executed in multiple counterparts, this Agreement shall become binding when any counterpart or counterparts hereof, individually or taken together, bear the signatures of all of the parties reflected hereon as the signatories.

(f) *Provisions Separable.* The provisions of this Agreement are independent of and separable from each other, and no provision shall be affected or rendered invalid or unenforceable by virtue of the fact that for any reason any other provision may be invalid or unenforceable in whole or in part.

(g) *Entire Agreement.* This Agreement contains the entire understanding among the parties hereto with respect to the subject matter hereof and supersedes all prior and contemporaneous agreements and understandings, inducements or conditions, express or implied, oral or written. The express terms hereof control and supersede any course of performance and/or usage of the trade inconsistent with any of the terms hereof.

(h) *Amendments or Modifications.* This Agreement may not be amended or modified other than by an agreement in writing signed by all of the parties hereto.

(i) *Headings.* The headings in this Agreement are for convenience only; they form no part of this Agreement and shall not affect its interpretation.

(j) *Gender, Etc.* Words used herein, regardless of the number and gender specifically used, shall be deemed and construed to include any other number, singular or plural, and any other gender, masculine, feminine or neuter, as the context indicates is appropriate.

(k) *Number of Days.* In computing the number of days for purposes of this Agreement, all days shall be counted, including Saturdays, Sundays and holidays; provided, however, that if the final day of any time period falls on a Saturday, Sunday or holiday on which federal banks are or may elect to be closed, then the final day shall be deemed to be the next day which is not a Saturday, Sunday or such holiday.

(l) *Assurances.* Each Member shall execute all certificates and other documents and shall do all such filing, recording, publishing and other acts as the Members deem appropriate to comply with any Laws relating to the acquisition, operation or holding of the property of the Company.

(m) *Specific Performance.* The parties recognize that irreparable injury will result from a breach of any provision of this Agreement and that money damages will be inadequate to fully remedy the injury. Accordingly, in the event of a breach or threatened breach of one or more of the provisions of this Agreement, any party who may be injured (in addition to any other remedies which may be available to that party) shall be entitled to one or more preliminary or permanent orders (i) restraining and enjoining any act which would constitute a breach, or (ii) compelling the performance of any obligation which, if not performed, would constitute a breach.

(n) *Estoppel Certificate.* Each Member shall, within ten (10) days after written request by any Member, deliver to the requesting Person a certificate stating, to the Member's knowledge, that: (a) this Agreement is in full force and effect, (b) this Agreement has not been modified except by any instrument or instruments identified in the certificate, and (c) there is no default hereunder by the requesting Person, or if there is a default, the nature and extent thereof.

IN WITNESS WHEREOF, the undersigned have executed and delivered this Agreement as of the date first above written.

SCHEDULE A

MEMBER (Name and Address)	INITIAL CAPITAL CONTRIBUTION	PERCENTAGE INTEREST
Member, Incorporated	\$100,000	40%
John Jones	50,000	20%
Sally Smith	100,000	40%
Total	\$250,000	100%

A.12 Real estate investment trust--general investments--declaration of trust**COMMENT**

A real estate investment trust (REIT) is a pass through entity used for investment in real estate by holders of beneficial interests. If specific requirements are met, the REIT will not be required to pay tax. The requirements are designed to insure that (1) the organization is a trust or corporation with widely held beneficial interests, (2) its principal assets are real estate, (3) it is engaged only in passive investment, and (4) it distributes its income currently to its beneficiaries.

The organization must be either a corporation, a trust, or an association that is managed by one or more directors or trustees. In order for a trust or an association to qualify for REIT status, it must possess those characteristics that would require it to be taxed as a corporation, but for the real estate investment trust provisions of the Code. Thus, the trustee must have the rights and powers which would meet the "centralization of management" test for the taxability of an association as a corporation. This includes exclusive authority to manage the trust. A trust may qualify despite the shareholders' rights to elect or remove trustees, to terminate the trust, and to ratify amendments proposed by the trustees.

Beneficial ownership of the trust must be evidenced by transferable shares, or by transferable certificates of beneficial interest, and must be held by 100 or more persons. This 100-person ownership must exist during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months. This requirement does not apply for the first tax year of the REIT. Shares are considered "transferable" even though the trustee has the power to redeem shares or to refuse to transfer shares whenever he believes in good faith that such action is required to maintain the trust's status as a real estate investment trust. A second class of beneficial interest shares granting dividend and liquidation preference is permissible. A trust is disqualified if it is closely held, i.e. more than 50 percent of the beneficial interests are owned by no more than five individuals.

Real estate assets:

Under the first asset qualification test, at least 75 percent of the value of the organization's total assets must consist of real estate assets, cash and cash items (including receivables) and government securities. This test must generally be met at the close of each quarter of the taxable year. Not more than 25 percent of the value of the trust's total assets may be invested in other securities. "Real estate assets" means real property (including "interests in real property" and interests in mortgages on real property) and shares in other qualified real estate investment trusts. "Interests in real property" include fee ownership and coownership of land or leaseholds, options to acquire land or leaseholds, or improvements with respect

to any of the foregoing, but exclude mineral, oil, or gas royalty interests. Real property includes land or improvements of an inherently permanent nature, including structural components such as plumbing systems, etc.

Sources of income:

In order to insure that the trust will engage in primarily "passive" real estate investment, the Code requires that at least 75 percent of its gross income must consist of real estate items, and at least 95 percent must consist of those real estate items plus other investment items.

Rents from real property:

Rents from real property are included in the sources of income that must satisfy the 75 percent and 95 percent income-source tests. Rents include rent from interests in real property; charges for services customarily furnished in connection with the rental of real property, whether or not they are separately stated; and rent attributable to personal property which is leased in connection with a lease of real property, provided that the amount allocable to the personal property (in accordance with a prescribed formula) is less than 15 percent of total rent. To ensure that such rent is "passive" in nature, the Code excludes rent received under circumstances that are based upon sharing of profits, the trust's equity interest in the lessee, and the active conduct of business. Rents include rents based on the net income of a tenant, but only if the tenant itself receives substantially all of its income from subleasing the property, and these sublease rents would qualify as rents if received by the REIT. Rents derived in connection with providing services, unless provided by an independent contractor, will not qualify as rents from real property. Certain services, such as providing parking facilities on an unreserved basis to tenants, do not require an independent contractor.

Failure to meet income-source tests:

A trust is not deprived of its status as a qualified trust if it fails to meet the income-source tests, provided that such failure is due to reasonable cause and not willful neglect. The trust must report the nature and amount of each item of its gross income in a separate schedule attached to its income tax return. Even if the trust complies with these requirements, it must still pay a 100 percent tax on the greater of the amount by which it fails to meet the 75 percent or 95 percent income-source test.

Current distribution of income:

In order to retain its qualified status, a trust must distribute to its shareholders at least 95 percent of its annual real estate investment trust taxable income and net income derived from foreclosure property, less the amount of any net loss sustained from prohibited transactions and any penalties paid with respect to deficiency dividends. The required percentage of income must be distributed in the taxable year during which it is earned or in the next succeeding year. However, if a trust fails to distribute at least 75 percent of its taxable income during the year in which it is earned, it must pay a 3 percent nondeductible excise tax on the difference between such amount and the amount actually distributed.

Deficiency dividend procedure:

A trust is not deprived of its qualified status for failure to distribute the required percentage of income provided that it complies with a deficiency dividend procedure. This procedure permits distributions of income, qualifying for a deduction, to be made in subsequent years if a "determination" results in an adjustment that either increases that amount of income which the trust is required to distribute in order to

meet the distribution requirement for a prior year in question, or decreases the amount of the deduction for dividends previously paid for that year. A "determination" refers to a decision of the Tax Court or any other court of competent jurisdiction which has become final, a closing agreement, or an agreement relating to the tax liability of the trust. The deficiency dividend must be paid within 90 days after the determination and a claim for its deduction must be filed after its payment, but not later than 120 days after the date of the determination. The trust pays interest and penalties in conjunction with this procedure.

Taxation of REITs and shareholders:

Although a qualified trust is taxable at regular corporate rates, it is entitled to a deduction for the amount of dividends paid in computing its taxable income for the year. In this connection, a trust must distribute most of its income as dividends in order to obtain qualified trust status.

Beneficiaries of a trust are taxed in essentially the same manner as any corporate shareholder, except that no exclusion or deduction for dividends received is allowable to either an individual or corporate beneficiary. Thus, distributions out of "earnings and profits" are fully taxable ordinary income when received. The portion of any distribution designated by the trust as a "capital gain dividend" is treated by the beneficiary as long-term capital gain. Distributions out of depreciation reserves by a trust without earnings or profits are treated as a return of capital upon the shares, and thereafter as capital gain.

Since the real estate investment trust is a creature of the tax law, this form for a trust which intends to engage in general real estate investments follows closely the specifications of the Revenue Code and the Regulations. There are provisions for transferable shares and for the exercise of broad powers by the trustees. In addition, there are provisions insuring continuity of life, and limited liability on the part of shareholders. Thus, it is clear that the trust would be taxable as a corporation if it did not qualify as a real estate investment trust. Several special powers are given to the shareholders. They may elect and remove trustees, terminate the trust, and approve amendments to the basic declaration of trust. These rights may be granted to the shareholders without reducing the powers of the trustees below the minimum required by the statute.

It should be noted that local law may pose problems. In the absence of a state statute which recognizes a real estate investment trust, there may be questions connected with the rule against perpetuities, personal liability of the trustees or beneficial owners, and the permissible uses of a trust. In addition, consideration must be given to federal and state regulations relating to the sale of securities. As to the rule against perpetuities, this instrument provides that in any jurisdiction where it is found that the holding of property by the trust violates the local rule against perpetuities the trust is to continue only for specified lives in being plus 21 years.

It should also be noted that in recent years several jurisdictions, including New York and Connecticut, have codified the powers which every fiduciary possesses by virtue of his designation, whether or not such powers are expressly conferred upon him by the underlying trust indenture, will, or other instrument. The enumerated powers in this type of legislation are of the kind normally found in carefully drafted trusts and wills. Accordingly, in those jurisdictions where this type of legislation is in force, the draftsman does not need to encumber the instrument with the typical fiduciary powers clauses but can, when necessary, modify or add to the powers enumerated in the statute as the situation requires.

For further information, see Chapter 16.

FORM

DECLARATION OF TRUST made December 15, 2002, by the Trustees of Queensbrook Real Estate Trust, creating a trust primarily to invest and reinvest in real estate, interests in real estate, leasehold interests, mortgages, and interests in mortgages secured by real estate. All funds contributed to or invested in the Trust by those who have acquired and who will acquire beneficial interests herein as hereinafter provided are referred to herein as the "Shareholders."

Whereas the Trustees hereunder have acknowledged the receipt of \$10 and agreed to hold and manage the same and any property added thereto; and

Whereas the Trustees for the purpose of defining the respective interests of the Shareholders in the Trust, have agreed to issue to each Shareholder negotiable certificates of beneficial interest or shares ("Shares"), in the respective amounts and with the designations and form as hereinafter provided.

Now, therefore, the Trustees hereby declare that they assume the duties of Trustees hereunder and will hold all assets of the Trust, including those received as above recited and those to be received as hereinafter provided, and all rents, income, profits, and gains therefrom, from whatever source derived, in trust for the Shareholders in accordance with the terms and conditions hereinafter in this instrument provided and all amendments thereto, hereinafter called the Declaration.

Article I The Trust

Section 1. *Name.* The Trust shall be designated as "Queensbrook Real Estate Trust," in which name the Trustees may conduct business, sue and be sued, and otherwise do all things and take all action they may deem appropriate to carry out the business and preserve the assets of the Trust except as is provided in Article IV, Section 6, with respect to the holding of title to property owned by the Trust.

Section 2. *Location.* The Trust's principal office shall be in such city, town, or locality in the United States of America as the Trustees shall from time to time determine. The Trust may have such other offices or places of business as the Trustees may from time to time determine.

Section 3. *Nature of trust.* The Trust shall be of the type commonly termed a business trust, and shall not be a general partnership, limited partnership, partnership association, or corporation. The Shareholders are *cestuis que trustent* hereunder. No Trustee or Shareholder shall ever be, in any way whatsoever, liable or responsible hereunder as a partner. This Trust is intended to have the status of a "real estate investment trust" as that term is defined in Part II, Subchapter M of Chapter 1 of the Internal Revenue Code of 1986, as now enacted and as it may be hereafter amended, and the Declaration and all actions of the Trustees shall be construed in accordance with such intent.

Section 4. *Purposes.* The Trust shall be primarily engaged in the investment and reinvestment of its funds and other assets in real property, interests in real property, mortgages secured by real property, leasehold interests in real property, and interests in mortgages on real property. If, however, the Trustees are of the opinion that investment in real estate assets at any particular time is not prudent because of market or economic conditions, the Trust's assets may be maintained in cash or government securities, or both. The Trust shall not be primarily engaged in investing, reinvesting, or trading in securities. It is the express purpose and objective of the Trust to have invested from time to time such percentages of the value of its total assets in real property, leaseholds thereof, mortgages on real property, or interests therein, cash, cash items, and government securities, and to follow such investment policies, as may be required in order that the Trust qualify (so long as such qualification, in the opinion of the Trustees, is advantageous to its Shareholders) as a "real estate investment trust."

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Section 5. *Particular policies.* The Trust shall follow such policies as are required to maintain its qualification as a "real estate investment trust." If the Trust shall desire to issue or sell Shares or other securities in any state or jurisdiction in which there shall be in force and effect a law, rule, or regulation of the governmental body having jurisdiction over any such sale requiring that this Declaration contain one or more particular limitations or restrictions on the Trust's policies or operations, then anything else in this Declaration contained to the contrary notwithstanding, the Trustees may, without the Shareholders' prior approval, amend this Declaration to incorporate herein any such limitations or restrictions. These shall include, without affecting the generality of the foregoing, limitations or restrictions on the issuance of senior securities, borrowing money, requiring appraisals in particular circumstances, making loans, underwriting securities of others, investing in unimproved real estate, investing in mortgages, investing in securities of other real estate companies, investing in real estate contracts of sale and commodities, issuing different classes of shares or options or redeemable securities, and on the amount of operating expenses that may be incurred. The Trustees shall also have the power to provide that no further amendments of this Declaration may be made without the Shareholders' consent.

Section 6. *Definitions.* The terms "value," "real estate assets," and "interests in real property" as used in this Declaration of Trust shall have the same meaning as the definitions of these words contained in Part II of Subchapter M of Chapter 1 of the Internal Revenue Code of 1986, as now enacted, and as hereafter amended.

The terms "mortgage" or "mortgages" as used herein shall mean and include all forms of liens on real estate and all transfers of real estate for security purposes, including deeds of trust and all other forms of security transfers.

Article II Shares

Section 1. *Shares: certificates of beneficial interest.* The units into which the beneficial interests in the Trust will be divided shall be designated as Shares. The certificates evidencing ownership of shares in the Trust will be designated as Certificates of Beneficial Interest or Shares, and shall be in such form as the Trustees may from time to time prescribe. The registered holders thereof shall be designated as Shareholders. The number of Shares authorized hereunder shall be unlimited. There shall be no limit upon the number of Shares to be issued. All Shares shall be without par value, shall be of the same class, shall have equal voting, distribution, liquidation, and other rights, and shall be fully paid and nonassessable.

The Shareholders shall have no legal title or interest in the Trust property and no right to a partition thereof or to an accounting during the continuance of the Trust but only the rights expressly provided in the Declaration.

Section 2. *Sale of shares.* The Trustees may from time to time issue, sell by private or public offering, or exchange Trust shares in such number or for such sums of money, real estate assets, or other considerations, and on such terms as they deem proper. The Shareholders shall have no preemptive rights of any kind whatsoever. Preemptive rights are hereby defined to include, but not be limited to, the right to purchase or subscribe for or otherwise acquire any Trust shares of any class, whether now or hereafter authorized, or any securities or obligations convertible into or exchangeable for, or any right, warrant, or option to purchase such shares, whether or not they are issued or disposed of for cash, property, or other consideration of any kind. The Trustees shall cause to be issued certificates of beneficial interest to evidence the ownership of Shares. Shares when issued for consideration in accordance with the provisions of this Section 2 shall be fully paid and nonassessable.

Section 3. *Offering of shares.* The Trustees may cause to be made from time to time offerings of the Trust Shares to the public at public offering prices deemed appropriate. For this purpose, the Trustees may enter into a contract with an underwriter upon such terms and with such commissions for its services as the parties may agree upon.

Section 4. *Shares purchased by trust.* The Trust may repurchase or otherwise acquire its own shares on such terms and conditions as the Trustees deem appropriate. For this purpose the Trust may create and maintain such reserves as are

deemed necessary and proper.

Shares issued hereunder and purchased or otherwise acquired for the account of the Trust shall not, so long as they belong to the Trust, either receive distributions (except that they shall be entitled to receive distributions payable in Trust Shares) or be voted at any meeting of the Shareholders. Such Shares may, in the Trustees' discretion, be cancelled and the number of Shares authorized by thereby reduced or be held in the treasury and be disposed of by the Trustees at such time or times, to such party or parties, and for such consideration, as the Trustees may deem appropriate.

Section 5. *Transferability of shares.* Shares in the Trust shall be transferable in accordance with the procedure prescribed from time to time in the Trustees' Regulations. The persons in whose names the Shares are registered on the Trust's books shall be deemed the absolute owners thereof and, until a transfer is effected on such books, the Trustees shall not be affected by any notice, actual or constructive, of any transfer.

Section 6. *Ownership, stop-transfer, and redemption.* The Shareholders, upon request, shall furnish to the Trustees, in writing, such particulars as to the direct and indirect ownership of the Shares as the Trustees deem necessary for compliance with the provisions of the Internal Revenue Code of 1986 and the Regulations thereunder regarding beneficial ownership in a real estate investment trust, as those provisions and the Regulations may be amended from time to time. If the Trustees, at any time, in good faith, shall be of the opinion that beneficial ownership of Trust Shares has or may become so concentrated as to prevent the Trust from continuing to qualify as a real estate investment trust under the applicable provisions of the Internal Revenue Code, the Trustees may prevent the transfer of such Shares by means deemed equitable to them or to call such number of Shares for redemption as will be sufficient to maintain or bring the beneficial ownership of Shares in conformity with the applicable provisions of the Internal Revenue Code. Any transferor in violation of the transfer restrictions shall be void *ab initio*. The price to be paid for the redeemed Shares shall be (a) the sale price on the securities exchange on which the Shares are traded, as reported at the close of the last business day prior to the date of redemption, or (b) if the Shares are not traded on any securities exchange, the last bid quotation on such business day as reported by the National Association of Security Dealers or a similar organization selected by the Trustees, or (c) if not determined as above, the book value of the Shares. From the date of redemption, the holder of any Shares called for redemption shall no longer be entitled to any dividends, distributions, voting rights, or any other benefits of Shareholders, except the right to the redemption price.

Section 7. *Effect of transfer of shares or death, insolvency, or incapacity of shareholders.* Neither the transfer of Shares nor the death, insolvency or incapacity of any Shareholder shall operate to dissolve or terminate the Trust, nor shall it entitle any transferee, legal representative, or other person to a partition of the Trust property or to an accounting.

Article III Shareholders

Section 1. *Meetings of shareholders.* (a) *Annual meetings.* Annual meetings of the Shareholders shall be called upon not less than 30 nor more than 60 days' prior written notice, and at such times and places as the Trustees' Regulations shall prescribe, for the election of all Trustees, the transaction of such other business as Shareholders may be entitled to vote upon as hereinafter provided in this Article III, or as the Trustees may determine. At such meeting the Trustees shall make a report of the business and operations of the Trust. The holders of a majority of Shares in the Trust, present in person or by proxy, shall constitute a quorum at any meeting.

(b) *Special meetings.* Special meetings of the Shareholders may be called at any time upon not less than 30 nor more than 60 days' prior written notice, at such places as the Trustees' Regulations shall prescribe for annual meetings, by the Chairman of the Trustees or by a majority of the Trustees. A special meeting shall be called by any Trustee upon written request of Shareholders holding in the aggregate not less than 20% of the issued and outstanding Shares entitled to vote at such meeting. The call shall state the nature of the business to be transacted, and no other business shall be considered.

Section 2. *Voting rights of shareholders.* The Shareholders shall be entitled to vote only upon the following matters:

(a) *Election of trustees.* Trustees shall be elected annually by vote of Shareholders. Each Shareholder shall be entitled to one vote in person or by proxy for each Share registered in his name. The candidates receiving the highest respective numbers of votes up to the number of trusteeships to be filled in the election shall be elected.

(b) *Removal of trustees.* Any Trustee who willfully violates any provision of the Declaration or willfully acts contrary to the Shareholders' interests may be removed at any time as Trustee by the vote or written consent of the holders of a majority of the issued and outstanding Shares so declaring. Such vote or written consent shall be conclusive evidence of such wilful violation or contrary action so far as such removal is concerned.

(c) *Termination of trust.* The Trust may be terminated as provided in Article V, Section 1 hereof.

(d) *Amendment of declaration of trust.* No change in or amendment of the Declaration shall be made without the vote or written consent of the holders of a majority of the issued and outstanding Shares, except as otherwise provided in Section 5 of Article I hereof.

(e) *Creation of corporation to acquire assets of trust.* Any action on the part of the Trustees creating a corporation to acquire the Trust assets shall be subject to the approval of the holders of a majority of the issued and outstanding Shares.

(f) *General.* Anything in Section 8, paragraph (u) of Article IV, or in Articles V and VI of the Declaration to the contrary notwithstanding, any action taken by the Trustees to merge or consolidate or otherwise amalgamate the Trust with any other trust or corporation, to terminate the Trust, to reorganize the Trust as a corporation, or to amend the Declaration shall not become effective until such action is first approved by the vote or written consent of the holders of a majority of the issued and outstanding Shares.

Section 3. *Distributions.* It is the declared policy of the Trust that the Trustees shall (and may more frequently) declare and pay, within 30 days after the end of each three calendar-month period in each calendar year after the calendar year in which the Trust is created, to the Shareholders as near to all of the net income of the Trust as shall be available therefor. No distribution shall be made, however, if the Trustees deem it imprudent to do so. Net income for the purpose of this Section shall mean net income for tax purposes adding back deductions for depreciation and similar noncash charges. In any event, however, the Trustees shall, from time to time, declare and pay to the Shareholders all distributions that may be necessary to continue to qualify the Trust as a "real estate investment trust" (provided that such qualification, in the opinion of the Trustees, is in the best interest of the Shareholders), as well as all additional distributions that the Trustees may in their discretion declare. Each distribution shall be accompanied by a written statement indicating, to the fullest extent practicable, its sources.

Section 4. *Reports to shareholders.* The Trust shall transmit to the Shareholders annually, within two calendar months following the close of its fiscal year, a report which shall contain:

(a) A statement by the Trustees as to the course of the Trust's operations during the fiscal year covered by such report, including a schedule of the funds distributed to the Shareholders during such fiscal year and the respective sources thereof;

(b) A description of the major real estate assets and mortgages owned by the Trust at the close of such fiscal year, and other disclosures of material interest to the Shareholders; and

(c) Financial statements consisting of a balance sheet, a profit and loss statement, and an analysis of surplus, all prepared in accordance with generally accepted accounting principles, and generally conforming to the requirements for

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financial statements to be included in annual reports filed with the Securities and Exchange Commission by companies subject to its jurisdiction. Such statements shall be audited and certified by an independent certified public accountant.

As promptly as possible after the close of each quarterly period in each fiscal year, the Trustees shall transmit an income and expense statement to the Shareholders for such three-month period. Such statement need not be audited or certified by an independent certified public accountant.

Section 5. *Books and records.* The Trust's books and records shall be open to inspection upon the written demand of a Shareholder at any reasonable time for a good faith purpose reasonably related to the interests of such Shareholder as a Shareholder, and shall be exhibited at any time when required by the demand at any Shareholders' meeting of 10% of the Shares represented at the meeting.

Such inspection by a Shareholder may be made in person or by agent or attorney, and the right of inspection includes the right to make extracts.

Demand of inspection other than at a Shareholders' meeting shall be made in writing upon the Chairman of the Trustees, or the Trust's Secretary or Executive Agent.

The duly authorized officials of any state shall have the same right of inspection as a Shareholder.

Section 6. *Nonliability of shareholders.* The Shareholders shall not be liable to assessment and the Trustees shall have no power to bind the Shareholders personally. Upon any debt, claim, demand, judgment, decree, or obligation of any nature whatsoever against or incurred by the Trust or by the Trustees or by a representative or agent of the Trust, in their respective capacities, whether founded upon contract, tort, or otherwise, resort shall be had solely to the Trust property and the Shareholders shall not be personally liable therefor. Any Shareholder held so personally liable shall be entitled to exoneration from the Trust's assets.

Section 7. *Notice of nonliability.* In each written order, contract, bond, note, mortgage instrument, or obligation given or executed by the Trustees or with their authority, the Trustees shall cause to be inserted a provision that the Shareholders shall not be personally liable and that the other party shall look solely to the Trust property for the payment of any claim thereunder, and reference shall be made to the Declaration.

Section 8. *Insurance.* The Trust shall use its best efforts to obtain or cause to be obtained all customary types of insurance against liabilities or hazards.

Article IV Trustees

Section 1. *Number, term of office, qualification, and compensation of trustees.* There shall be not less than three nor more than five Trustees, as fixed in the Trustees' Regulations, all of whom shall be United States citizens. The term of office of each Trustee shall be from the date of his election or appointment until the next annual meeting of Shareholders and shall continue until the election and qualification of his successor by the Shareholders. The Trustees shall be individuals of full age. No person shall qualify as a Trustee until he shall have either signed the Declaration or agreed in writing to be bound in all respects by the Declaration. The Trustees shall be entitled to receive compensation for their services as Trustees, in amounts, and in the manner fixed by them, but not in any event to exceed 11/2 % annually of the Trust's gross income. There shall be no requirement that each Trustee receive compensation in the same amount.

Section 2. *Resignation.* A trustee may resign at any time by giving written notice to the Trustees at the Trust's principal office. Such resignation shall take effect on the date it is received or any later time specified therein. Unless otherwise specified therein, the acceptance of a resignation shall not be necessary to make it effective.

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Section 3. *Vacancies.* The resignation, incompetency, or death of any or all of the Trustees shall not terminate the Trust or affect its continuity. During a vacancy, the remaining Trustee or Trustees may exercise the powers of the Trustees hereunder. Vacancies among the Trustees may be filled by a written designation signed by a majority of the remaining Trustees and entered in the Trust's records. The determination of a vacancy among the Trustees by reason of resignation, incompetency, or death, or for any other reason, when made by a majority of the remaining Trustees and stated in the instrument filling such vacancy, shall be final and conclusive for all purposes. If at any time, by reason of resignations, incompetencies, or deaths, there shall be no remaining Trustees, a meeting of the Shareholders shall be forthwith called for the election of successor Trustees. Any Shareholder or Shareholders owning of record an aggregate of 10% of the issued and outstanding Trust Shares shall be entitled to call such meeting and to nominate candidates for election as successor Trustees at any such election.

Section 4. *Successor trustees.* Title to the Trust property shall vest in successor Trustees, upon written acceptance of their election or appointment without any further act. They shall thereupon have the same powers, duties, and exemptions as though originally named as Trustees in this Declaration. Such written acceptance shall be filed with the records of the Trust. A certificate signed by a majority of the Trustees as to who are or were Trustees at any time shall be conclusive and binding for all purposes.

Section 5. *Actions by trustees.* The Trustees may act with or without a meeting. Any action of a majority of Trustees in office shall be conclusive and binding as an action of the Trustees. All agreements, deeds, and other instruments executed by a majority of the Trustees or executed by one Trustee pursuant to authorization of a majority of the Trustees given either at a meeting or in writing shall be effective and binding as if executed by all the Trustees.

Section 6. *Title and authority of trustees.* The Trustees, as joint tenants, shall hold the legal title to all property belonging to the Trust in its name, or in the name of one or more of the Trustees, as Trustees for the Trust, or in the name of one or more nominees for the Trust provided that each such nominee shall execute an instrument in recordable form recognizing the interest of the Trust in the property so held. The Trustees shall have absolute and exclusive control, management, and disposition thereof, and absolute and exclusive control over the management and conduct of the business affairs of the Trust, free from any power or control on the part of the Shareholders, in the same manner as if they were the absolute owners thereof, subject only to the express limitations in the Declaration.

Section 7. *Advisor and independent contractor.* In their exercise of the absolute control and management of all the Trust assets, the Trustees may contract for the services of an advisory firm or corporation, (the Advisor), to advise them in respect of investing and reinvesting the Trust funds in real property assets, interests in real property, mortgages secured by real property, leasehold interests in real property, interests in mortgages, or other assets. The total compensation to be paid to the Advisor and to be provided in such contract shall not exceed $\frac{1}{2}$ of 1% annually, of the Trust's gross income. Such contract may provide that the Advisor shall act as agent of the Trust in the purchase and sale of real estate, leaseholds, or real estate mortgages, or any interest therein, but without any independent compensation, direct or indirect, for such service. Such contract may also provide that the Advisor shall act as agent of the Trust in the management of real estate, leaseholds or real estate mortgages, or any interest therein, and receive commissions or other compensation for such management services at rates not in excess of those prescribed by real estate boards or similar organizations in the area in which the real estate is located, or the Trustees may employ a different firm or corporation to perform these functions for all or some of the Trust's properties and to receive such commissions and compensations. Such contracts shall provide that they shall not be assignable without the Trust's written consent. No employee or officer of the Trust, nor any investment advisor, shall receive a commission or other remuneration, directly or indirectly, in connection with the disposition or acquisition of Trust assets.

Section 8. *Powers of trustees.* The Trustees shall have all the powers necessary, convenient, or appropriate to effectuate the purposes of the Trust and may take any action which they deem necessary or desirable and proper to carry out such purposes. Any determination of the purposes of the Trust made by the Trustees in good faith shall be conclusive. In

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construing the provisions of the Declaration, the presumption shall be in favor of the grant of powers to the Trustees.

Subject to the limitations contained in Article I hereof, the Trustees' powers shall include the following:

(a) To purchase, acquire through the issuance of Shares in the Trust, obligations of the Trust, or otherwise, and to mortgage, sell, acquire on lease, hold, manage, improve, lease to others (without limitation as to the term of such lease, which may extend beyond the termination of the Trust), option, exchange for real or personal property, release, and partition interests in personal property and real estate interests of every nature, including freehold, leasehold, mortgage, ground rent, and other interests therein, and to erect, construct, alter, repair, demolish, or otherwise change buildings and structures of every nature.

(b) To purchase, acquire through the issuance of Shares in the Trust, obligations of the Trust, or otherwise, option, sell, and exchange shares, bonds, notes, certificates of indebtedness, and securities of every nature.

(c) To purchase, acquire through the issuance of Shares in the Trust, obligations of the Trust, or otherwise, grant security interests in, sell, acquire on lease, hold, manage, improve, lease to others, option, and exchange personal property of every nature.

(d) To hold title to the property of the Trust as is provided in Article IV, Section 6, hereof.

(e) To borrow money for the purposes of the Trust and to give notes, debentures, including debentures convertible into Shares, bonds, and other negotiable or nonnegotiable instruments of the Trust therefor; to enter into other obligations on behalf of and for the purposes of the Trust; and to mortgage, create security interests in, or pledge or cause to be mortgaged, have security interests created in, or pledged real and personal property of the Trust to secure such notes, debentures, bonds, instruments, or other obligations; and to subordinate the interests of the Trust in real and personal property, or interests therein to such other persons and on such conditions as is deemed desirable.

(f) To lend money on behalf of the Trust and to invest its funds.

(g) To create reserve funds for such purposes as they deem advisable.

(h) To deposit Trust funds in banks and other depositories without regard to whether such accounts will draw interest.

(i) To pay taxes and assessments imposed upon or chargeable against the Trust or the Trustees by virtue of or arising out of the Trust's existence, property, business, or activities.

(j) To purchase, issue, sell, or exchange Shares of the Trust as provided in Article II hereof. The good faith determination of the value of the consideration received by the Trust shall be within the Trustees' absolute discretion.

(k) To adopt and, from time to time, amend Trustees' Regulations which may include but shall not be limited to provisions relating to the time, place, and notice of meetings of the Trustees and of the Shareholders; record dates and other matters relating to voting and the use of proxies; designation, appointment, and compensation of representatives and agents and their number, duties, powers, authorities, and qualifications; the conditions for replacing lost, mutilated, or stolen Shares; and the procedure for amendment of the Trustees' Regulations.

(l) To exercise with respect to Trust property all options, privileges and rights, whether to vote, assent, subscribe, or convert, or of any other nature; to grant proxies; and to participate in and accept securities issued under any voting trust agreement.

(m) To participate in any reorganization, readjustment, consolidation, merger, dissolution, sale, or purchase of assets,

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lease, or similar proceedings of any corporation, partnership, or other organization in which the Trust shall have an interest, and in connection therewith to delegate discretionary powers to any reorganization, protective, or similar committee and to pay assessments and other expenses in connection therewith.

(n) To engage or employ agents, representatives, and employees of any nature, or independent contractors, including, without limiting the generality of the foregoing, Transfer Agents for the transfer of Trust Shares, Registrars, underwriters for the sale of Trust Shares, independent certified public accountants, attorneys at law, appraisers, and real estate agents and brokers; and to delegate to one or more Trustees, agents, representatives, employees, independent contractors, or other persons such powers and duties as the Trustees deem appropriate. The same persons may be employed in multiple capacities and may receive compensation from the Trust in as many capacities as they may be engaged or employed by the Trust. Any Trustee who serves in such capacities may receive compensation in addition to that provided in Article IV, Section 1 hereof.

(o) To determine conclusively the allocation between capital and income of the Trust's receipts, holdings, expenses, and disbursements, regardless of the allocation which might be considered appropriate in the absence of this provision.

(p) To determine conclusively the value from time to time and to revalue the Trust's real estate, securities, and other property, in accordance with such appraisals or other information as they deem satisfactory.

(q) To compromise or settle claims, questions, disputes, and controversies by, against, or affecting the Trust.

(r) To solicit Shareholders' proxies.

(s) To adopt a fiscal year for the Trust and to change such fiscal year.

(t) To adopt and use a seal.

(u) To merge or consolidate or otherwise amalgamate the Trust or any successor thereto with or into any other trust or corporation engaged or to be engaged in business activities substantially similar to those engaged in by the Trust, subject to the provisions of Article III, Section 2, paragraph (f).

(v) To deal with the Trust property in every way, including the entering into joint ventures, partnerships, and all other combinations or associations, that it would be lawful for an individual to deal with the same, whether similar to or different from the ways herein and hereinabove specified.

(w) To cause the Trust to file with its federal income tax return for the first year of its existence an election to be a real estate investment trust.

Section 9. *Trustees' right to own shares in trust.* A Trustee may acquire, hold, and dispose of Trust Shares for his individual account and may exercise all rights of a Shareholder to the same extent and in the same manner as if he were not a Trustee. After the commencement of any public offering of the Trust Shares, the Trustees may purchase Shares only at the current offering price then prevailing in connection with such public offering, less all or any part of the selling or other commission as may be agreed with the Distributor.

Section 10. *Transactions between trustees and their affiliates.* No trustee shall receive a commission or other remuneration in connection with the acquisition or disposition of Trust assets. Nothing herein, however, shall prohibit any Trustee who is a lawyer, or any law firm with which he may be affiliated, from performing legal services for the Trust and receiving reasonable compensation for such services, nor shall anything herein prohibit any person who is a Trustee from performing services for the Trust, in addition to services as a Trustee, and being separately compensated therefor.

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Section 11. *Nonliability of trustees.* No Trustee shall be liable individually for any act or omission of any other Trustee or agent or representative of the Trust, or for negligence, error in judgment, or any act or omission except his own willful misfeasance, bad faith, or gross negligence in the conduct of his duties.

Every act or thing done or omitted, and every power exercised or obligation incurred by any of the Trustees in the administration of the Trust or in connection with its business or property, whether ostensibly in their own names or in their trust capacity, shall be deemed done, omitted, exercised, or incurred by them as Trustees and not as individuals. Upon any debt, claim, demand, judgment, decree, or obligation of any nature whatsoever against or incurred by the Trustees in their capacities as such, whether founded upon contract, tort or otherwise, resort shall be had solely to the Trust property.

Nothing contained in the Declaration shall protect a Trustee or agent or representative of the Trust against liability to the Trust or to the Shareholders for willful misfeasance, gross negligence, or bad faith in the conduct of his duties.

Section 12. *Indemnification.* The Trust shall indemnify and hold harmless each Trustee from and against all claims and liabilities, whether they proceed to judgment or are settled, to which such Trustee may become subject by reason of his being or having been a Trustee, or by reason of any action alleged to have been taken or omitted by him as Trustee, and shall reimburse him for all legal and other expenses reasonably incurred by him in connection with any such claim or liability. No Trustee, however, shall be indemnified or reimbursed under the foregoing provisions in relation to any matter unless it shall have been adjudicated that his action or omission did not constitute willful misfeasance, bad faith, or gross negligence in the conduct of his duties, or, unless, in the absence of such an adjudication, the Trust shall have received a written opinion from independent counsel, approved by the Trustees, to the effect that if the matter of willful misfeasance, bad faith, or gross negligence in the conduct of duties had been adjudicated, it would have been adjudicated in favor of such Trustee. The rights accruing to a Trustee under these provisions shall not exclude any other right to which he may be lawfully entitled, nor shall anything herein contained restrict the right of the Trust to indemnify or reimburse such Trustee in any proper cause even though not specifically provided for herein. No Trustee, however, may satisfy any right of indemnity or reimbursement granted herein or to which he may be otherwise entitled except out of the Trust property and no Shareholder shall be personally liable with respect to any claim of a Trustee for indemnity or reimbursement. Notwithstanding any of the provisions hereof, however, no Trustee shall be indemnified for any liability which he personally may have under the provisions of the Securities Act of 1933, as amended.

Section 13. *Persons dealing with trustees.* Any act of the Trustees purporting to be done in their capacity as such, or by their agents or representatives under their authority shall, as to other persons dealing with such Trustees, agents, or representatives be conclusively deemed to be within the purposes of the Trust and within the powers of the Trustees. No person dealing with the Trustees or any of them, or with their authorized agents or representatives, shall be bound to see to the application of any funds or property passing into their hands or control.

The receipt of the Trustees or any of them, or of their authorized agents or representatives, for moneys or other consideration paid or delivered to any of them shall be effectual discharges to persons paying or delivering the same.

Section 14. *Administrative powers of trustees.* The Trustees may pay the expenses of the Trust's organization and administration, including all legal and other expenses in connection with the preparation and carrying out of the plan for its formation, the acquisition of properties thereunder and the issuance of Shares thereunder; and may employ such officers, experts, counsel, managers, salesmen, agents, workmen, clerks and other persons as they think best, and fix their compensation and define their duties. Any Trustee so employed may receive special or additional compensation therefor.

Article V Duration and Termination
of Trust

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Section 1. *Termination of trust.* The Trust shall, unless sooner terminated as provided hereinafter, continue in existence until all of its assets have been liquidated and distributed to the Shareholders. The Trust may be terminated at any time by the Trustees (subject to the requirements of Article III, Section 2, paragraph (f) hereof) or, if the Trustees have not so terminated the Trust, by the affirmative vote of the holders of a majority of the issued and outstanding Shares.

If a court of competent jurisdiction in any state in which the Trust owns property shall finally determine that the holding of such property is or shall be in violation of any statutory or other law that is similar to the common law "rule against perpetuity," then with respect to property affected thereby, unless this Trust is terminated earlier as provided in this Section, it shall continue only until the expiration of 21 years after the death of the last survivor of the following named persons:

[Insert list of names of persons in being on the date of the execution of this Declaration whose lives will govern the duration of the Trust]

In connection with any termination of the Trust, the Trustees, upon receipt of such releases or indemnity as they deem necessary for their protection, may

- (a) Sell and convert into cash the Trust property and distribute the net proceeds among the Shareholders ratably; or
- (b) Convey the Trust property to one or more persons, entities, trusts, or corporations for consideration consisting in whole or in part of cash, shares of stock, or other property of any kind, and distribute the net proceeds among the Shareholders ratably, at valuations fixed by the Trustees, in cash or in kind, or partly in cash and partly in kind; provided that the proposal to proceed as described in this paragraph (b) shall have been set forth in the written approval of the Shareholders holding a majority of the Shares issued and outstanding.

Upon termination of the Trust and distribution to the Shareholders as herein provided, a majority of the Trustees shall execute and enter in the Trust's records an instrument setting forth the fact of such termination, and the Trustees shall thereupon be discharged from all further liabilities and duties hereunder, and the right, title, and interest of all Shareholders shall cease and be cancelled and discharged.

Section 2. *Organization as a corporation.* Whenever the Trustees deem it for the best interests of the Shareholders that the Trust be organized as a corporation and such action shall have been approved as provided in Article III, Section 2, paragraph (e), the Trustees shall have full power to organize such corporation, under the laws of such State as they may consider appropriate, in the place and stead of the Trust without procuring the further consent of any Shareholder. In that event the capital stock of the corporation shall be and remain the same as fixed under this agreement and Declaration, and the Shareholders shall receive and accept stock in such corporation on the same basis as they hold Shares in the Trust.

Article VI Amendments

Section 1. *When no shares outstanding.* At any time when no shares in the Trust are outstanding, the Trustees may amend any provision of the Declaration. A certificate signed by a majority of the Trustees, setting forth such amendment and reciting that it was duly adopted by them, shall be lodged among the Trust records and shall be conclusive evidence of such amendment.

Section 2. *When shares outstanding.* At any time when Shares in the Trust are outstanding, except as provided in Article I, Section 5, the Declaration may be amended by the Trustees then in office only with the consent of Shareholders owning a majority of the issued and outstanding Shares. A certificate signed by a majority of the Trustees setting forth an amendment and reciting that it was duly adopted shall be lodged among the Trust records and recorded or filed in

each public office or registry in which the Declaration shall be recorded or filed and shall be conclusive evidence of such amendment, and any restatement of any provision of the Declaration purported to be contained therein.

Article VII Miscellaneous

Section 1. *Applicable law.* The Declaration is executed and delivered in New York, New York, and the laws of the State of New York shall govern the construction, validity, and effect of the Declaration and the administration of the Trust hereby created.

Section 2. *Headings for reference only.* Headings preceding the text, articles, and sections of this Declaration have been inserted solely for convenience and reference, and shall not be construed to affect its meaning, construction, or effect.

In witness whereof this Declaration of Trust is being executed by the Trustees on December 15, 2002.

Trustee

Trustee

Trustee

Trustee

Trustee

(Acknowledgments)

A.13 Real estate investment trust: trustees' regulations

COMMENT

The basic declaration for a real estate investment trust will rarely set out the various mechanics for operating the entity. As in the case of the corporation, these details are reserved for a code of regulations (or bylaws) which can be amended if necessary by the trustees without going back to the individual beneficiaries for their consent. The declaration of trust (Form A.12) therefore provides that the trustees may adopt and, from time to time, amend regulations, which may include provisions covering meetings of trustees and of beneficiaries, voting procedures, appointment of agents, issuance and transfer of certificates of beneficial interest, and methods for amending the regulations. This set of regulations includes provisions for these and other matters generally covered in corporate bylaws.

For further information see Chapter 16.

FORM

TRUSTEES' REGULATIONS

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Article 1 Office, Seal, and Records

Section 1. The Trust's principal office shall be in New York, New York. The Trust may also have offices at such other places as the Trustees may from time to time designate.

Section 2. The seal of this Trust shall be circular in form and have inscribed thereon the name of the Trust and the year and place of its formation (2002).

Section 3. The original or a certified copy of these regulations, including all amendments, shall be kept at the Trust's principal office and be available during usual business hours for inspection and copying.

Section 4. The Trust shall keep correct and complete books and records of accounts of its transactions, and minutes and other records of the proceedings or other actions of its Trustees and of their committees.

Section 5. The Trust shall maintain at its principal office, or at such other of its offices or agencies as the Trustees may specify, the original Certificate of Beneficial Interest or Share Ledger containing the names and addresses of all Shareholders and the number of Shares held by each Shareholder.

Article 2 Trustees

Section 1. There shall be five Trustees.

Section 2. The Trustees shall elect one Trustee as Chairman of the Trustees, who shall act as chairman at all of the Trustees' meetings. The Chairman may appoint committees of the Trustees and perform all administrative acts on the Trustees' behalf, except to the extent that the Declaration of Trust specifically requires such acts to be performed by a majority of the Trustees. The Chairman shall be entitled to receive 25 percent greater compensation than the other Trustees.

The Trustees may elect one or more of their number as Alternate Chairman of the Trustees. The Alternate Chairman shall, in order of election, exercise the powers and duties of the Chairman, in case of the Chairman's absence, or until a new Chairman shall be elected, in case of a vacancy in that office.

Section 3. Meetings of the Trustees shall be held at the Trust's principal office, or at such other place or places as the Trustees may fix from time to time.

Section 4. Regular meetings of the Trustees shall be held at such times as the Trustees shall determine, but not less frequently than quarter-annually.

Section 5. Special meetings of the Trustees shall be held whenever called by the Chairman or by any two other Trustees at such time and place as may be designated in the notice of the meeting.

Section 6. At least three days' written notice shall be given of the time and place of any regular or special meeting of the Trustees. If the notice is sent by mail or telegraph, it shall be deemed to have been given when deposited in the mail or with the telegraph office for transmission. Notice of an adjourned meeting need not be given if the time and place of the adjourned meeting are announced at the meeting at which such adjournment action is taken.

Section 7. Three of the Trustees in office shall constitute a quorum for the transaction of business. The acts of a majority of the Trustees present at a meeting at which a quorum is present shall be the acts of the Trustees. The Trustees may, in lieu of a meeting, take any action which would be lawful if done at a meeting by having a certificate describing such action signed by the number of Trustees which would be required to vote for such action at a meeting and

depositing such certificate in the minute book of the Trust.

Article 3 Beneficiaries or Shareholders

Section 1. Meetings of the Shareholders shall be held at such place in New York City or elsewhere as the Trustees may fix.

Section 2. The Annual Meeting of Shareholders for the election of Trustees shall be held at the Trust's principal office at 10 a.m., E.S.T., on the fourth Tuesday of March in each year, unless the Trustees shall, by resolution, from time to time fix some other place, hour, or date.

Section 3. Written notice setting forth the time, place, and purpose of each such Annual Meeting shall be given to each Shareholder of record not less than 20 nor more than 50 days prior to the date fixed for the meeting. Notice sent by mail shall be deemed given when it is deposited in the mail addressed to the Shareholder at the address appearing on the Trust's records. Notice of an adjourned meeting need not be given if the time and place of the adjourned meeting is announced at the meeting at which such adjournment action is taken.

Section 4. If all of the Trustees shall resign, die, or become incompetent, a special meeting of Shareholders shall be called with the same requirements as to notice, time, place, and record date as herein provided for Annual Meetings to elect successor Trustees, except that the meeting may be called and nominations of Trustees may be made by any person or persons owning not less than 10% of the Shares of record as of the record date fixed for such meeting.

Section 5. The Chairman of the Trustees, or such other person as the Trustees may designate, shall preside and the Secretary shall take the minutes at every Shareholders' meeting. In the absence of the Secretary, the Trustees shall appoint one of themselves, or such other person as they may select, to act as Secretary of the meeting.

Section 6. A majority of the Shares in the Trust present in person or by proxy shall constitute a quorum at a Shareholders' meeting.

Section 7. Proxies shall be executed in writing and filed with the Chairman of the Trustees or such other officer or office of the Trust as may be designated in the notice of the meeting. No revocation of a proxy, whether by voluntary action, death, or incapacity of the Shareholder granting it or otherwise, shall be effective until notice thereof has been received by the Trust or one of the Trustees. No proxy shall be valid more than one year after its execution.

Section 8. Shares may be voted at the Shareholders' Annual Meeting as follows:

(a) Shares in the Trust registered in the name of a corporation may be voted by one of its officers or by a proxy appointed by an officer, unless the corporation's Board of Directors has, by resolution, appointed a general or special proxy, and notice thereof has been given to the Chairman of the Trustees, in which case such other proxy may vote such shares.

(b) Except as otherwise provided by law and as hereinafter provided in the case of certain fiduciaries, shares in the Trust registered in the name of two or more persons jointly, or as tenants in common, or in partnership may be voted by any one or more of such persons, either in person or by proxy.

(c) Shares of the Trust registered in the names of executors of an estate, trustees, or guardians may be voted by a majority of such fiduciaries, either in person or by proxy.

Section 9. The Trustees may appoint one or more Judges of Election, who need not be Shareholders, to act at Shareholders' meetings. If a Judge of Election fails to appear or refuses to act at a meeting, the Chairman of the Trustees

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or other person designated to preside at the Shareholders' meeting shall appoint a substitute Judge of Election. The Judge of Election shall determine the number of Shares in the Trust as of the applicable record date, the number of Shares represented at the meeting, the existence of a quorum, and all questions relating to voting, and shall count the votes and shall determine the results of any voting.

Section 10. For any lawful purpose, including but without being limited thereto, the determination of the Shareholders who are entitled to (a) receive notice of and vote at a meeting of the Shareholders, (b) receive payment of a distribution, and (c) participate in the execution of written approvals, the Trustees may fix a record date which shall not be earlier than the date on which the record date is fixed, and shall not be more than 60 days preceding the meeting, payment, final date of written approvals or waivers, or other event to which the record date relates. If no record date is fixed, the record date for determining the Shareholders who are entitled to receive notice of or to vote at a Shareholders' meeting shall be the close of business on the twentieth day prior to the date of the meeting.

Article 4 Agents

Section 1. The Trustees may appoint an Executive Agent, a Fiscal Agent, and a Secretary. Each appointee shall have all of the authority and duties prescribed in these regulations and as may be prescribed by the Trustees. The Trustees may also appoint other agents and representatives, including Alternate Executive Agents, Assistant Fiscal Agents, and Assistant Secretaries, to perform the business of the Trust. Each of these other agents and representatives shall have such authority and duties as the Trustees may prescribe.

Section 2. The Executive Agent shall administer the affairs of the Trust. Except as otherwise directed by the Trustees, he may execute all contracts, leases, and other documents requiring execution by the Trust.

Section 3. In the event of the death, resignation, absence, or disability of the Executive Agent then, except as otherwise directed by the Trustees, the Alternate Executive Agent (or if there is more than one, then the Alternate Executive Agents in order of their seniority) shall perform the duties of the Executive Agent.

Section 4. The Fiscal Agent shall have or provide for custody of the Trust's funds and securities which may come into his possession.

Section 5. The Secretary shall keep the minutes of all meetings of the Trustees and the Shareholders in appropriate minute books, and shall give all notices on behalf of the Trust including notice of the meetings of the Trustees and the Shareholders. Except as otherwise directed by the Trustees, he shall perform all of the customary duties of a Secretary.

Section 6. The Trustees may fix any compensation they deem appropriate for the services rendered by agents and representatives appointed under the authority of this Article 4.

Article 5 Shares

Section 1. Each Certificate of Beneficial Interest or Share shall state (a) that it represents units of Beneficial Interest in the Trust; (b) the name of the registered owner of the units of Beneficial Interest represented thereby; and (c) the number of Shares or units of Beneficial Interest which the certificate represents.

Section 2. Each Share certificate shall be signed by the Executive Agent or other duly authorized agent of the Trust. The signature, however, may be a facsimile signature on any certificate which contains the manual signature of a person authorized to sign on behalf of a Transfer Agent acting for the Trust. If the Executive Agent shall cease to be such prior to the issuance of a certificate signed by him, such certificate may, nevertheless, be issued by the Trustees with the same effect as if the Executive Agent had not ceased to be such at the date of its issuance.

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Section 3. Transfer of Shares may be made on the Share Ledger of the Trust only by the registered owner thereof or by an attorney duly authorized in writing and upon surrender of the Share certificate properly endorsed. The certificate shall be cancelled at the time of transfer. The Trustees may prescribe the requirements for any transfer of Shares otherwise than by an assignment validly executed by the registered owner or his attorney duly authorized as herein provided.

Section 4. The Trustees may establish transfer offices each in the charge of a Transfer Agent appointed by the Trustees, where the Shares of the Trust shall be transferable, and a Registry Office in the charge of a Registrar appointed by the Trustees, where the Shares shall be registered. If a Transfer Agent is appointed, no certificate for a Share shall be valid unless countersigned by him.

Section 5. If any Share or Certificate of Beneficial Interest is mutilated, lost, or destroyed, the holder thereof shall immediately notify the Trust or its Transfer Agent of that fact. The Trustees shall then cause one or more new certificates for the same number of shares or units in the aggregate to be issued to such beneficiary. The new certificate or certificates shall be issued, in the case of mutilation, upon surrender of the mutilated certificate, or in the case of loss or destruction, upon satisfactory proof of such loss or destruction. A deposit of indemnity shall be made by way of a bond or otherwise in such form and amount and with such surety as the Trustees may require, to indemnify the Trust against loss or liability by reason of the issuance of the new certificate or certificates.

Section 6. The Certificates of Beneficial Interest issued by the Trustees hereunder shall be in substantially the following form:

Share Or Certificate Of Beneficial Interest

..... Shares

Queensbrook Real Estate Trust

This certifies that _____ is the owner of _____ fully paid Shares in Queensbrook Real Estate Trust, a New York trust, which are held subject to a Declaration of Trust made on December 15, 2002, which, together with any subsequent amendments thereto, is hereby incorporated in and made a part of this certificate.

The holder hereof has no legal or equitable interest, in any specific property of the Trust. No transfer of this certificate will affect Queensbrook Real Estate Trust until this certificate has been surrendered at the offices of the Trust, or Transfer Agent, and the transfer recorded on the books of the Trust. This certificate is not valid until countersigned by the Transfer Agent and Registrar.

In witness whereof the Trustees have caused this certificate to be signed by the signatures of their duly authorized agents and a seal of the Trust to be imprinted thereon.

Dated:

[Seal] Chairman of Trustees

Secretary

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Countersigned by
 _____ Transfer Agent and Registrar

Article 6 Miscellaneous

Section 1. The fiscal year of the Trust shall be the calendar year.

Section 2. No Trustee, representative, or agent of the Trust shall have power or authority to borrow money in the Trust's behalf, to pledge its credit or to buy, sell, or mortgage its real property or securities except within the scope and to the extent of authority expressly delegated by resolution of the Trustees. Authority given by the Trustees for any of the above purposes may be general in scope or limited to specific instances.

Section 3. The Trustees may, by resolution, designate the Trust's representative or representatives who shall be authorized to act as signatory or signatories on the Trust's bank accounts and shall designate the number of signatures required. Any such signatory may, but need not, be a Trustee.

Section 4. Whenever any written notice must be given to the Trustees or the Shareholders, a waiver thereof in writing signed by a person entitled to such notice, whether before or after the time stated therein, shall be deemed equivalent to the giving of such notice. Attendance of a person either in person or by proxy at a meeting shall constitute a waiver of notice of the meeting unless such person attends it for the express purpose of objecting to the transaction of any business because the meeting was not lawfully called or convened.

Section 5. If any provision in these regulations shall be construed to be inconsistent with the provision of the Declaration of Trust, the provisions of the Declaration of Trust shall control.

Article 7 Amendments

These regulations may be amended at any regular or special meeting of the Trustees if notice of the proposed amendment is contained in the notice of meeting. The Trustees may make amendments to these regulations, with or without a meeting, by executing an instrument, which must be signed by all of them and entered in the records of the Trust. A.14 Plan of organization for cooperative apartment house

COMMENT

Cooperative housing is primarily utilized in multiple dwellings. The typical venture is one in which a corporation is organized to hold fee title to real estate and to lease apartments to its shareholders.

Organizing a cooperative:

The organization of a cooperative corporation is usually initiated by a "sponsor" who, apart from arranging the preliminary corporate matters, undertakes to provide improved real estate for acquisition by the cooperative corporation. All the details of the program of acquisition, improvement, and sale are usually set forth in a plan of cooperative organization which is made available to prospective tenant-stockholders. A copy of the stock purchase agreement and the proprietary lease is also provided with the plan. The forms included in this group are those required in the various stages of the organization of a particular cooperative, including (1) the plan of organization, (2) the certificate of incorporation, (3) the bylaws, (4) the contract with an agent to sell the corporation's stock, (5) the stock purchase agreement, and (6) the proprietary lease. Also included is a contract for the sale by a tenant-stockholder of his stock and the accompanying lease.

In the plan of cooperative organization illustrated, the sponsor sets forth in complete detail a description

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of the building which he undertakes to make available to the cooperative corporation and all aspects of the cooperative organization. Among the elements to be described are: (1) the property, (2) financing of the purchase of the fee, (3) proprietary lease, (4) conditions for the purchase of stock, (5) estimated completion date, (6) procedure for occupancy, (7) arrangement for management of the property, (8) parties involved in the enterprise, (9) corporate charter, and (10) corporate bylaws and other relevant information.

Appended are schedules of estimated income and expenses for the cooperative corporation, the selling price of the stock of the cooperative corporation, and estimated charges and income tax deductions attributable to each apartment. (In some states, such as New York, special statutes prescribe strict procedures and disclosures in the sale of cooperative real estate ventures.)

The plan of organization is intended to incorporate every essential detail of the venture. Its significance is evident from the fact that it is incorporated by reference in the purchase agreement with every prospective tenant-stockholder (see Form A.17). Note, however, that since cooperative corporations are creatures of state and local legislation, any plan will have to be modified to conform with applicable laws and regulations.

Cooperative plans may provide that, unless a minimum percentage of shares are contracted for sale by a given date, the plan will not become operative, but that, after a certain percentage of shares are contracted for sale, the plan must be declared operative.

The sponsor's obligation to provide responsible persons to purchase the shares which are unsold at the time the premises are ready for occupancy, and to enter into proprietary leases for all apartments to which the unsold shares are allocated is a vital element. This insures that each tenant-stockholder will bear only his expected proportionate share of the operating and other expenses of the property. In addition, it insures compliance with the requirement that at least 80% of the gross income of the cooperative corporation be from tenant-stockholders. The cooperative corporation may merely hold a long-term lease on the real property, in which case the stockholders merely receive subleases to their respective apartments.

The cooperative ownership technique has also been applied to a group of houses. In this type of cooperative, each shareholder executes a lease on a specific house in the group development. The common denominator in all cooperatives is the so-called "proprietary" lease which can be held only by the owner of a specific number of shares in the cooperative corporation. Generally, the tenant-stockholder may sublet his apartment or may sell the unit consisting of the lease and the related corporate stock to a person approved by the cooperative corporation (see comment to Form A.20). The term "tenant-stockholder" means a person whose stock is fully paid-up in an amount which bears a reasonable relationship to the portion of the cooperative corporation's equity in the property that such person is entitled to occupy.

Tenant's rights and duties:

As a shareholder in the owning corporation, the tenant has a voice in the management of the cooperative building. But under the proprietary lease, the tenant is further obligated to make periodic rent payments in amounts established annually by the directors of the cooperative corporation. These payments are designed to cover the tenant's proportionate share of the following recurring expenses:

(1) Interest;

- (2) Taxes;
- (3) Maintenance;
- (4) Special assessments;
- (5) Operating expenses; and
- (6) Mortgage amortization.

Income tax impact:

Tenant-stockholders may deduct that portion of their rent which is attributable to real estate taxes of the cooperative corporation and to its interest incurred on an indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of the land, houses, or apartment building. Each tenant-stockholder may deduct a portion of the taxes and interest paid or accrued by the corporation, measured by the proportion that his own stock bears to the entire amount of stock outstanding, including that owned by the corporation itself.

If the tenant-stockholder uses a cooperative apartment in his trade or business or for the production of income, he may take a depreciation deduction on the cost of his stock attributable pro rata to the proprietary lease or tenancy. The allowable depreciation to the shareholder is determined by a three-step formula:

- (1) Total depreciation which would be allowed to the cooperative is computed.
- (2) This amount is then reduced by the ratio that the space rented to nonshareholders bears to the total rentable space.
- (3) The shareholder's proportionate share of this reduced depreciation is the ratio that the number of his shares bears to the total number outstanding, including any held by the cooperative.

The depreciation allowed to a shareholder may not exceed his adjusted basis for the stock, reduced by the above ratio for space rented to nonshareholders. When the tenant-stockholder uses only a portion of the property for business or income production, he is allowed a proportionate deduction for such portion.

Real estate taxes:

If a cooperative corporation pays real estate taxes on a leased apartment building, generally, no deduction for taxes is available to the tenant-stockholders because the corporation's payment is for rent rather than for taxes imposed on it.

If a cooperative corporation builds an apartment building on leased land, and the building has a useful life less than that of the term of the lease, the real estate taxes on the building are treated as taxes on its own property because the entire use of the building rests in the cooperative lessee; therefore, the tenant-stockholders may deduct both their proportionate shares of the taxes and their proportionate shares of interest paid by the corporation in financing the construction.

Conditions precedent to pro rata deduction:

For the purpose of the tenant-stockholder's deduction, the following conditions must be satisfied:

- (1) The corporation must have only one class of stock outstanding;
- (2) The corporation must have shareholders who are entitled to possession only by reason of their ownership of stock of a house or apartment in a building owned or leased by the corporation;
- (3) None of the corporation's shareholders may be entitled (either conditionally or unconditionally) to any distribution, other than from earnings and profits of the corporation, except on its complete or partial liquidation; and
- (4) The corporation must receive at least 80 percent of its gross income from tenant-stockholders.

Tax impact on cooperative corporation:

The cooperative corporation is itself a taxpaying entity which must file an income tax return but it can avoid tax liability by means of the following principles:

- (1) Annual payments by tenant-stockholders which are earmarked for amortization of mortgage indebtedness are treated as contributions to capital and are not included in gross income.
- (2) The corporation will pay no tax on amounts received for interest, taxes, and maintenance if
 - (a) It actually expends these funds for the purposes; or
 - (b) It refunds any amounts not so expended to the tenant-stockholders in the year it receives them.

The undertaking by the sponsor to provide responsible persons to purchase the shares which are unsold at the time the premises are ready for occupancy, and to enter into proprietary leases for all apartments to which the unsold shares are allocated is a vital element. This insures that each tenant-stockholder will bear only his expected proportionate share of the operating and other expenses of the property. In addition, it insures compliance with the requirement that 80% of the gross income of the cooperative corporation be from individual tenant-stockholders.

A cooperative housing association recognizes neither gain nor loss on its distribution of a dwelling unit to a stockholder if such distribution is in exchange for the stockholder's stock in the corporation, and the exchange qualifies for nonrecognition of gain under *IRC Section 1034(f)*. According to the legislative history Congress expects the Service to prescribe regulations providing procedures to assure that this relief is available **only** in cases where the dwelling unit is used by the taxpayer as his principal residence both before and after the distribution.

For further information, see Chapters 9 and 16.

FORM

Plan of cooperative organization

Ace Realty Corp., (the "Sponsor") submits through Harris & Co., Inc., (the "Agent"), this Plan of Cooperative Organization with respect to premises 500 East 68th Street, New York, New York (the "Building"), and the new apartment building to be erected thereon (the "Skyline").

Skyline Apartments, Inc., hereinafter called the Apartment Corporation, has been organized for the purpose of acquiring the fee ownership of the land and completed Building. The land is presently owned by Ace Builders, Inc., hereinafter called the Builder, which will erect the Building from plans prepared by James Hoe & Associates, Inc., hereinafter called the Architect, which plans have been filed with the Department of Buildings in the City of New York. The Apartment Corporation has retained William Bender, hereinafter called the Consulting Architect, to check on the construction of the Building and to certify as to stages of and completion of construction. The shares of the Apartment Corporation are being offered for sale through the Agent on the terms and conditions herein set forth. The Sponsor will guarantee to the Apartment Corporation the completion of the Building and the payment of costs of construction.

As hereinafter set forth the Sponsor is a publicly owned corporation and is the holder of all of the stock of the Builder.

1. *Property and Improvements.* The property is located on the southerly side of 68th Street at the East River Drive. It has a frontage on 68th Street of approximately 132 feet and a depth of approximately 102 feet irregular and contains approximately 13,000 square feet. The Building will have 20 floors and Penthouse containing 128 residential apartments, a superintendent's apartment, nine separate servants' rooms, each with its own bath. The apartments will range in size from three and one-half to seven rooms. There will be a garage in the basement which will accommodate about 35 automobiles and there will also be an area on the ground floor, west of the main entrance, which will be leased as a doctor's office. No shares are being allocated to this space. The Building will be centrally air-conditioned and will be heated by steam purchased from the Consolidated Edison Company. The entrance and lobby as well as the public portions of the Building will be decorated and furnished under the supervision of Allen Hart, designer. There will be 24-hour doorman service and the passenger elevators will be operated by tenant owners but a day and evening hall man will be available to assist tenant owners. The plan anticipates 13 employees including superintendent, doorman, service elevator, porter, and handyman.

As set forth in Schedule B, 60,080 shares of the Apartment Corporation have been allocated to the 128 residential apartments plus nine separate servants' rooms. No shares are being allocated to the superintendent's apartment, the garage, or the rentable space on the ground floor. A lease has been entered into by the Sponsor with a garage operator affiliated with the sponsor to rent the garage space for a ten-year term at \$7,500 per annum. The garage operator in turn will rent space in the garage to the tenant-shareholders and others, with priority to the tenant-shareholders at prevailing rates. The garage may be closed between the hours of 2 a.m. and 7 a.m. It is also proposed to lease the rentable space on the ground floor at not less than \$5,200 per annum. Copies of these leases when executed will be on file with the Agent and the income therefrom will be received by the Apartment Corporation. The Sponsor will pay or cause to be paid the estimated income from the garage and the doctor's office for the first year starting from the time the plan is put into full force and effect. There will be a laundry on the service level, which is leased for ten years to a concessionaire, and the laundry equipment is to be coin-operated by the tenant-shareholders. The concessionaire is a wholly owned subsidiary of the Sponsor.

A general description of the Building is attached hereto. This description is for information purposes only and to assist in the examination of the Building plans and specifications. A copy of the plans and specifications are on file with the Agent. The Sponsor and Builder reserve the right, up to the time of the completion of the Building, to make such changes or amendments in the plans and specifications, construction contract, equipment, materials, furnishings, and supplies, as any governmental department or bureau or as may be deemed necessary or advisable by the Architect and

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Consulting Architect, or such may deem necessary or advisable, or such as may only affect particular apartments and are contracted for by the individual purchasers or such as are minor. Where alternatives are specified or where a particular practice or method of construction or equipment, material, or supplies is not specified, the choice and decision of the Architect and Consulting Architect shall be final.

Construction was started in June of 2000. It is anticipated that the Building will be substantially completed on or about February 1, 2002, unless delayed by strikes or other causes over which the Sponsor, the Builder, or the Apartment Corporation have no control.

2. Cooperative organization. The aggregate number of shares which the Apartment Corporation shall have authority to issue is 65,000 shares of the par value of \$1 each, of which 60,080 shares have been allocated to the residential apartments and separate servants rooms. The balance of the shares will be authorized and unissued. Ownership of the respective blocks of shares will entitle the purchasers to proprietary leases of the apartments and servants' rooms to which such blocks of shares are allocated.

The Apartment Corporation proposes to offer its shares to suitable purchasers, hereinafter called The Purchasers. In order to meet possible demands for greater or less space than is shown on any floor plan, the Apartment Corporation reserves the right to change the size and number of apartments and to vary the amount of shares to accompany each proprietary lease. No change, however, will be made with respect to shares allocated to any apartment for which a purchase agreement has been accepted, nor will any such change have the effect of increasing or decreasing the total number of shares allocated to the residential apartments and separate servants' rooms.

The proceeds from the sale of shares will be used for the acquisition of the land with the completed Building thereon, on the terms and conditions hereinafter outlined.

If, when the Plan is put into full force and effect, any shares are unsold, the Sponsor guarantees to provide responsible individuals to take over such unsold shares and to enter into proprietary leases for all the apartments in the Building to which the unsold shares are allocated. These purchasers may not be purchasing for personal occupancy and may assign the shares and proprietary leases or sublet the apartments, subject only to the approval of the Agent, but such purchasers will be responsible for the maintenance and carrying charges thereunder until any such shares and proprietary leases are resold, and the Sponsor will guarantee the same. Thus when the Plan is put into full force and effect proprietary leases outstanding for all the apartments and separate servants' rooms in the Building to which shares are allocated.

An estimate of the Apartment Corporation as prepared by the Agent and approved by the Sponsor is set forth in Schedule A hereto attached. The location of the respective units, the allocation and purchase price of the shares, the estimated annual maintenance charges, and the estimated income tax deductions are set forth in Schedule B attached hereto.

Financial Plan

The financial plan under which the land and completed Building will be acquired by the Apartment Corporation is as follows:

Acquisition of the land and completed

Building	\$5,626,000
Working Capital	\$ 41,552

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	\$5,667,552
Mortgage Indebtedness	\$3,000,000
60,080 shares @ \$44.40 per share	\$2,667,552

The mortgage indebtedness of \$3,000,000 above referred to, will have constant annual charges to the Apartment Corporation of \$172,500, payable in equal monthly installments to be applied to the interest at the effective rate of 5% per annum and the balance to the reduction of principal. The total mortgage indebtedness will be self-liquidating and will be fully paid in approximately 41 years or sooner. On the maturity of the mortgage indebtedness, the Apartment Corporation will have no further obligations with respect thereto and will be relieved of the annual charges thereon.

A mortgage commitment has been obtained from the Riverview Savings Bank in the City of New York for a first mortgage loan on the land and completed building of \$2,250,000, with constant quarter-annual charges of \$42,188 or a total annual payment of \$168,752, to be applied first to interest at the rate of $5\frac{3}{4}$ % per annum and the balance to reduction of principal, which will fully liquidate the loan within a period of $25\frac{1}{2}$ years. There will be a prepayment privilege after the tenth year with a 2% penalty declining $\frac{1}{4}$ of 1% annually to a minimum penalty of 1% of the then outstanding amount of the first mortgage. The Builder will take back a second purchase money mortgage in the amount of \$750,000 providing for interest at the average rate of 3.6% per annum until the first mortgage is fully paid or refinanced as hereinafter provided. Thereafter, the interest on the purchase money second mortgage will be at the rate of 5% per annum.

As previously stated, the total amount of interest and amortization payment that the Apartment Corporation will be obligated to pay in any one year is \$172,500. This sum is insufficient to pay all of the interest accruing on the second purchase money mortgage. Such mortgage will provide that the difference between the amount accruing and the amount annually paid will be added to the principal of the second mortgage. After the first mortgage is fully paid, then the sum of \$172,500 per year will be applied towards payment of interest and amortization on the second mortgage and it will be fully liquidated in 41 years from the date of the mortgages. The purchase money second mortgage may be prepaid at any time without penalty.

The holder of the second mortgage, so long as all or part of such indebtedness is unpaid, shall have the right at its expense to refinance the entire mortgage indebtedness provided the then unpaid principal is not increased, the annual interest or amortization charges are not increased, and the mortgage indebtedness remains self-liquidating within 41 years. Such refinancing may be in the form of one mortgage with senior or junior interests or in the form of two or more mortgages.

The Builder has obtained from the Central Manhattan Bank a commitment for a building loan in the principal amount of \$2,000,000. This will be fully paid before the Plan becomes effective, and no other mortgage indebtedness will be placed on such property in excess of \$2,000,000 before the Plan becomes effective.

Up to the time the Plan is put into full force and effect and when the rent commences to accrue under the proprietary leases, hereinafter called Effective Date, the Sponsor has agreed to pay all expenses of the Apartment Corporation, other than the principal of the mortgage indebtedness, including mortgage fees and taxes, legal fees, architect's charges, fee equity title policy, organization expenses, original issue stamps, advertising, printing, sales commissions, and all other

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expenses or debts and liabilities of the Apartment Corporation. It is estimated that these expenses will be not less than \$200,000. The Apartment Corporation will retain \$41,552 as working capital in the form of cash or prepaid expenses such as real estate taxes and insurance.

As a consideration for having transferred to the Apartment Corporation title to the land and completed Building, the Sponsors will be intitled to receive and retain the proceeds of the permanent mortgage financing of \$3,000,000 as well as the balance of the proceeds from the sale of the shares of the Apartment Corporation, which is \$2,667,552, as set forth in Schedule B. The Apartment Corporation has entered into a contract of sale with the Sponsor and Builder embodying the provision of the Plan and copy thereof is on file with the Agent.

3. *Ownership.* After the land and completed Building have been transferred to the Apartment Corporation and upon the Effective Date, the Apartment Corporation will have:

(a) Good and marketable title to the land and completed Building thereon and all equipment therein free and clear of all liens and encumbrances (and all of its debts will have been paid or provided for) except:

- (1) Mortgage indebtedness above described;
- (2) Accrued interest on such mortgage indebtedness, subject to an apportionment on closing;
- (3) Accrued real estate taxes, water charges, and sewer rent and prepaid insurance, subject to apportionment on closing;
- (4) Proprietary leases made to its shareholders;
- (5) Leases, if any, for garage, ground floor rentable space, and laundry space;
- (6) Restrictive covenants and agreements of record and such state of facts which an accurate survey would show, provided that neither prevents the proposed use of the land and Building;
- (7) Zoning regulations;
- (8) Service contracts.

(b) Title policy insuring the fee equity in the Apartment Corporation in an amount of not less than \$2,650,000, subject to normal title exceptions which will not prevent the proposed use of the land and Building.

(c) Working capital of \$41,552 in cash or prepaid expenses.

(d) All of the authorized shares of the Apartment Corporation allocated to residential units and separate servants' rooms will be issued and outstanding and proprietary leases will have been executed with respect to each such apartment and separate servants' room.

(e) Assignment to the Apartment Corporation of all assignable guarantees.

(f) Guaranty by the Sponsor that if within one year from the date of the issuance of the permanent Certificate of Occupancy, it shall be notified in writing by registered or certified mail and addressed to the Sponsor by the Apartment Corporation of the existence of then known defects in the construction of the Building or in the installation or operation of the Building's mechanical equipment, which shall be due to improper workmanship or materials supplied by the Builder, the Sponsor, at its own cost and expense, shall repair and correct such defects.

(g) Certificate by the Architect and Consulting Architect that the Building has been erected and completed generally in accordance with the plans filed with the Agent, subject to such changes or omissions as may be permitted.

(h) Temporary Certificate of Occupancy for the Building and a \$50,000 escrow fund pending issuance of permanent Certificate of Occupancy.

(i) Management contract with Harris & Co., Inc., hereinafter described.

4. *Corporate details.* The Certificate of Incorporation of the Apartment Corporation provides among other things that its primary purpose is to provide homes for its shareholders, and that its shareholders, solely by reason of their ownership of shares in it, shall be entitled to proprietary leases entitling them to occupancy of apartment or servants' rooms in the Building to which their shares have been allocated. The Apartment Corporation shall have not less than three nor more than 11 directors.

The Bylaws of the Apartment Corporation provide among other things that the shares accompanying each proprietary lease shall be in the amount allocated to the particular apartment or servants' rooms described in such proprietary lease as shown in Schedule B; that the shares accompanying each proprietary lease shall be represented by a single certificate; that such shares shall not be sold or transferred except as an entirety to a person who has acquired such proprietary lease or new lease in place thereof with proper approval; and that the Apartment Corporation shall at all times have a lien upon the shares owned by each shareholder to secure his payment of all rent and maintenance charges to become payable by him under the provisions of the proprietary lease issued by the Apartment Corporation and at any time held by him and to secure his performance of all the covenants and conditions of the proprietary lease.

Each share certificate issued by the Apartment Corporation will contain reference to such restrictions upon the sale and transfer of shares and to such lien.

All shares shall have equal voting privileges of one vote per share. The Apartment Corporation will submit annual reports to all of its shareholders including an annual balance sheet and profit and loss statement, certified by an independent certified public accountant. Even if less than 51% of the shares are sold at the time the Plan is put into full force and effect, the Purchasers will have the right to elect a majority of the Apartment Corporation's directors.

5. *Proprietary lease.* The printed form of proprietary lease intended to be used has been prepared and is on file with the Agent. All proprietary leases of apartments and servants rooms in the Building will be in the same form, subject to the provisions of the proprietary lease regarding possible future changes therein. The term and accrual of rent under the proprietary lease will begin when the Building has been completed as hereinafter described. The term of the proprietary lease will expire September 30th in the year 2057, unless sooner terminated as provided in the proprietary lease. The Lessee may not sublet the apartment or assign the proprietary lease or sell the accompanying shares at any time, unless the terms and conditions of such sublease or assignment and the sublessee or the purchaser-assignee are first approved by the Board of Directors or shareholders of the Apartment Corporation. The proprietary lessee may pledge his shares and lease with the seller thereof or a bank or lending institution, but no assignment of the shares or lease shall be made on the Apartment Corporation's books except as above provided in the proprietary lease. In the event of such cancellation the lessee shall have no further rights or liabilities in or to the shares and proprietary lease and will receive no cash payment. Rent under the proprietary lease will be determined by apportioning among the proprietary lessees the cash requirements of the Apartment Corporation in amounts proportionate to the number of shares held. The shares and leases allocated to apartments taken by persons provided by the Sponsor may be assigned or such apartments may be sublet, subdivided, or combined without the Apartment Corporation's consent. Gas will be included in the annual maintenance charges, but electricity will be separately metered and charged to each proprietary lessee. This charge will include electricity for the fans in the units in the apartments which will circulate the warm or cooled air. Reference should, of course, be made to the printed form of the proprietary lease for the details of the features above mentioned

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and the other provisions thereof. As provided in the purchase agreement each Purchaser shall sign two copies of such lease after the Plan has been declared operative, one copy of which is to be for the Purchaser.

As more specifically set forth in the description of the Building, attached hereto, the apartments and servants' rooms will be delivered in white plaster and the painting, decorating, and installation of additional fixtures and equipment will be the obligation of the proprietary lessee to be performed by a contractor or contractors to be approved by the Sponsor. The Lessee shall continue to do his own painting and decorating and maintain the equipment in the apartment at his expense, as provided in the proprietary lease.

6. *Income tax deductions.* Section 216 of the Internal Revenue Code and Section 360 of the New York Tax Law allow certain income tax deductions to tenant-shareholders of cooperative housing corporations. The Apartment Corporation has been advised by counsel that the tenant-shareholders entitled to occupancy may deduct from their gross income for federal and New York State income tax purposes, their proportionate share of the interest with respect to the mortgage indebtedness and of the real estate taxes on the land and Building and paid by the Apartment Corporation, when 80% of the Apartment Corporation's gross income is derived from qualified tenant-shareholders. The estimated deduction at the inception of the Plan is as set forth in Schedule B. The exact amount of the actual tax savings to each individual will depend on the amount allowable by the Treasury Department and the New York Department of Taxation and Finance, and will further depend upon the tenant-shareholder's own income tax bracket. The Apartment Corporation, the Sponsor, the Agent, and counsel can make no warranties or representations that the United States Treasury Department or the New York Department of Taxation and Finance will allow the deductions, and they shall not be liable, if, for any reason, it is held that the Apartment Corporation does not meet, or at any future date ceases to meet, the requirements of the sections above enumerated, or any amendments thereof.

7. *Completion of building.* It is estimated that the Building will be completed and ready for occupancy on or about February 1, 2002, subject, of course, to delays by strikes, lockouts, government restrictions on operations or materials, or other causes beyond the control of the Sponsor, the Apartment Corporation, or the Builder. This Plan and all agreements shall continue in effect notwithstanding any such delays. The Building will be deemed completed as soon as all the following conditions are met:

- (a) The Department of Buildings of the City of New York has issued a temporary or permanent Certificate of Occupancy permitting the use for residential purposes of all of the apartments and servants' rooms to which shares are allocated, except for unsold apartments or where delayed for special work in individual apartments.
- (b) The financing has been completed as provided herein.
- (c) The Architect and Consulting Architect have certified to the Apartment Corporation and the Sponsor that the Building has been erected and completed substantially in accordance with the plans and specifications filed with the Agent and the general description of the Building, subject to such modifications and changes as may be permitted under this Plan, and the Building is ready for occupancy, except for special work in individual or unsold apartments, or such work in the public portions or rentable area of the Building as is customarily left uncompleted until after its occupancy.
- (d) Certification from the Sponsor to the Apartment Corporation that the completed Building has been fully paid for or adequate reserves have been made by the Sponsor for all unpaid items.

When the four events above mentioned have occurred, this shall be deemed and considered by all parties as conclusive proof that the Building has been fully completed in accordance with the provisions of any agreement or obligation of the Builder or the Sponsor, subject to their obligations as otherwise herein specifically provided. The sole obligation of the Builder or Sponsor is to complete the Building in accordance with the plans and specifications, as amended or modified, and as approved by the Architect and Consulting Architect.

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If title is transferred to the Apartment Corporation prior to the issuance of a permanent Certificate of Occupancy, the Apartment Corporation shall retain \$50,000 pending the issuance thereof.

8. *Plan in operation.* In order that the Purchasers as well as the Sponsor and the Apartment Corporation may have assurance that this Plan will be truly cooperative, the following safeguards have been established:

(a) The Sponsor will not declare the Plan operative unless and until contracts for the sale to Purchasers of at least 30% of the shares have been procured.

(b) The Sponsor agrees to declare the Plan operative when contracts for the sale to Purchasers of at least 65% of the shares have been procured.

(c) The Sponsor reserves the right to declare the Plan abandoned prior to the time the 65% quota described in subparagraph (b) above has been reached and the Plan has not previously been declared operative.

If the Plan is abandoned all Purchasers will be promptly notified and all moneys paid by them under their purchase agreements will be promptly returned by the Escrow Agent, without interest. The Sponsor has agreed that all such moneys will be repaid in full to the Purchasers in the event of abandonment.

If the Plan is declared operative, all Purchasers will be promptly notified. The Apartment Corporation shall call a meeting of all Purchasers in ample time before the completion of the Building so that they can receive a report on the estimated date of the Building's completion, select a Board of Directors in preparation for the passing of title, and attend to other organization matters.

9. *Purchase agreement and payments to sponsor.* A form of purchase agreement is annexed hereto as Exhibit I. When a prospective purchaser has indicated his decision to purchase the shares allocated to an apartment or servants' room, a form of purchase agreement in similar form will be prepared in duplicate for his signature. Such agreement will not be binding on the Apartment Corporation until accepted by it and approved by the Sponsor, in writing at the end thereof.

The Purchase Agreement will provide for the following payments: (a) a down payment of 10% of the purchase price of the shares as specified in Schedule B; (b) 40% thereof after the Plan has been declared operative and the Architect and Consulting Architect certify that the outside brick work has been completed, except such portions thereof as are customarily left to be completed after the interior portions are erected; (c) 30% thereof when the Architect and Consulting Architect certify that the white plaster in the apartments above the ground floor has been completed (except such portions thereof as are left incompleting due to individual tenant changes); and (d) the balance of 20% thereof when the Department of Buildings has issued a temporary certificate of occupancy. The Apartment Corporation or the Agent shall give purchasers not less than 15 days' prior written notice of the anticipated date for such payments. Prices of the several blocks of shares as shown on Schedule B, are subject to change or withdrawal at the Sponsor's direction without notice at any time, before acceptance by the Apartment Corporation of a purchase agreement for any such block of shares.

All payments are to be made by the Purchaser's personal check to the order of the Trust Bank of New York, as Escrow Agent. The proceeds are to be held in trust as required by law. The Sponsor and the Apartment Corporation have entered into an Escrow Agreement with the Trust Bank, a copy of which is attached hereto as Exhibit II, which provides that if the Plan is abandoned all moneys so deposited will be returned by the Escrow Agent to the several purchasers, without interest. After the Plan has been declared operative, the moneys received by the Escrow Agent from purchasers will be paid in the following installments:

(a) To the Sponsor, 80% of the moneys then or thereafter received by the Escrow Agent after the Architect and Consulting Architect have certified to the Apartment Corporation that the outside brick work has been completed,

except such portions as are customarily left to be completed after the interior partitions are erected.

If, after any such payments provided for above have been made, additional shares shall be sold and additional payments shall be received by the Escrow Agent, it shall pay to the Sponsor 80% of such additional funds.

(b) When the Architect and the Consulting Architect have certified to the Apartment Corporation that the Building has been erected and completed substantially in accordance with the plans and specifications, subject to such modifications and changes as may be permitted under the Plan, and all of the apartments and servants' rooms to which shares are allocated are ready for occupancy except for unsold apartments and special work in individual apartments, or such work in the public portions or rentable area of the Building as is customarily left uncompleted until after occupancy of the Building. Upon transfer of the land and completed Building to the Apartment Corporation, as acknowledged by it, the Escrow Agent shall pay the balance of the moneys received by it from Purchasers as follows:

(1) \$41,552 to the Apartment Corporation for its working capital.

(2) \$50,000 to the Apartment Corporation if the permanent Certificate of Occupancy has not then been issued.

(3) The balance of all moneys to the Sponsor.

The Apartment Corporation shall pay the Sponsor the \$50,000 referred to in (2) above when the permanent Certificate of Occupancy has been issued.

If the Plan is not declared operative by May 1, 1987, any Purchaser may, within 15 days thereafter, elect to cancel the purchase agreement by giving written notice to the Apartment Corporation. In the event of any such cancellation, the Purchaser shall receive back all moneys paid under any such purchaser agreement, without interest.

10. *Attorneys and architects.* The law firm of Ferris & Meyers has been retained to represent the Apartment Corporation in connection with the Plan and at the closing.

The Sponsors are being represented by Arnold Josephs, Esq.

James Hoe and Associates have been retained as the Architect for the Building.

William Bender has been retained as Consulting Architect for the Apartment Corporation to check on the construction of the Building and to certify as to its completion.

If the Architect, Consulting Architect, or Agent above named shall cease to act in such capacity the Sponsor and the Apartment Corporation may appoint a substitute or substitutes.

11. *Management.* The Apartment Corporation will enter into an agreement with Harris & Co., Inc., for it to act as Managing Agent of the Building for a period of five years commencing from the date on which it is completed and ready for occupancy. The Agent may not cancel, renew, or assign the management contract except with the Apartment Corporation's written consent. The Agent will receive an annual fee of \$12,000. The Managing Agent's services shall include the billing and collection of rent, the hiring of help, and the operation of the Building, all under the supervision of the Apartment Corporation's Board of Directors, and the other usual services rendered by managing agents of cooperative apartment house buildings. The officers and employees of the Agent who will handle the moneys received from purchasers are bonded.

The only interest of Harris & Co., Inc. in the successful consummation of this Plan is as follows:

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If the Plan is put into effect it will receive from the Sponsors a commission of 4% of the funds paid by Purchasers for the purchase of shares under this Plan and a management fee from the Apartment Corporation as above provided.

It has no other financial interest and acts merely as Agent under this Plan, which has been formulated and issued by the Sponsor and Apartment Corporation.

The Agent has been in the real estate business since 1930 and manages many buildings in the area.

12. *Parties and agreements.* As hereinbefore stated the Sponsor is Ace Realty Corp., with its principal office at 600 First Avenue, New York, New York. It is a publicly owned corporation which has shares listed on the American Stock Exchange. Harvey Price is President and a director, William Price is a director, and Benjamin Green is Vice President and a director. The Sponsor owns all of the shares of Ace Builders, Inc., the Builder named in the Plan. The Sponsor or its subsidiaries or predecessor companies have been in the building business for over 25 years, and they have built or caused to be built many residential apartment house buildings.

The land was acquired in November, 1994, by the Builder at a cost of \$825,000 plus accrued expenses, and the construction work is on an actual cost basis plus the builder's fee of \$250,000. The Builder will receive a profit in the form of a \$750,000 second mortgage or junior participation, previously described. This mortgage is self-liquidating in approximately 41 years.

The Apartment Corporation was organized on September 14, 1999, and the incorporators and directors are: James Ferris, William Meyers, and Allen Pace. They are partners or employees of the law firm of Ferris & Meyers. They are only acting temporarily as nominees of the Sponsor and upon transfer of title of the land and completed Building to the Apartment Corporation will resign in favor of directors to be elected by the tenant-shareholders who in turn will elect officers. James Ferris, William Meyers, and Allen Pace have no financial interest in the Sponsor or the Cooperative Plan, and will receive no compensation for acting as the Apartment Corporation's officers and directors. The Apartment Corporation will be under the Sponsor's control up until the time the plan is put into full force and effect.

The Sponsor, as Seller, and the Apartment Corporation, as Buyer, have entered into a contract of sale which embodies the provisions of this Cooperative Plan, and the Sponsor agrees to comply with all of their obligations as set forth herein or therein. The Sponsor will cause the Building to be erected and will pay the full cost thereof.

13. *Schedules and exhibits.* Annexed hereto are the following:

--General description
of Building.

--Schedule A-- Estimated annual income and expenses.

--Schedule B-- Description of apartments, share allocations, selling prices and additional equity payments, estimated annual maintenance charges, estimated annual tax deductions, and other data.

--Exhibit I-- Purchase Agreement.

--Exhibit II-- Escrow Letter.

Copies of the contract of sale between the Sponsor and the Apartment Corporation, plans and specifications, the management contract, the proprietary lease, the Certificate of Incorporation and Bylaws of the Apartment Corporation

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are on file with the Agent and may be examined by prospective purchasers.

The estimates in Schedules A and B have been prepared by the Agent based on past experience with cooperative buildings of a substantially similar type. The estimates are believed to be correct and dependable. However, they are not intended to be representations, guaranties, or warranties of any kind whatsoever, including, without limitation, that the actual expenses or income for any period of operation may not vary from the amounts shown or that the Apartment Corporation may not incur additional expenses, or its Board of Directors may not provide for reserves not reflected in such schedules, or that the annual maintenance charges for any period of the proprietary leases may not vary from the amounts shown on Schedules A and B due to economic conditions, increased taxes or wages, or other causes. The Agent is not a builder, engineer, or architect, and assumes no responsibility with respect to the building plans or specifications, the general description thereof as hereinafter set forth, the equipment, materials, decoration, workmanship, or completion of the Building.

Any information, data, or representation not referred to in this plan or contained in the various documents mentioned herein must not be relied upon. There are no suits pending or judgments outstanding against any party mentioned herein which might become a lien against the property.

No person has been authorized to make any representations other than those set forth herein. This Plan may not be modified orally. This offer is made only to individuals over the age of 21 years who are residents of the State of New York.

This plan does not omit any material fact or contain any untrue statement of a material fact.

Dated: April 1, 2001, New York, New York

Ace Realty Corp., Sponsor

by _____

President

General Description of Building to Assist in the Examination of Plans and Specifications

The Skyline will be a 20-story and penthouse apartment building. It will be of fireproof construction, having reinforced concrete floors, columns, and beams. The exterior walls will be of glazed brick, backed up with cinder block, forming a cavity wall as shown on plans. The exterior of the building will be so designed as to create a pleasing architectural effect. The first floor of the 68th Street facade will be treated with granite plus other ornamentation as designed by the Architect. (Here follows detailed description of important features of the building including: entrances, basement, plumbing, heating, ventilating, cooling, electrical work, plastering, partitions, roofing, gas, electricity, elevators, telephone system, windows, railings, floors, bathrooms, kitchens, doors, trim, closets, painting, mail chute, venetian blinds, and laundry.)

Schedule A Estimated Annual Income and Expenses for First Year of Operation

Estimated Maintenance (60,080 Shares at \$7.40 per share)	\$444,592.00
Estimated Rent from Garage and Ground Floor Space (West of Entrance)	12,700.00

\$457,292.00

Operating:

Management	10,000.00

\$136,400.00

Mortgage Indebtedness--

Interest:--

Accrued	17,700.00	21,500.00	\$150,000.00

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Amortization:

1st Mortgage	\$ 40,200.00		
Less Accrued Interest added	17,700.00	22,500.00	\$172,500.00(***)
to 2nd Mortgage			
Estimated Contingency Reserve		\$ 14,392.00	
TOTAL ESTIMATED EXPENSES			\$457,292.00
.....			

(*) There will be 24-hour doorman service. Passenger elevators to be operated by tenant-owners but a day and evening hallman will be available to assist tenant-owners. Service car is to be manned during operation--Monday through Saturday.

(**) The figure given above is an estimate of real estate taxes for a full year after both the land and the completed building have been assessed. The full assessment of the land and building will probably not be determined by the Tax Commission of the City of New York until after the consummation of the Plan.

(***) This payment remains constant during term of mortgage, but portion allocable to interest decreases and amortization increases as mortgage is reduced.

Schedule B

Apartment	Size Number of Rooms and Baths	Share Allocation	Cash Sales Price of Shares Allocated @ \$44.40 per share	Estimated Total Annual Charges (incl. Gas) @ \$7.40 per share	Estimated Total Monthly Charges (incl. Gas) @ \$7.40 per share	Estimated Initial Annual Deduction for Income Tax Purpose* @ \$4.30 per share
Mais.-A Duplex	6R-2B/L-Bal.-T	500	\$ 22,200.00	\$ 3,700.00	\$ 308.33	\$ 2,150.00
2-A	4R-B/L	275	12,210.00	2,035.00	169.58	1,182.50
3-A	4R-B/L	285	12,654.00	2,109.00	175.75	1,225.50
4-A	4R-B/L	290	12,876.00	2,146.00	178.83	1,247.00

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			0			
5-A	4R-B/L	295	13,098.0	2,183.00	181.92	1,268.50
			0			
6-A	4R-B/L	300	13,320.0	2,220.00	185.00	1,290.00
			0			
7-A	4R-B/L	305	13,542.0	2,257.00	188.09	1,311.50
			0			
8-A	4R-B/L	310	13,764.0	2,294.00	191.17	1,333.00
			0			
9-A	4R-B/L	320	14,208.0	2,368.00	197.33	1,376.00
			0			
10-A	4R-B/L	330	14,652.0	2,442.00	203.50	1,419.00
			0			
11-A	41/2 R- 2B/L-Bal.-T	520	23,088.0	3,848.00	320.67	2,236.00
			0			
12-A	41/2 R- 2B/L-Bal.(2)	510	22,644.0	3,774.00	314.50	2,193.00
			0			
14-A	41/2 R- 2B/L-Bal.(2)	515	22,866.0	3,811.00	317.58	2,214.50
			0			
15-A	41/2 R- 2B/L-Bal.(2)	520	23,088.0	3,848.00	320.67	2,236.00
			0			
16-A	41/2 R-2B/L-Bal.	490	21,756.0	3,626.00	302.17	2,107.00
			0			
17-A	41/2 R-2B/L-Bal.	495	21,978.0	3,663.00	305.25	2,128.50
			0			
18-A	41/2 R-2B/L-Bal.	500	22,200.0	3,700.00	308.33	2,150.00
			0			
19-A	41/2 R-2B-T	510	22,644.0	3,774.00	314.50	2,193.00
			0			
20-A	41/2 R-2B-Bal.	470	20,868.0	3,478.00	289.83	2,021.00
			0			
21-A	41/2 R-2B	450	19,980.0	3,330.00	277.50	1,935.00
			0			
Penthouse- A	7R-3B/L-T	820	36,408.0	6,068.00	505.68	3,526.00
			0			
		9,010	\$400,044	\$66,674.0	\$5,556.1	\$38,743.0
			.00	0	7	0

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T --Terrace

* --This amount may change as principal of mortgage indebtedness is reduced or taxes increase or decrease.

(Similar schedules are required for all other apartments, this schedule reflecting the figures relating only to the "A" line of apartments)

Schedule B (Continued) SUMMARY Breakdown of Purchase Price and Estimated Maintenance

Apartments	Shares	Purchase Price at \$44.40 per share	Estimated Annual Maintenance at \$7.40 per share	Estimated Total Monthly Charges (incl. Gas) @ \$7.40 per share	Estimated Initial Annual Deduction for Income Tax Purposes* @ \$4.30 per share
A	9,010	\$ 400,044.00	\$ 66,674.00	\$ 5,556.17	\$38,743.00
B	8,206	364,346.40	60,724.40	5,060.37	35,285.80
C	9,977	442,978.80	73,829.80	6,152.48	42,901.10
D	10,090	447,996.00	74,666.00	6,222.16	43,387.00
E	9,295	412,698.00	68,783.00	5,731.92	39,968.50
F	8,870	393,828.00	65,638.00	5,469.83	38,141.00
G	4,200	186,480.00	31,080.00	2,590.00	18,060.00
Total Apartments:	59,648	\$ 2,648,371.20	\$ 441,395.20	\$ 36,782.93	\$256,486.40

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Servants'
Rooms
and
Private
Bath

#1	60	\$ 2,664.00	\$ 444.00	\$ 37.00	\$ 258.00
#2	48	2,131.20	355.20	29.60	206.40
#3	48	2,131.20	355.20	29.60	206.40
#4	45	1,998.00	333.00	27.75	193.50
#5	45	1,998.00	333.00	27.75	193.50
#6	48	2,131.20	355.20	29.60	206.40
#7	45	1,998.00	333.00	27.75	193.50
#8	45	1,998.00	333.00	27.75	193.50
#9	48	2,131.20	355.20	29.60	206.40
	432	\$ 19,180.80	\$ 3,196.80	\$ 266.40	\$ 1,857.60
GRAND TOTAL:	60.080	2,667,552.00	444,592.00	37,049.33	\$258,344.00

*--This amount may change as principal of mortgage indebtedness is reduced or taxes increase or decrease.

A.15 Certificate of incorporation--New York corporation

COMMENT

This form illustrates a certificate of incorporation for a cooperative corporation organized under the Business Corporation Law of New York. The information to be included in any certificate of incorporation will, of course, vary with the requirements of local law. However, the particular characteristics of a real estate cooperative corporation will dictate the inclusion of certain provisions regardless of the state of incorporation. Obviously, the certificate should not contain provisions which would result in loss of the tax benefit.

This certificate, therefore, provides for only one class of shares. In addition, the purpose clause makes it clear that shareholders shall be entitled solely by reason of their ownership of shares to proprietary leases permitting them to occupy the dwelling units of the cooperative. The statutory requirement prohibiting distributions to shareholders is taken care of in the corporate bylaws (see Form A.16). Certain other provisions in the certificate are indigenous to the cooperative corporation: a statement that the primary purpose is to provide homes for shareholders under proprietary leases; a broad statement of purposes with respect to the purchase of land, construction of buildings, and acquisition of personal property necessary to the operation of apartments; and a provision that the corporation may withhold its consent to a transfer of shares by a shareholder if he is in default on any indebtedness to the corporation.

For further information, see Chapters 9 and 16.

FORM

Certificate of Incorporation of Skyline Apartments, Inc.
Under Section 402 of the Business Corporation
Law of the State of New York

We, the undersigned, for the purpose of forming a business corporation pursuant to the provisions of the Business Corporation Law of the State of New York, do hereby certify:

1. *Name.* The name of the Corporation shall be

Skyline Apartments, Inc.

2. *Purposes.* The purposes for which it is to be formed are:

(a) To acquire by purchase, lease, or otherwise the land and building or buildings erected or to be erected thereon at 500 East 68th Street, New York, New York; to demolish existing building or buildings; to erect a new building or buildings; to hold, operate, manage, sell, or exchange and lease the same and the several parts and apartments in any building thereon, and in any replacement thereof, or additions thereto; to do and transact all other lawful business incident to, necessary, and suitable or advisable for, or in any way connected with, such purposes for which the Corporation is formed as above set forth. The primary purpose of this Corporation is to provide homes for its shareholders by leasing to them, under leases now commonly known as proprietary leases, apartments in the building or buildings on such premises, and all of its shareholders shall be entitled solely by reason of their ownership of shares in the Corporation to proprietary leases, entitling them to occupy for dwelling purposes apartments in the building or buildings.

(b) To acquire, by purchase, lease, or otherwise, own and possess any other lands and premises and any interest or rights therein or thereto appertaining, with the buildings and improvements thereon erected to be used incidental and appurtenant to such premises, 500 East 68th Street, New York, New York, and to improve, rebuild, manage, and operate any such property or properties; to rent, lease, and sublease apartments to its shareholders and to others upon such terms and for such periods as any individual might or could; to procure the necessary permits or licenses from municipal authorities for the operation of apartment houses and to do and perform every act required by law to be done or performed in the maintenance and operation of any type of apartment house; to maintain and operate the necessary conveniences, such as elevators, lighting, and heating, as may be required in the proper operation of any apartment house; to mortgage or otherwise encumber its real property and improvements thereon and equipment thereof; to sell, exchange, or otherwise transfer, convey, or dispose of real estate, in whole or in part, or lease the same in whole or in part, for cash or by taking purchase money bonds and mortgages in payment therefor or for valuable consideration of any character; to buy, sell, and deal in bonds and loans secured by mortgages; and generally to deal with and act in relation to such real estate and any and every part thereof and to the fullest extent that a corporation organized under the Business Corporation Law is lawfully empowered to do.

(c) To acquire by purchase, or lease, or by way of a secured transaction or otherwise, any personal property necessary or proper or useful in the equipment, furnishing, improvement, development, operation, or management of any such buildings and to trade and deal in any personal property beneficial to the Corporation, and to enter into security agreements in connection with, pledge, sell, let, or otherwise dispose of any personal property at any time owned or

held by the Corporation.

(d) To purchase, acquire, hold, and dispose of corporate shares of rights to subscribe thereto, bonds and other evidences of indebtedness of any corporation, domestic or foreign, and to issue in exchange therefor its shares, bonds, or other obligations; to possess and exercise in respect thereto all the rights, powers, and privileges of individual holders or owners thereof; and to exercise any and all voting power thereon, to purchase, hold, and reissue its own shares, insofar as permitted by law, and to purchase and hold its own bonds and to take and acquire, and hold or sell and dispose of bonds and mortgages and assignments thereof.

(e) To borrow money, to make and issue promissory notes, bills of exchange, bonds, debentures, and obligations and evidences of indebtedness of all kinds, whether secured by mortgage, pledge, security agreement, or otherwise, without limit as to amount and to secure the same by mortgage, security agreement, or pledge of its property or otherwise, provided the same is permitted by the Business Corporation Law of the State of New York.

(f) To compromise or settle all claims, debts, leases, tenancies, or occupancies asserted by or against the Corporation.

(g) To do all and everything necessary, suitable, convenient, or proper for the accomplishment of any one or more of the objects herein enumerated, or incidental to the powers herein named, or which at any time appear conducive or expedient for the protection or benefit of the Corporation, either as holders of, or as interested in any property or otherwise, with all the powers now or hereafter conferred by the laws of the State of New York upon corporations incorporated under the Business Corporation Law.

(h) The foregoing clauses shall be construed both as objects and powers. It is hereby expressly provided that the foregoing enumerations of specific powers shall not be held to limit or restrict in any manner the powers of the Corporation.

3. *Authorized shares.* The Corporation may issue a total of 65,000 shares, each with a par value of \$1, all of which shall be common shares. These shares shall be issued only in connection with the purchaser's and Corporation's execution and delivery of a proprietary lease of an apartment or apartments in a building owned or leased by the Corporation.

4. *Office.* The office of the Corporation shall be located at 500 East 68th Street, City, County, and State of New York.

5. *Agent for service of process.* The Secretary of State of the State of New York is hereby designated as the agent of the Corporation upon whom process in any action or proceeding against it may be served. The address within the State to which the Secretary of State shall mail a copy of process in any action or proceeding against the Corporation which may be served upon him is 500 East 68th Street, New York, New York.

6. *Restriction on transfer of shares.* If a shareholder shall be indebted to the Corporation, the directors may refuse to consent to a transfer of his shares until such indebtedness is paid, provided a copy of this section or the substance thereof is written or printed upon the share certificate.

7. *Salaries.* No salary or other compensation shall be paid to any director or officer of the Corporation for services rendered in that capacity unless and until it shall have been approved in writing or by affirmative vote taken at a duly held shareholders' meeting by the record holders of at least two-thirds of the Corporation's then outstanding shares.

8. *Contracts.* No contract or other transaction between the Corporation and any other corporation shall be affected by the fact that the Corporation's directors are interested in or are directors or officers of such other corporation, and any director individually may be a party to or may be interested in any contract or transaction of the Corporation. No contract or other transaction of the Corporation with any person or persons, firm, or association shall be affected by the fact that any of its directors may be a party or parties to or interested in any contract or transaction with such person or

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persons, firm, or association; provided that the director's interest in any such transaction or other contract shall be fully disclosed. Each and every person who may become a director of the Corporation is hereby relieved from any liability which might otherwise exist from contracting with the Corporation for his benefit or that of any firm, association, or corporation in which he may in any way be interested.

9. *Subscription for unissued shares.* No holder of any shares now or hereafter issued by the Corporation shall be entitled as a matter of right to subscribe for or purchase any part of its unissued shares of any class whatsoever or to subscribe for or purchase any additional shares, whether common, preferred, or of any other class, to be issued by reason of any increase in its authorized shares, or to subscribe for or purchase any bonds, certificates or indebtedness, debentures, or other securities, convertible into shares of the Corporation. Any and all such unissued shares and such additional authorized issuance of new shares and such securities convertible into shares may be issued, allotted, and disposed of to such persons, firms, corporations, or associations and for such lawful consideration, and upon such terms, as the Board of Directors may deem advisable and for the best interests of the Corporation.

10. *Incorporators.* All of the incorporators are natural persons over the age of 21 years.

In witness whereof the incorporators have signed and acknowledged this Certificate this 14th day of September, 1999.

_____	100 East 49th Street
James Foote	New York, New York
_____	200 Fifth Avenue
William Mason	New York, New York
_____	95 Church Street
Harrison Smith	New York, New York

(Acknowledgments)

A.16 Bylaws of cooperative corporation

COMMENT

In addition to defining the intracorporate procedures found in the usual corporate bylaws, those of a cooperative corporation must contain special provisions relating to the problems inherent in the cooperative purpose of the organization. Thus, the board of directors is granted the power to fix the annual cash requirements of the cooperative which in turn will establish the rental payments to be made by the tenant-shareholders; the power to adopt a form of proprietary lease; the power to determine the number of shares to be allocated to each apartment; and the power to subdivide and regroup space at the request of one or more owners. Corporate shares may be issued only in connection with the execution of proprietary leases, and the ownership of the shares entitles the shareholder to occupy a specified apartment for dwelling purposes. No shareholder is entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution not out of the earnings and profits of the corporation. These latter provisions are designed to secure the tax benefit for the tenant-shareholders (see comment on Form A.14). The corporation is given a lien on its shares to secure the payment of rent and compliance with the terms of the proprietary leases, but this lien is subordinate to any lien to secure payment of the purchase price of the shares.

For further information, see Chapters 9 and 16.

FORM

Bylaws of Skyline Apartments, Inc. Article I Meetings of Shareholders

1. *Annual meeting.* The annual meeting of the Corporation's shareholders, for the election of directors and for such other business as may properly come before such meeting, shall be held in the Borough of Manhattan, at 5 p.m. on the first Monday of May of each year commencing with the year 2000. If that day is a legal holiday, however, the meeting shall be held on the first day thereafter not a legal holiday. The notice of the meeting shall be in writing and signed by the President or a Vice President or the Secretary or an Assistant Secretary. Such notice shall state the purpose or purposes for which the meeting is called and the time when and the place within the state where it is to be held. A copy thereof shall be served, either personally or by mail, upon each shareholder of record entitled to vote at such meeting, not less than ten nor more than 40 days before the meeting.

2. *Special meetings.* The President or Secretary, or a majority of the Board of Directors, may at any time call special meetings of shareholders, other than those regulated by statute. The Secretary shall also call a special meeting whenever so requested in writing by shareholders of record of at least one-quarter of the outstanding shares. A notice of each special meeting, stating its time, place, and purpose and the officer or other person or persons by whom the meeting is called, shall be served, either personally or by mail, on each shareholder of record, at least ten days before such meeting. No business other than that stated in the notice shall be transacted at any special meeting unless the holders of record of all the Corporation's outstanding shares are present in person or by proxy.

3. *Waiver of mailing of notice.* The notice provided for in the two foregoing sections is not indispensable. Any shareholders' meeting whatever shall be valid for all purposes if the shareholders of record of all the Corporation's outstanding shares are present in person or by proxy, or if a quorum is present as provided in the next succeeding section and notice of the time, place, and purpose of such meeting has been duly waived in writing by all shareholders not so present. Any notice to be served upon a shareholder by mail shall be directed to him at his address as it appears on the Corporation's books unless the shareholder shall have filed with the Secretary of the Corporation a written request that notices intended for him be mailed to some other address, in which case it shall be mailed to the address designated in such request.

4. *Quorum.* At all meetings of shareholders, in order to constitute a quorum and to permit the transaction of any business, except to adjourn a meeting, there shall be present, either in person or by proxy, holders of record of a majority of the Corporation's outstanding shares.

5. *Voting.* Each shareholder of record shall be entitled at each shareholders' meeting to one vote, in person or by proxy, for each share standing in his name on the Corporation's books at the time of the meeting. All proxies shall be in writing and shall be filed with the Secretary at or before the time of the meeting. All voting shall be viva voce, except that any qualified voter may demand a ballot vote, in which case the voting shall be by ballot. Each ballot shall state the name of the shareholder voting and the number of shares owned by him, and in addition the name of the proxy, if such ballot is cast by a proxy.

6. *Inspectors of election.* Inspectors of election shall not be required to be appointed at any meeting of shareholders unless requested by a shareholder present (in person or by proxy) and entitled to vote at such meeting. Upon the making of such request inspectors shall be appointed or elected as provided in the applicable statute.

7. *Order of business.* The regular order of business for the annual meeting of shareholders, and for each special meeting to the extent such order is applicable, shall be as follows:

(a) Roll call.

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- (b) Presentation of notice of the meeting and proof of service, or waiver of notice.
- (c) Reading of minutes of preceding shareholders' meeting.
- (d) Reports of officers.
- (e) Reports of committees.
- (f) Appointment or election of inspectors of election, if requested.
- (g) Election of directors for ensuing year.
- (h) Miscellaneous business.

Article II Directors

1. *Election and term.* Directors shall be elected at the annual meeting of shareholders, or at a special meeting called for that purpose as provided by law, by a plurality of the votes cast at such election. Directors shall serve until the date herein fixed for the next annual meeting of shareholders and until the election of their respective successors. Directors need not be shareholders.

2. *Vacancies.* Vacancies in the Board of Directors resulting from death, resignation, or removal may be filled without notice to any of the shareholders by a vote of a majority of the remaining directors present at the meeting at which such election is held even though no quorum is present. Such vote may be at any regular meeting of the Board of Directors or any special meeting thereof called for such purpose. Vacancies in the Board of Directors resulting from an increase in its size shall be filled in the manner provided in the resolution increasing its size. If all the directors die or resign, any shareholder may call a special meeting of the shareholders as provided herein, at which directors for the unexpired term may be elected in the manner provided for their election at annual meetings. If any director, by ceasing to be a resident of the State of New York, reduces the number of such residents remaining on the Board to less than one, he shall be deemed to have resigned and his place shall be vacant.

3. *Removal.* Any director may be removed from office without cause by the Corporation's shareholders at a meeting duly called for that purpose.

4. *Meetings.* The Board of Directors shall hold its annual meeting immediately after the annual meeting of shareholders, without notice. It shall hold a special meeting whenever called together by the President or by a Vice President, or, after written request of any two directors then holding office, by any other officer, upon two days' written notice to each director served in person or by mailing the same to him at the last address furnished by him to the Corporation. Any meeting of the Board at which all the directors are present, or of which notice has been duly waived by all absentees, shall be valid for all purposes provided a quorum is present. A majority of the directors shall constitute a quorum. Meetings of the Board shall be held at such place within the City of New York as is specified in the notice calling the meeting. At meetings of the Board, each director shall be entitled to one vote.

5. *Annual budget.* In furtherance of the definitions and provisions of the proprietary leases entered into by the Corporation with its shareholders, the Board of Directors shall determine the cash requirements, as defined therein, and shall likewise fix the terms and times of payment of the rent due from shareholders who are lessees under such proprietary leases to meet such cash requirements. The Board of Directors shall have discretionary power to prescribe the manner of maintaining and operating the Corporation's apartment building, and any other premises acquired by the Corporation by purchase or otherwise, and to determine the foregoing cash requirements. Every such determination by

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the Board shall be final and conclusive as to all shareholders who are lessees under proprietary leases. All expenditures made by the Corporation's officers or agents under the direction or with the approval of the Board shall, as against such shareholders, be deemed necessarily and properly made for such purposes. The operating year of the Corporation shall be the calendar year.

6. *Distributions.* The Board of Directors shall by vote declare dividends from the surplus profits of the Corporation whenever in their opinion the condition of its affairs will render it expedient for such dividends to be declared. The shareholder shall not, either conditionally or unconditionally, except upon a complete or partial liquidation of the Corporation, receive any distribution not out of the Corporation's earnings and profits.

7. *House rules.* The Board of Directors may make and change the house rules applicable to the Corporation's apartment building whenever the Board deems it advisable so to do. All house rules shall be binding upon all tenants and occupants of the apartment building.

8. *Executive committee.* The Board of Directors may by resolution appoint an executive committee to consist of three or more Directors of the Corporation. Such committee shall have and may exercise all of the powers of the Board in the management of the Corporation's business and affairs during the intervals between the meetings of the Board, so far as may be permitted by law. The Executive Committee, however, shall not have power to determine the cash requirements defined in the proprietary leases, to fix the rent to be paid under the proprietary leases, or to vary the terms of payment thereof as fixed by the Board.

Article III Officers

1. *Election and removal.* The Board of Directors at its first meeting and at each annual meeting shall elect by a majority vote, a President and one or more Vice Presidents, a Secretary, and a Treasurer. The Board may also at any time appoint one or more Assistant Secretaries or Assistant Treasurers and accord to such assistant officers such powers as it deems proper. Any person otherwise qualified may hold any two offices. Each officer shall serve until the next annual meeting of the Board and until the election or appointment of his respective successor. Any officer, however, may be removed from office at any time, and a successor chosen, at the Board's pleasure, upon affirmative vote, taken at any meeting, by a majority of the then total authorized number of directors.

2. *President and vice president.* The President shall preside at meetings of shareholders and of the Board of Directors. He shall, subject to the control of the Board: have general management of the Corporation's affairs; perform all the duties incidental to his office or prescribed for him by these Bylaws or the Board; and make and sign in the Corporation's name all contracts, leases, and other instruments that the Board may from time to time authorize. If the President shall be absent or unable to perform these duties, any Vice President shall have his powers and perform his duties. A Vice President shall at all times have power to make and sign proprietary leases in the Corporation's name.

3. *Secretary.* The Secretary shall keep and record, in proper books provided for the purpose, the minutes of meetings of the Board of Directors and of the shareholders, record all transfers of stock and cancel and preserve certificates of the shares so transferred, and keep such other records as the Board shall require. He shall attend to the giving and serving of notices of the Corporation, have custody of the corporate seal, and affix the same to the share certificates and to instruments required by law or by these Bylaws or authorized by the Board. He shall also perform all other duties incidental to his office. He shall keep a book, to be known as the share book, containing the names, alphabetically arranged, of all persons who are shareholders of the Corporation, showing their places of residence, the number of shares held by them respectively, the time when they respectively became the owners thereof, the amount paid thereon, and the denomination and amount of all transfer stamps affixed thereto. The share book shall be open daily, during at least three business hours, for inspection by any judgment creditor of the Corporation, by any person who shall have been a shareholder of record for at least six months immediately preceding his demand, or by any person holding, or

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thereunto in writing authorized by the holders of, at least 5% of all the outstanding shares. Persons so entitled to inspect the share book may make extracts therefrom. If the Secretary shall be absent or unable to perform these duties, the Assistant Secretary shall have all his powers and perform all his duties.

4. *Treasurer.* The Treasurer shall, subject to the Board's control, have the care and custody of, and be responsible for, all funds and securities of the Corporation and shall keep the same in its name in such banks, trust companies, or safe deposit companies as the Board shall designate, and shall perform all other duties incidental to his office, or prescribed for him by these Bylaws or by the Board. If so required by the Board, he shall, before receiving any such funds or securities, furnish to the Corporation a bond with a surety company as surety, in such form and amount as the Board from time to time shall determine. The premium upon such bond shall be paid by the Corporation. Within a reasonable time after the close of each year ending December 31st, the Treasurer shall furnish to each shareholder who is a lessee under a proprietary lease then in force a statement of the Corporation's income, expenses, and paid-in surplus during such year. The statement shall indicate the portions of the rent paid by such shareholder under his proprietary lease during such year which the Corporation has used to pay real estate taxes and interest on its mortgage or other indebtedness. If the Treasurer shall be absent or unable to perform these duties, the Assistant Treasurer shall have all his powers and perform all his duties.

5. *Salaries.* No director or officer of the Corporation shall be paid a salary or other compensation for his services in that capacity unless and until such payment shall have been authorized in writing or by affirmative vote, taken at a duly held shareholders' meeting, by the record holders of at least two-thirds of the Corporation's then outstanding shares.

Article IV Proprietary Leases

1. *Form.* The Board of Directors shall adopt a form of proprietary lease to be used by the Corporation for the leasing of all apartments and extra servants' rooms, if any, in the apartment building to be leased to shareholders under proprietary leases. Such proprietary leases shall be for such terms, with or without provisions for renewals, and shall contain such restrictions, limitations, and provisions in respect to the assignment thereof, the subletting of the premises demised thereby, and the sale or transfer of the shares of the Corporation accompanying the same, and such other terms, provisions, conditions, and covenants, as the Board deems advisable. After the Corporation has executed and delivered a proprietary lease in the form so adopted by the Board of Directors, all proprietary leases subsequently executed and delivered shall be in the same form (except with respect to the statement as to the number of shares owned by the lessee), unless the variation is approved by lessees owning at least two-thirds of the Corporation's shares then owned by all lessees under proprietary leases then in force.

2. *Assignment.* Proprietary leases shall be assigned or transferred only in compliance with, and shall never be assigned or transferred in violation of the terms, conditions, and provisions of, such proprietary leases. A duplicate original of each proprietary lease shall always be kept on file in the office of the Corporation or with the managing agent of the apartment building.

3. *Accompanying shares.* The Board of Directors shall allocate to each apartment or extra servant's room to be leased under a proprietary lease the number of the Corporation's shares that must be owned by the proprietary lessee thereof. If the size of any such apartment or extra servant's room is changed from that shown on the typical plan thereof, the number of shares so allocated to such apartment or extra servant's room and to any other apartment or extra servant's room affected by such change shall be ratably and correspondingly changed by the Board.

4. *Regrouping of space.* The Board of Directors, upon the written request of the owner or owners of one or more proprietary leases covering one or more apartments or extra servants' rooms in the apartment building and of the shares issued to accompanying the same, may in its discretion, at any time, permit such owner or owners, at his or her own expense: (1) to subdivide or combine all or any portions of any such apartment or apartments or extra servants' rooms

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into one or any desired number of apartments or extra servants' rooms, (2) to convert all or any portion of any such apartment into extra servants' rooms or into a suite or suites of extra servants' rooms, and (3) to reallocate the shares issued to accompany the proprietary leases, in such proportions as such owners request and the Board approves, provided only that (a) the total number of the shares so reallocated is not less than the shares previously allocated, and (b) the proprietary leases so affected and the accompanying share certificates are surrendered, and that there are executed and delivered in place thereof, respectively, a new proprietary lease for each separate apartment, extra servant's room, or suite of extra servants' rooms so created and a new share certificate for the number of shares so reallocated to each such new proprietary lease.

5. *Fees on assignment.* The Board of Directors may fix by resolution and collect, before any assignment of a proprietary lease or any reallocation of shares takes effect as against the Corporation as lessor, reasonable fees to cover the Corporation's expenses and attorneys' fees in connection with such proposed assignment or reallocation, or both, as the case may be.

6. *Lost proprietary leases.* If any proprietary lease in full force and effect shall be lost, stolen, destroyed, or mutilated, the Board of Directors may authorize the issuance of a new proprietary lease in lieu thereof, in the same form and with the same terms, provisions, conditions, and limitations. The Board may, in its discretion, before the issuance of such new proprietary lease, require the owner of the lost, stolen, destroyed, or mutilated proprietary lease, or the owner's legal representative, to make an affidavit or affirmation setting forth such facts as to the loss, destruction, or mutilation as it deems necessary, and to give the Corporation a bond in such reasonable sum as it directs, to indemnify the Corporation.

Article V

Corporate Shares

1. *Issuance of shares.* Shares of the Corporation shall be issued only in connection with the execution and delivery by the lessee and the Corporation of a proprietary lease of an apartment in the building owned or leased by the Corporation. The ownership of the shares so issued shall entitle the holder thereof to occupy for dwelling purposes the apartment specified in the proprietary lease so executed and delivered in connection with the issuance of such shares, subject to the covenants and agreements contained in such proprietary lease.

2. *Share certificates.* Certificates for the Corporation's shares shall be in the form prescribed by the Board of Directors. Such certificates shall be signed by the President or a Vice President and the Secretary or an Assistant Secretary or the Treasurer or an Assistant Treasurer, and sealed with the seal of the Corporation, and shall be numbered in the order in which issued. Certificates shall be bound in a book and issued in consecutive order therefrom, and in the margin or stub thereof shall be entered the name of the person holding the shares therein represented, the number of shares, and the date of issue. Each certificate exchanged or returned to the Corporation shall be cancelled, and the Secretary shall indicate the date of cancellation thereon. Such certificate shall be immediately pasted in the certificate book opposite the memorandum of its issue.

3. *Transfer.* Transfers of shares shall be made only upon the books of the Corporation by the holder in person or by power of attorney, duly executed and witnessed and filed with the Secretary, and on the surrender of the certificate of such shares, except that shares sold by the Corporation to satisfy any lien which it holds thereon may be transferred without the surrender of such certificate. No transfer of shares shall be valid as against the Corporation, its shareholders, and creditors for any purpose until it shall have been entered in the share book by an entry showing from whom and to whom transferred.

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4. *Units of issuance.* Shares issued to accompany each proprietary lease shall be issued in the amount allocated by the Board of Directors to the apartment or extra servant's room or suite of extra servants' rooms described in such proprietary lease. Unless and until all proprietary leases which have been executed by the Corporation shall have been terminated, the shares which accompany each proprietary lease shall be represented by a single certificate. These shares shall not be sold or transferred except to the Corporation or as an entirety to a person who has acquired such proprietary lease, or a new one in place thereof, after complying with and satisfying the requirements of such proprietary lease in respect to its assignment.

5. *Fees on transfer.* The Board of Directors may fix by resolution and collect, before the transfer of any shares, reasonable fees to cover the Corporation's expenses and attorneys' fees in connection with such proposed transfer.

6. *Corporation lien.* The Corporation shall at all times have a lien upon the shares owned by each shareholder to secure the payment of all rent to become payable by such shareholder under the provisions of any proprietary lease issued by the Corporation and at any time held by such shareholder and for all other indebtedness from such shareholder to the Corporation, and to secure the performance of all the covenants and conditions of such proprietary lease to be performed or complied with by the shareholder. Unless and until such shareholder or lessee makes default in the payment of any such rent or other indebtedness or in the performance of any such covenant or condition, such shares shall continue to stand in the name of the shareholder upon the Corporation's books and the shareholder shall be entitled to exercise the right to vote thereon. The Corporation may issue to any purchaser of such shares upon its enforcement of such lien, or to the nominee of such purchaser, a certificate of the shares so purchased substantially of the tenor of the certificate issued to such defaulting shareholder. Thereupon the certificate for such shares issued to such defaulting shareholder shall become void and such defaulting shareholder shall surrender the same to the Corporation on demand. The defaulting shareholder's failure so to surrender such certificate, however, shall not affect the validity of the certificate issued in replacement thereof.

7. *Lost certificates.* If any share certificate shall be lost, stolen, destroyed, or mutilated, the Board of Directors may authorize the issuance of a new certificate of the same tenor and for the same number of shares in lieu thereof. The Board may in its discretion, before the issuance of such new certificate, require the owner of the lost, stolen, destroyed, or mutilated certificate, or the owner's legal representative, to make an affidavit or affirmation setting forth such facts as to the loss, destruction, or mutilation as it deems necessary, and to give the Corporation a bond in such reasonable sum as it directs, to indemnify the Corporation.

Article VI Seal

The seal of the Corporation shall be in the form of a circle, and shall bear its name, the year of its incorporation, and the words "Corporate Seal, New York."

Article VII Checks, Notes, Etc.

1. *Signatures on checks.* Checks drawn against the Corporation's deposit accounts with banks or trust companies shall be signed by such officer or officers, or employee or employees, as the Board of Directors may from time to time prescribe.

2. *Signatures on notes and bonds.* The Corporation's promissory notes and bonds shall be signed by any two officers who the Board of Directors shall from time to time designate for that purpose.

3. *Safe deposit boxes.* Any officer or officers who, from time to time, the Board of Directors shall designate for that purpose shall have access to any safe deposit box of the Corporation in the vault of any safe deposit company.

4. *Securities.* Any officer or officers who, from time to time, the Board of Directors shall designate for that purpose shall have power to control and direct the disposition of any bond or other security or property of the Corporation deposited in the custody of any bank, trust company, or other custodian.

Article VIII Amendments

These Bylaws may be amended at any shareholders' meeting provided that the proposed amendment has been inserted in the notice of meeting or that all of the shareholders are present in person or by proxy. These Bylaws may also be amended at any directors' meeting provided that the proposed amendment has been inserted in the notice of the meeting and that at least two-thirds of the then authorized total number of directors shall be present at such meeting. The shareholders, however, may at any time rescind, repeal, or amend any Bylaw adopted by the Board of Directors.A.17
Proprietary lease

COMMENT

A distinctive feature of a proprietary lease for a cooperative apartment is that the lessee's "rent" consists of a proportionate share of the cash requirements as determined annually by the board of directors. The proportionate share of each lessee depends upon his percentage of ownership of the total outstanding shares of the cooperative corporation. Most proprietary leases extend for a long term, usually between 30 and 50 years. In this form the lessee may cancel the lease as of September 1 of any year after the second year by giving notice on or before the preceding April 1.

The tenant's responsibility for repairs is usually broader under proprietary leases than under other types of leases. Thus, the lessee is responsible under this lease for the maintenance or replacement in his apartment of plumbing fixtures, lighting fixtures, refrigerators, and ranges. Another unique feature of the proprietary lease is that its terms are virtually the same for all tenants and can be altered only by a vote of the shareholders at a meeting called for this purpose or by the written consent of at least two-thirds of the shareholders owning at least two-thirds of the corporation's stock. Subleasing is permitted only with the consent of the board of directors, except in the case of those tenants who are designated by the sponsor for the purpose of putting the plan into operation (see comment on Form A.14).

Except for the above features, this lease is basically similar to leases for the conventional type of apartment house.

For further information, see Chapters 9 and 16.

FORM

INDENTURE OF LEASE, made the _____ day of _____, 20 _____, by and between Skyline Apartments, Inc., a corporation organized under the laws of the State of New York, (the "Lessor"), and

(the "Lessee").

Whereas the Lessor is the owner of the land and the building erected thereon in the Borough of Manhattan, City of New York, known as The Skyline and by the street number 500 East 68th Street (the "building"); and

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Whereas the Lessor has leased or proposes to lease the apartments in the building to the several owners of its common shares by instruments known as proprietary leases; and

Whereas the Lessee is the owner of _____ of the common shares of the Lessor, which have been allocated to the apartment;

Now, therefore, in consideration of the premises and of the rents, covenants, and agreements hereinafter provided and contained, the Lessor hereby leases to the Lessee, subject to the terms and conditions hereinafter expressed, and the Lessee hereby hires and takes from the Lessor, all that certain space on the _____ floor of the building, known as apartment _____ (the "apartment"),

To Have and To Hold the apartment, with the appurtenances, unto the Lessee and the executors, administrators, legal representatives, and authorized assigns of the Lessee, upon the terms and conditions herein set forth, from the _____ day of _____, 20 _____, until the 30th day of September, 2053 (unless the term shall sooner expire as hereinafter in this lease provided), at a rent for each year or portion of year during such term equal to the Lessee's proportionate share as hereinafter provided of the aggregate amount of the cash requirements of the Lessor, as hereinafter defined, for such year or portion of year, together with additional rent as hereinafter provided.

If at the time the Lessee executes this lease the date of the commencement of the term has not been inserted herein, then the Lessee hereby authorizes the Lessor to insert such date, which shall be the same date that title to the premises is transferred to the Lessor.

The cash requirements above referred to for each year or portion of year are hereby defined and shall be deemed to be such aggregate sum as the Lessor's Board of Directors from time to time, by a resolution or resolutions adopted during such year or portion of year or the preceding year, shall determine, in its judgment, is to be paid by all the lessees under proprietary leases then in force (after deducting all estimated rents or income to be received during such year other than rents under proprietary leases) on account of the Lessor's estimated expenses and outlays to the close of such year, growing out of or connected with the ownership, maintenance, and operation of such land and building. Such sum may include among other things taxes, assessments, water rates, insurance premiums, operating expenses, legal and accounting fees, management fees, commissions, employees' gratuity fund, alterations, replacements and repairs, expenses and liabilities incurred by the Lessor under or by reason of this or other leases, interest on mortgage or other indebtedness, mortgage amortization payments, the payment of any other liens or charges, the payment of any deficit remaining from a previous period, the creation of a reasonable contingency or other reserve or surplus fund or capital contribution, and expenses for other corporate purposes. The Lessor's Board of Directors may, from time to time, by resolution or resolutions duly adopted up to the close of the year for which such cash requirements have been so fixed or determined, increase or diminish the amount previously fixed or determined for such year. The Board of Directors may include in the cash requirements for any year all liabilities or items of expense which accrued or became payable in a previous year, or which might have been included in the cash requirements for a previous year but were not included therein, and also all sums which it may deem necessary or prudent to provide as a reserve against liabilities or expenses then accrued or thereafter to accrue although not payable in that year.

The rent payable by the Lessee in and for each year or portion of year of such term shall be a sum (within the limits and on the conditions hereinabove provided) bearing to the aggregate amount of such cash requirements for such year or portion of year, determined as herein provided, the same ratio as that which the number of shares of the Lessor, owned by the Lessee at the time of the execution hereof as stated in the recitals of this proprietary lease, bears to the aggregate of the shares similarly specified in all the proprietary leases in effect at the time of the fixing and determination of such cash requirements. Such rent, together with any additional rent accruing under this lease, shall be payable monthly in advance or in such payments or installments as the Lessor's Board of Directors by resolution shall require, and at such times as such resolution shall provide.

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The Lessor's Board of Directors shall have discretionary power to prescribe the manner of maintaining and operating the building, and to determine the Lessor's cash requirements to be paid as herein provided by the lessees under proprietary leases. Every such determination by the Board of Directors, within the bounds of this agreement of lease, shall be final and conclusive as to all lessees. All expenditures made by the Lessor's officers or managing agent, under the direction or with the approval of the Lessor's Board of Directors, within the bounds of this agreement of lease, shall, as against the lessees, be deemed necessarily and properly made for such purposes.

The power and authority to determine and establish the amount of and to require payment of the rent above provided for shall be possessed only by the Board of Directors, as elected by the Lessor's shareholders, and shall not pass to or be exercised by:

(a) any creditor, receiver, or trustee of the Lessor or any of their representatives, except to the extent of actual cash requirements for operating the building and the payment of current real estate taxes and current interest and amortization on any mortgage that may then be a lien on the premises; or

(b) any Board of Directors elected by any such creditor, receiver, or trustee or by any of their representatives, except to the extent of actual cash requirements for operating the building and the payment of current real estate taxes and current interest and amortization on any mortgage that may then be a lien on the premises.

Article I

The Lessor hereby covenants with the Lessee, as follows:

1. *Repairs.* The Lessor shall keep in good repair the foundations, sidewalks, walls (except interior surfaces of all walls of apartments), supports, beams, roofs, terraces, gutters, fences, cellars, chimneys, entrances and street and court doorways, main halls, main stairways, windows, fire escapes, elevators, pumps and tanks, and all main and principal pipes for carrying water, gas, or steam through the building, and the main drain pipes and electrical conduits, together with all plumbing, heating, cooling, and other apparatus intended for the general service of the building, except those portions of any of the foregoing which it is the Lessee's duty to maintain and keep in good repair as provided in paragraph 7 of Article II hereof and subject to the provisions of paragraph 16 of Article II hereof. The Lessee shall give the Lessor prompt notice in writing of any accident or defect known to the Lessee and requiring repairs to be made. Subject to the foregoing limitations all such repairs shall be at the Lessor's expense. The Lessee, however, shall bear all expenses for such repairs that have been rendered necessary by the act, neglect, carelessness, or improper use of equipment either by Lessee or by any of Lessee's family, guests, employees, or subtenants.

2. *Maintenance.* The Lessor shall maintain and manage the building as a first-class apartment building, keep the elevators and the public halls, cellars, and stairways clean and properly lighted and heated, provide unattended passenger elevator service and the number of employees requisite in the judgment of the Board of Directors for the care and service of the building, and, without extra cost to the Lessee, provide the apartment with a proper and sufficient supply of hot and cold water. The building will have a central heating and cooling system, and the unit fans for the circulation of warm or cooled air will be connected to the Lessee's meter and paid for by the Lessee. The replacement of filters in the heating and cooling units shall also be at the Lessee's expense.

The covenants by the Lessor herein contained are subject, however, to the discretionary power of its Board of Directors to prescribe the manner of maintaining and operating the building and to determine the cash requirements of the Lessor, as hereinabove stated. Such covenants are subject to the further proviso that there shall be no diminution or abatement of rent or other compensation accruing to the Lessor for its failure to perform the same or for interruption or curtailment of service, when such failure, interruption, or curtailment shall be due to accident or to alterations or repairs desirable or

necessary to be made, or to inability or difficulty in securing supplies or labor, or to some other event not caused by the Lessor's gross negligence. All of the Lessor's covenants contained in this instrument are also subject to the provisions of paragraph 16 of Article II hereof.

3. *Damage to building.* If the building shall be partly damaged by fire or other cause, it shall be repaired as speedily as is reasonably possible, at the Lessor's expense, so as to conform substantially to the plans and specifications under which the building was completed. If the damage shall be so extensive as to render the apartment untenable, the rent hereunder shall cease until the apartment shall again be rendered tenantable. If the building shall be totally destroyed by fire or otherwise, the rent shall be paid up to the time of such destruction, and thereupon this lease and all rights and obligations of the parties hereunder, and the tenancy hereby created shall wholly cease and expire. If, however, the Lessor or insurer shall elect to rebuild the building, this lease shall, at the option of the Lessee exercised within 30 days after the Lessor's or insurer's notice of election to rebuild, be reinstated at such time as the apartment may again be ready for occupancy.

4. *Books.* The Lessor shall keep full and correct books of account at the office of the managing agent or at such other place as the Board of Directors may from time to time determine. Such books shall be open during all reasonable hours to inspection by the Lessee or his representative.

5. *Accompanying shares.* In every proprietary lease heretofore executed by the Lessor there has been specified, and in every proprietary lease hereafter executed by it there will be specified, the number of its shares issued therewith. Such number, in relation to the aggregate of all numbers of shares similarly specified in all the proprietary leases at the time in force, shall constitute the basis for fixing, as hereinbefore provided, the proportionate share of the aggregate amount of the Lessor's cash requirements, as hereinbefore defined, which shall be payable as rent by the Lessee. If after the fixing of the amounts payable as rent by the lessees under proprietary leases for any period of time, one or more additional proprietary leases are made, thus increasing the aggregate number of shares specified in all proprietary leases, the rent to be paid under such additional lease or leases, unless and until the Board of Directors shall otherwise fix the rent to be paid under all proprietary leases, shall be at the same rate per share specified in such additional lease or leases as applied to the shares specified in all other proprietary leases in effect at the time of the fixing and determination of such cash requirements. The rent payable for such period of time by lessees under such other proprietary leases shall not be modified or affected by any increase in the aggregate number of shares specified in all proprietary leases.

6. *Changes in leases.* All proprietary leases of apartments in the building hereafter executed shall be in the form of this lease except with respect to statements as to the number of shares owned by the Lessee and his proposed use and occupancy. The Lessor will not make or consent to any change or alteration in the terms or conditions of any proprietary lease which the Lessor shall have executed (as distinct from the house rules) unless such change or alteration shall be made pursuant to the affirmative vote taken at a meeting called for that purpose, or written consent signed, by lessees owning at least two-thirds in amount of the Lessor's shares then owned by all lessees under proprietary leases then in force, and being at least two-thirds in number of such lessees.

7. *Penthouses, balconies, and terraces.* A lessee of an apartment embracing a penthouse, balcony, or terrace or a portion thereof shall have and enjoy the exclusive use of the balcony or terrace (but not the roof above the penthouse) appurtenant to such apartment as shown on the building plan, subject to all the applicable provisions of this lease and to the use of any penthouse roof by the Lessor to enable it to fulfill its obligations hereunder. The Lessor, on behalf of itself or other lessees, may erect on the roof of a penthouse radio or television aerials and antennas for its use and the use of the other lessees in the building and shall have the right of access thereto for such installations and for the repair thereof. The Lessor shall have no duty to keep such roof clean or free from ice or snow and this shall be the Lessee's obligation. The Lessee shall not install any walls, enclosures, awnings, or planting on any penthouse, balcony, or terrace, except with the prior written approval of the Lessor or its agent.

8. *Quiet enjoyment.* The Lessee, upon paying the rent and performing the covenants and complying with the conditions

that the Lessee is required to perform, as herein set forth, shall, at all times during the term hereby granted, quietly have, hold, and enjoy the apartment without any let, suit, trouble, or hindrance from the Lessor.

Article II

The Lessee hereby covenants with the Lessor, as follows:

1. *Payment of rent.* The Lessee will pay to the Lessor, or to its managing agent, the rent upon the terms, at the times, and in the manner herein provided, without any deduction on account of any set-off or claim which the Lessee may have against the Lessor. If the Lessee shall fail to pay any installment of rent within one month from the time when it becomes due, the Lessee shall pay interest thereon at the rate of 6% per annum from the due date of the installment to the date of the payment thereof, and such interest shall be deemed additional rent hereunder.

2. *Default by lessee.* If the Lessor shall resume possession of the apartment, either by summary proceedings, action of ejectment, or otherwise, because of the Lessee's default in the payment of any rent or any part of the same, on or the expiration of the term pursuant to a notice given as provided in Article III hereof upon the happening of any event specified in subparagraphs (a), (b), (c), (d), (e), and (g) of paragraph 1 of Article III, the Lessor may, at its option, either (1) relet the apartment for its own account, or (2) from time to time relet the apartment as the agent of or for the account of the Lessee. If the Lessor relets the apartment under its option in (2), it shall, after reimbursing itself for its reasonable expenses in connection therewith, including a reasonable amount for decorations, alterations, and repairs in and to the apartment, apply the remaining proceeds of such reletting to the payment of any and all sums then due to it from the Lessee and which would thereafter have become due from the Lessee under the provisions of this lease if the Lessor had not so resumed possession, accounting to the Lessee at the expiration of each of the several terms of such reletting for any surplus. If at any time or from time to time before the expiration of the term originally demised hereunder, there shall be a deficiency between the proceeds of such reletting and such sums as would have become due hereunder, the Lessee shall pay such deficiency upon demand. If the Lessee shall at any time sublet the apartment and shall default for a period of one month in the payment of any rent, the Lessor may, at its option, so long as such default shall continue, demand and receive from any subtenant of the Lessee occupying the apartment the rent due or becoming due from such subtenant to the Lessee, up to an amount sufficient to pay all sums due from the Lessee to the Lessor. Any payment of such rent to the Lessor shall be sufficient payment and discharge of such subtenant as between the subtenant and the Lessee, to the extent of the amount so paid. Any such demand or acceptance of rent from any subtenant, or from any assignee hereof, shall not be deemed the Lessee's consent or approval of any sublease or assignment.

3. *Failure to fix rent.* The failure of the Lessor's Board of Directors, before the expiration of any year of such term, to fix the rent hereunder for that or the next year, shall not be deemed a waiver or modification in any respect of the covenants or provisions of this lease, or a release of the Lessee from the obligation to pay the rent or any installment thereof for that or any subsequent year, provided such rent shall ultimately be fixed.

4. *House rules.* The Lessor may from time to time establish such reasonable house rules as its Board of Directors may deem necessary for the management and control of the building, and may also from time to time alter, amend, and repeal such rules. This lease shall be in all respects subject to such rules, which, when a copy thereof has been furnished to the Lessee, shall be taken to be part hereof. The Lessee shall obey all such rules and see that they are faithfully observed by his family, guests, employees, and subtenants. All such rules shall apply to and be binding upon all of the tenants of the building, whether shareholders of the Lessor or not, but the Lessor shall not be responsible to the Lessee for the nonobservance or violation of such rules by any other lessee or person other than the Lessor's employees. Without limiting the generality of the foregoing, such house rules may regulate and control the use of any roof or terrace appurtenant to the apartment.

5. *Use of premises.* The Lessee shall not occupy or use the apartment, or permit the same or any part thereof to be occupied or used, for any purpose other than as a private dwelling apartment for the Lessee, and the Lessee's family and

servants, except such portions of the building as the Lessor's Board of Directors may allocate as professional offices or servants' rooms. The Lessee shall not permit or suffer anything to be done or kept in the apartment which will increase the rate of fire insurance on the building or its contents, or which will interfere with the rights of other tenants or annoy them by unreasonable noises or otherwise, or which will obstruct the building's public halls or stairways. The Lessee shall comply with all the requirements of the Board of Health and other governmental authorities and with all laws, ordinances, rules, and regulations with respect to the occupancy or use of the apartment, and will not do anything or permit anything to be done which might increase the rate of fire insurance on the building, its contents or the individual apartments. If, however, by reason of the occupancy or use of the apartment by the Lessee, the rate of fire insurance on the building, its contents or the individual apartments shall be increased, the Lessee shall become personally liable to the Lessor or other lessees for the additional insurance premiums or payments caused by Lessee's use of the apartment.

6. *Subletting and assignment.* The Lessee may sublet the apartment for any term to any person or persons subject to the Lessor's written consent to the sublessee and the terms of the sublease, authorized by a resolution of the Board of Directors, or signed by a majority of the directors, or by lessees owning of record at least a majority of the Lessor's capital stock accompanying proprietary leases then in force. Whenever the Lessee applies to the Lessor for a consent to a subletting, the Lessee may be required to deliver to the Lessor a copy of the sublease to which consent is requested. The Lessor reserves the right to adopt rules and regulations with respect to subletting.

Except as provided in Article IV of this lease, the Lessee shall not assign this lease, or any interest therein. No such assignment shall take effect as against the Lessor for any purpose, unless and until all of the following requirements have been complied with and satisfied:

- (a) An instrument of assignment containing a covenant by the assignee to perform and comply with all the covenants and conditions of this lease to be performed or complied with by the Lessee on and after the effective date of such assignment must be executed and acknowledged by the assignee and delivered to the Lessor.
- (b) All shares of the Lessor accompanying this lease must be transferred to the assignee.
- (c) All sums due from the Lessee, together with a sum to be fixed by the Lessor's Board of Directors to cover the Lessor's reasonable legal and other expenses in connection with such assignment and transfer of the shares, must be paid to the Lessor.
- (d) A written consent to such assignment, authorized by a resolution of the Board of Directors, or signed by a majority of the directors, or by lessees owning of record at least a majority of the Lessor's shares accompanying proprietary leases then in force, must be delivered to the Lessor. If the Lessee shall die during the term of this lease, the Board of Directors or the other lessees owning the Lessor's shares shall not unreasonably withhold the consent provided for in this paragraph to any assignment or transfer of the shares and the lease which the Lessee may make in his or her last will and testament, or through the acts of his or her administrator or executor, to a financially responsible member of his immediate family; provided, however, that the other conditions of this paragraph 6 are complied with.

Whenever the Lessee shall, under the provisions of this lease, be permitted to assign and shall so assign the same, and the assignee shall deliver to the Lessor an instrument assuming all of the assignor's unfulfilled obligations hereunder, the assignor shall have no further liability on any covenant of this lease to be thereafter performed. Upon the making of any assignment of this lease, as herein provided and permitted, the same shall, at the Lessor's option, be surrendered. In such case the Lessor and the assignee shall enter into a new lease, in the same form, for the remainder of the term of this lease.

No executor, administrator, personal representative, or successor of the Lessee, or trustee, or receiver of his property, or anyone to whom his interest hereunder shall pass by law, may assign this lease, or sublet the apartment, or any part thereof, except upon compliance with the requirements of this paragraph 6. The character of and restriction upon the

occupancy of the apartment, and upon assignment of this lease, as hereinbefore expressed, restricted, and limited, are an especial consideration and inducement for the granting of this lease by the Lessor to the Lessee. If the Lessee shall violate any restriction or covenant herein contained in respect to either subletting or assignment, this lease may be terminated and shall expire at the Lessor's option as hereinafter provided. In such case the Lessor may cease performance of its covenants contained in Article I of this lease, and may restrain and prevent the occupancy of the apartment by any one other than the Lessee.

Notwithstanding the above, if an individual supplied by the Sponsor to purchase unsold shares pursuant to the Lessor's plan of organization is the Lessee under this lease then the apartment may be sublet or this lease and the accompanying shares assigned without requiring the Lessor's written consent, as provided herein, except that the sublessee or assignee shall be approved by the building's then managing agent. The foregoing exception shall apply only to an assignment by individuals supplied by the Sponsor and shall not apply to any subsequent assignment.

7. *Interior repairs.* The Lessee shall keep the interior of the apartment in good repair, and the Lessor shall not be held answerable for any repairs in or to the same except as hereinbefore specifically provided. If the Lessee shall refuse or neglect, during ten days after the Lessor's written notice, to make such repairs or to restore the apartment to good condition, the Lessor may do so. The Lessor may, by its officers or authorized agents, enter the apartment for that purpose, and collect the cost of such repairs or restoration as additional rent for the apartment. In addition to decorating and keeping the interior of the apartment in good repair the Lessee shall maintain or replace all its plumbing fixtures, lighting fixtures, refrigerators, and ranges.

8. *Alterations.* The Lessee shall not, without first obtaining the Lessor's written consent, make in the apartment, or on any penthouse, balcony, or terrace appurtenant thereto, any structural alteration or any alteration of the water, gas, or steam pipes, electrical conduits or plumbing, or, except as hereinafter authorized, remove any additions, improvements, or fixtures from the apartment. If the Lessee shall have heretofore or shall hereafter place in the apartment at his own expense any additions, improvements, or fixtures, such as mantels, lighting fixtures, refrigerators, ranges, woodwork, panelling, ceilings, doors, or decorations, which can be removed without structural alterations, then the Lessee may, prior to the termination of this lease, remove the same at his own expense, provided that: (a) the Lessee at the time of such removal shall not be in default in the payment of rent or in the performance of any other provision or condition of this lease; (b) upon any such removal, the Lessee shall give written notice thereof in advance to the Lessor; (c) the Lessee shall pay the cost of any such removal and shall repair any damage resulting therefrom; and (d) the Lessee shall replace and reinstall at his own expense any equipment that was in the apartment at the beginning of the term or shall replace and reinstall substitutes of a kind and quality customary in buildings of this type and satisfactory to the Lessor.

On the expiration of the term hereby granted, or upon a sooner termination of this lease, the Lessee shall surrender to the Lessor possession of the apartment with all additions, improvements, and fixtures then included therein except as hereinabove provided.

9. *Lease subordinate to mortgages.* This lease is and shall be subject and subordinate to all mortgages now a lien upon the land and building and to any and all extensions, modifications, renewals, and replacements thereof, and shall be subject and subordinate to the lien of any other mortgage or mortgages which shall at any time be placed on the land and building. The Lessee shall at any time, and from time to time, on demand, execute all instruments that may be required by any mortgagee, or by the Lessor, for the purpose of more formally subjecting this lease to the lien of any such mortgage or mortgages. Each of the Lessor's duly elected officers, for the time being, is hereby irrevocably appointed the Lessee's attorney-in-fact and agent to execute the same upon such demand. The Lessee hereby ratifies any such instrument hereafter executed by virtue of the power of attorney hereby given.

10. *Mechanics' liens.* In case a notice of mechanic's lien shall be filed against the building, for, or purporting to be for, labor or material alleged to have been furnished or delivered at the building or the apartment to or for the Lessee, or anyone claiming under him, the Lessee shall forthwith cause such lien to be discharged by payment, bonding, or

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otherwise. If the Lessee shall fail to cause such lien to be discharged within 20 days after the filing of such notice, the Lessor may cause such lien to be discharged by payment, bonding, or otherwise, without investigation as to the validity thereof or of any offsets or defenses thereto. The Lessor may collect, as additional rent, all amounts so paid and all costs and expenses paid or incurred in connection therewith, including reasonable attorneys' fees and disbursements, together with interest thereon from the time or times of payment.

11. *Cooperation.* The Lessee shall always in good faith endeavor to observe and promote the cooperative purposes for the accomplishment of which the Lessor was incorporated.

12. *Right of entry.* The Lessor and its agents shall be permitted to visit and examine the apartment at any reasonable hour of the day, and workmen may enter at any time, when authorized by the Lessor or its agents to make or facilitate repairs in any part of the building and to remove such portions of the walls, floors, and ceilings of the apartment as may be required for the purpose of making such repairs. The Lessor, however, shall at its own cost and expense thereafter restore the premises to their proper and usual condition. If the Lessee shall not be personally present to open and permit an entry into the apartment, at any time when for any reason an entry therein shall be necessary or permissible hereunder, the Lessor or its agents may forcibly enter the apartment without rendering any of them liable to any claim or cause of action for damages by reason thereof (if during such entry the Lessor shall accord reasonable care to the Lessee's property), and without in any manner affecting the obligations and covenants of this lease. The right and authority hereby reserved do not impose, nor does the Lessor assume by reason thereof, any responsibility or liability whatsoever for the care or supervision of the apartment, or any of the pipes, fixtures, appliances, or appurtenances therein contained or therewith in any manner connected, except as may be herein specifically provided.

13. *Waivers.* The Lessor's failure to insist, in any one or more instances, upon a strict performance of any term, covenant, condition, or agreement of this lease, or to exercise any right or option herein contained, or to serve any notice, or to institute any action or summary proceeding, or otherwise to act as though this lease had expired pursuant to the provisions of Article III hereof, shall not be construed as a waiver, or a relinquishment for the future, of such covenant or option or right thereafter to serve notice and to have this lease expire under the provisions of Article III, but such covenant or option or right shall continue and remain in full force and effect. The Lessor's receipt of rent, with knowledge of the breach of any covenant hereof, shall not be deemed a waiver of such breach. No waiver by the Lessor of any provision hereof shall be deemed to have been made unless expressed in writing and signed by one of its officers pursuant to authority contained in a resolution of its Board of Directors; and even though a consent to an assignment hereof, or to any subletting, be given, no further assignment or subletting shall be made without express consent in writing given as hereinbefore provided.

14. *Notices.* Any notice by the Lessor to the Lessee shall be deemed to be duly given, and any demand by the Lessor upon the Lessee shall be deemed to have been duly made, if enclosed in a postpaid envelope addressed to the Lessee at 500 East 68th Street, New York, New York, or such other address as the Lessee may designate in writing, and mailed by registered mail in any general or branch post office. Any notice by the Lessee to the Lessor shall be deemed to be duly given, and any demand by the Lessee upon the Lessor shall be deemed to have been duly made, if enclosed in a postpaid envelope, addressed to the Lessor at 500 East 68th Street, New York, New York, or such other address as the Lessor may designate in writing.

15. *Attorneys' fees.* If the Lessee shall at any time be in default hereunder, or if the Lessor shall institute an action or summary proceeding against the Lessee based upon such default, the Lessee will reimburse the Lessor for the reasonable expense of attorneys' fees and disbursements thereby incurred by the Lessor, and the Lessor shall have the right to collect the same as additional rent.

16. *Lessor's immunities.* The Lessor shall not be liable for any failure of heat, water supply, air conditioning, electric current, telephone, or elevator service, or other service to be supplied by it hereunder, or for injury or damage to person or property caused by the elements or by another tenant or person in the building, or resulting from steam, gas,

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electricity, water, rain, or snow which may leak or flow from outside or from any part of the building, or from any of its pipes, drains, conduits, radiators, boilers, tanks, appliances, or equipment, or from any other place, unless caused or due to its negligence. The Lessor shall not be liable for interference with light or other incorporeal hereditaments by anybody other than itself. The Lessor or its agent shall not be responsible for any damage to any automobile or other vehicle left in the care of any of its employees by the Lessee, and the Lessee shall hold the Lessor or its agent harmless from any liability arising from any injury to person or property caused by or with such automobile or other vehicle while in such employee's care. The Lessor or its agent shall not be responsible for any package or article left with or entrusted to any employee of the Lessor, or for the loss of any property within or without the apartment by theft or otherwise. If the Lessor shall, before, during, or after the term of this lease, furnish to the Lessee any storage space, use of laundry, or any other facility outside of the apartment, the same shall be furnished gratuitously by the Lessor. If any person shall use the same, such use shall be entirely at the risk of such person, and the Lessor or its agent shall not be liable for any loss of property therein, for any damage or injury whatever to person or property therein or in connection therewith. Storage space may only be used for the storage of empty trunks and bags. No diminution or abatement of rent, or other compensation, shall be claimed or allowed for inconvenience or discomfort arising from the making of repairs or improvements to the building or to its appliances.

Article III

It is hereby mutually agreed, as follows:

1. *Expiration of lease.* If upon, or at any time after, the happening of any event mentioned in subparagraphs (a) to (h) inclusive of this paragraph 1, the Lessor shall give to the Lessee a notice stating that the term hereof will expire on a date at least ten days thereafter, this lease shall expire on the date so fixed in such notice, and all right, title, and interest of the Lessee hereunder shall wholly cease and expire, it being the intention of the parties hereto to create hereby a conditional limitation. Thereupon the Lessor shall have the right to reenter the apartment and to remove all persons and personal property therefrom, either by summary dispossession proceedings, or by any suitable action or proceeding at law or in equity, or by force or otherwise, and to repossess the apartment in its former estate as if this lease had not been made. No liability whatsoever shall attach to the Lessor by reason of the exercise of the right of reentry, repossession, and removal herein granted and reserved.

(a) If at any time during the term of this lease the Lessee shall cease to be the owner of all of the shares which are hereinbefore stated to be owned by him and allocated to this lease, or if this lease shall pass or be assigned to anyone who is not then the owner of all of such shares.

(b) If: (1) the Lessee shall be declared a bankrupt under United States law or adjudicated insolvent or take the benefit of any insolvency act; (2) a receiver or trustee of the Lessee's property shall be appointed by any court; (3) the Lessee shall make a general assignment for the benefit of creditors; (4) any of the Lessor's shares owned by the Lessee shall be duly levied upon under court process; or (5) this lease or any of the Lessor's shares owned by the Lessee shall be pledged, other than to the seller thereof, a bank, or other lending institution, except with the consent of the Lessor's Board of Directors.

(c) If at any time there is an assignment of this lease, or any subletting hereunder, without full compliance with the requirements of paragraph 6 of Article II hereof.

(d) If the Lessee shall be in default for a period of one month in the payment of any rent or additional rent or of any installment thereof, hereinbefore provided for.

(e) If the Lessee shall default in the performance of any covenant or provision hereof, other than the covenant to pay rent, for 30 days after the Lessor shall have given written notice of such default.

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(f) If at any time the Lessor shall determine, upon the affirmative vote of two-thirds of its full Board of Directors and the affirmative vote of the record holders of at least two-thirds in amount of its shares then outstanding and owned by Lessees under proprietary leases then in force, at a shareholders' meeting duly called for that purpose, to terminate all proprietary leases or to sell the land and building above described.

(g) If at any time the Lessor shall determine, upon the affirmative vote of the holders of record of two-thirds or more of its Board of Directors, that because of objectionable conduct on the part of the Lessee, or of a person dwelling in or visiting the apartment, the Lessee's tenancy is undesirable. Objectionable conduct shall be deemed to occur if the Lessee or such other person repeatedly violates or disregards the house rules and regulations hereunto attached or hereafter established in accordance with the provisions of this lease, or permits or tolerates a person of dissolute, loose, or immoral character to enter or remain in the building or apartment.

(h) If at any time the building or a substantial portion thereof shall be taken by condemnation proceedings.

2. *Waiver of right of redemption.* The Lessee hereby expressly waives any and all right of redemption in case he shall be dispossessed by judgment or warrant of any court or judge. The words "enter," "reenter," and "reentry" as used in this lease are not restricted to their technical legal meaning. If the Lessee shall breach or threaten to breach any covenant or provision hereof, the Lessor shall have the right of injunction, and the right to invoke any remedy allowed at law or in equity, as if reentry, summary proceedings, and other remedies were not herein provided for.

3. *Surrender of possession.* Upon the termination of this lease under the provisions of subparagraphs (a), (b), (c), (d), (e), or (g) of paragraph 1 of this Article, the Lessee shall remain liable as provided in paragraph 2 of Article II here of. Upon the termination of this lease under the provisions of subparagraphs (f) or (h) of paragraph 1 of this Article, or upon the expiration of this lease, the Lessee shall be and remain liable to pay all rent, additional rent, and other charges due or accrued and to perform all his covenants and agreements up to the date of such termination. On or before such termination the Lessee shall vacate the apartment and remove therefrom all of his property which upon such termination does not become the property of the Lessor under the provisions of paragraph 8 of Article II hereof and surrender possession of the apartment to the Lessor or its assigns. Upon demand of the Lessor or its assigns the Lessee shall execute, acknowledge, and deliver to the Lessor or its assigns any instrument which may reasonably be required for surrendering all his estate and interest in the apartment, or in the building of which it is a part. The Lessee, however, may retain ownership of his shares in the Lessor, and shall continue to enjoy all rights of ownership of them other than the right to occupy any part of the building of which the apartment forms a part.

4. *Sale of shares.* Upon the termination of this lease under the subparagraphs (a), (b), (c), (d), (e), or (g) of paragraph 1 of this Article, the Lessee shall surrender to the Corporation his certificate or certificates for the shares of the Corporation owned by him and allocated to the apartment. Whether or not such certificate or certificates are surrendered, the Lessor may issue a new proprietary lease on the apartment and issue a new certificate for its shares owned by the Lessee and allocated thereto. In that event the certificate owned or held by the Lessee shall be automatically cancelled and rendered null and void. The Lessor may apply the proceeds received for the issuance of such shares towards the payment of the Lessee's indebtedness hereunder, including interest, attorneys' fees, and other expenses incurred by the Lessor. If the proceeds are sufficient to pay the same the Lessor shall pay over any surplus to the Lessee, but if insufficient the Lessee shall remain liable for the balance of the indebtedness. Upon the issuance of any such new proprietary lease and share certificate, the Lessee's continuing liability hereunder shall cease and he shall only be liable for rent and expenses accrued to that time.

Article IV

It is further mutually agreed, as follows:

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1. *Lessee's option to cancel.* The Lessee may cancel this lease on September 30, 1989, or on any September 30 thereafter, upon complying with all the provisions of this Article IV. The Lessee must serve irrevocable written notice of intention to cancel upon the Lessor on or before April 1 in the calendar year in which such cancellation is to occur. At the time such notice is served the Lessee must deposit with the Lessor:

(a) a proper assignment of the Lessee's counterpart of this lease whereby the full and absolute right, title, and interest in and to this lease is assigned as the Lessor may direct, as of August 31 of the year of cancellation, free from all subleases, liens, encumbrances, and charges whatsoever;

(b) the Lessee's certificate for the shares of the Lessor which accompany this lease, duly stamped and endorsed in blank for transfer;

(c) a written statement setting forth in detail those additions, improvements, and fixtures, such as mantels, lighting fixtures, refrigerators, cooking ranges, woodwork, panelling, ceilings, doors, and decorations, placed in the apartment at the Lessee's expense which the Lessee has, under the terms of this lease, the right to remove, and which the Lessee desires to remove.

2. *Additional payments by lessee.* If the Lessee shall give such notice of intention to cancel, the Lessee shall:

(a) subject to the limitations and conditions embodied in paragraph 8 of Article II hereof, replace all mantels, lighting fixtures, refrigerators, cooking ranges, woodwork (other than panelling), ceilings, doors, or other fixtures removed by the Lessee, with others of a kind and quality customary in buildings of this type, and pay the cost of such replacement; and

(b) pay the cost of repairing any damage resulting from Lessee's removal of any panelling or other additions, improvements, or fixtures, for which Lessee is not required to pay the cost of replacing.

3. *Removal of fixtures.* The Lessee shall remove all additions, improvements and fixtures which are removable under the terms of this lease and which are enumerated in the statement made as provided in subparagraph (c) of paragraph 1 of this Article IV prior to the 31st day of August next preceding the 30th day of September named in the notice of election to cancel as the date for the cancellation of this lease. On or before such 31st day of August the Lessee shall deliver possession of the apartment to the Lessor free from all subleases, liens, encumbrances, or other charges and remove therefrom all of Lessee's property which upon such cancellation does not become the Lessor's property under the provisions of paragraph 8 of Article II hereof. The Lessee shall pay to the Lessor (a) all rent, additional rent, and other charges which shall be payable under this lease up to and including the 30th of September succeeding such 31st day of August, and (b) the amounts due under subparagraph (b) of paragraph 2 of this Article IV. The requirements for delivery of possession to the Lessor shall be waived if, pursuant to the provisions of paragraph 6 of Article II of this lease, the Lessor shall have on or before August 31st entered into an agreement with any sublessee whereby it permits such sublessee to remain in possession of the apartment.

4. *Lessor's entry.* The Lessor and its agents may show the apartment to prospective or succeeding tenants at any time and from time to time after the Lessee gives notice of intention to cancel this lease as provided in this Article IV. After the 31st day of August next succeeding the date on which such notice the Lessor and its agents, employees, and tenants may enter the apartment, occupy the same, and make such alterations, additions, and repairs therein as it may deem necessary or desirable without diminution or abatement of the rent due hereunder.

5. *Cancellation of lease.* If the Lessee is not otherwise in default hereunder and if the Lessee shall have done the things and made the payments at the times, in the amounts, and in the manner required by this Article IV, then upon the 30th day of September named in the notice of intention to cancel as the date for the cancellation of this lease, this lease shall be cancelled and all rights, duties, and obligations of the parties hereunder shall cease, terminate, and expire as of such

date. The shares of Skyline Apartments, Inc. shall then become the Lessor's absolute property. The Lessee, however, shall not be released or discharged from any indebtedness to the lessor on such last mentioned date. Moreover, if the Lessee shall fail to do anything or make any payment at the time, in the amounts, and in the manner required by this Article IV, the Lessor may (a) return to the Lessee this lease, the share certificate, and other documents deposited, and the sums paid by the Lessee under this Article IV, other than any sum paid as rent under this lease or as the cost of repairing any damage resulting from the Lessee's removal of additions, improvements, or fixtures, and thereupon the Lessee shall be deemed to have withdrawn the notice of intention to cancel this lease, or (b) treat this lease as cancelled as of the 30th day of September named in the notice of intention to cancel as the date for the cancellation of such lease, and bring such proceedings and actions as it deems best to enforce the covenants of the Lessee contained in this Article IV, and collect from the Lessee the payments which he is required to make under this Article IV, together with reasonable counsel fees and costs.

Article V

It is further mutually agreed, as follows:

1. *Transfer of shares.* The Lessor's shares held by the Lessee and allocated to the apartment have been acquired and are owned subject to the following conditions agreed upon with the Lessor and with each of the other proprietary lessees for their mutual benefit:

(a) The shares represented by each certificate are transferable only as an entirety; and

(b) Neither the Lessee nor the Lessee's personal representatives shall sell or transfer such shares except to the Lessor, or to an assignee of this lease, after compliance with all of the provisions of paragraph 6 of Article II of this lease relating to assignments.

2. *Binding effect.* The references herein to the Lessor shall be deemed to include its successors and assigns, and the references herein to the Lessee or to a shareholder of the Lessor shall be deemed to include their respective executors, administrators, legal representatives, legatees, distributees, and assigns. The covenants herein contained shall apply to, bind, and inure to the benefit of the Lessor and its successors and assigns, and the Lessee and the executors and administrators, legal representatives, legatees, and assigns of the Lessee, except as hereinbefore stated.

3. *Waiver of jury trial.* The Lessor and the Lessee shall and they hereby do waive trial by jury in any action, proceeding, or counterclaim brought by either against the other on all matters whatsoever arising out of or in any way connected with this lease, the Lessee's use or occupancy of the apartment, or any claim of damage resulting from any act or omission of the parties in any way connected with this lease or the apartment.

4. *Modification.* This lease may not be changed orally but only in writing signed by both parties.

5. *Non-assignment.* This lease may not be assigned by either party, unless otherwise expressly provided herein.

6. *Notices.* All notices or other documents under this lease shall be executed and delivered as provided in paragraph 14 of Article II hereof.

7. *Governing law.* This lease shall be construed in accordance with and governed by the laws of the State of New York.

8. *Entire agreement.* This lease contains the entire understanding between the parties and supersedes all prior understandings and agreements between them respecting its subject matter.

9. *Non-waiver.* No delay or failure by either party to exercise any right under this lease, and no partial or single exercise

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of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

10. *Headings for reference only.* Headings preceding the text and paragraphs of this lease are for convenience and reference only, and shall not be used to interpret or construe its meaning, construction, or effect.

11. *Counterparts.* This lease may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

In witness whereof the Lessor has caused its corporate seal to be hereto affixed and this instrument to be signed by its President, and the Lessee has executed this instrument under seal, the day, and year first above written.

Attest:	Skyline Apartments Inc.,
	Lessor
by _____	by _____
Secretary	President
	_____ (L.S.)
	Lessee

Witness:

As to Lessee

(Acknowledgments)

The Skyline

House Rules

1. The public halls and stairways of the building shall not be obstructed or used for any other purpose than ingress to and egress from the apartments in the building, and the fire towers and fire escapes shall not be obstructed in any way.
2. Children shall not play in the public halls, stairways, fire towers, or elevators, and shall not be permitted in the service elevator of the building.
3. No public hall above the ground floor of the building shall be decorated or furnished by any lessee in any manner without the prior consent of the Lessor and all of the Lessees to whose apartments such hall serves as a way of ingress and egress.
4. No lessee shall make or permit any disturbing noises in the building or do or permit anything to be done therein which will interfere with the rights, comforts, or conveniences of other Lessees. No Lessee shall play upon or cause to be played upon any musical instrument or permit to be operated a phonograph or a radio or television loud speaker in such lessee's apartment between the hours of 11 p.m. and the following nine a.m. if such action disturbs or annoys other occupants of the building, and in no event shall practice or cause to be practiced either vocal or instrumental music for more than two hours in any day or between the hours of six p.m. and the following nine a.m. All floor space in apartments, other than baths and kitchens, shall be adequately covered with carpeting or rugs with a view to minimizing noise transmission to the apartment below.

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5. Each Lessee shall keep such Lessee's apartment in a good state of preservation and cleanliness and shall not sweep or throw or permit to be swept or thrown therefrom, or from the doors, windows, terraces, or balconies thereof, any dirt or other substance.
6. No article shall be placed in the halls or on the staircase landings, fire towers, or fire escapes, nor shall anything be hung or shaken from the doors, windows, terraces, or balconies or placed upon the window sills of the building.
7. No shades, awnings, window guards, ventilators, or air conditioning devices shall be placed or used in or about the building except such as the Lessor shall have approved.
8. No sign, signal, advertisement, or illumination shall be inscribed or exposed on or at any window or other part of the building, except such as the Lessor shall have approved in writing; nor shall anything be projected out of any window of the building without similar approval.
9. The passenger and service elevators in the building, unless of automatic type and intended for operation by a passenger, shall be operated only by the Lessor's employees, and there shall be no interference whatever with the same by Lessees or members of their families or their guests, employees, or undertenants.
10. No velocipedes, bicycles, scooters, or similar vehicles shall be allowed in the passenger elevators, and no baby carriages or any of the above-mentioned vehicles shall be allowed to stand in the public halls, passageways, areas, or courts of the building.
11. Servants, messengers, and tradespeople shall use the service elevators in the building for ingress and egress and shall not use the passenger elevators for any purpose, except that nurses in the employ of Lessees and of their guests or undertenants may use the passenger elevators when accompanying such children, guests, or undertenants.
12. Kitchen supplies, market goods, and packages of every kind are to be delivered only at the service entrance of the building and through the service elevators to the apartments.
13. Trunks and heavy baggage shall be taken in or out of the building through the service area.
14. Garbage and refuse from the apartments shall be sent to the basement of the building only at such times and in such manner as the superintendent of the building may direct. The incinerators in the building are to be used in connection with specific rules and instructions to be promulgated by the Lessor's Board of Directors.
15. Water closets and other water apparatus in the building shall not be used for any purpose other than those for which they were constructed, nor shall any sweepings, rubbish, rags, or any other article be thrown into the same. Any damage resulting from misuse of any water closets or other apparatus shall be paid for by the Lessee in whose apartment it shall have been caused.
16. No Lessee shall send any employee of the Lessor out of the building on the Lessee's private business.
17. No bird or animal shall be kept or harbored in the building unless the same in each instance is expressly permitted in writing by the Lessor and subject to such rules as the Board of Directors may promulgate.
18. If the Lessor supplies any storage space outside of the apartment to the Lessee, the same shall be deemed to be supplied gratuitously and the Lessor shall have no liability in connection therewith. Such space may only be used for the storage of empty trunks and bags.

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19. No radio or television aerial shall be attached to or hung from the exterior of the building without the Lessor's written approval.
20. The agents of the Lessor, and any contractor or workman authorized by it, may enter any apartment at any reasonable hour of the day for the purposes of inspecting such apartment to ascertain whether measures are necessary or desirable to control or exterminate any vermin, insects, or other pests and taking such measures, at the Lessee's expense as may be necessary to control or exterminate all pests.
21. No vehicle belonging to a Lessee or to a member of the Lessee's family or guests, undertenant, or employee shall be parked in such manner as to impede or prevent ready access to the entrance canopy of the building by another vehicle.
22. Except where the Lessee has been granted the exclusive use of a laundry, the Lessee shall use the laundry facilities available only upon such days and during such hours as the Lessor not designate.
23. The Lessor may from time to time to curtail or relocate any space devoted to storage or laundry purposes.
24. No air conditioning or other electrical device shall be installed or used by the Lessee without the Lessor's prior written approval as to the type, location, and manner of installation or use of such device and provided sufficient electric current is available for its use.
25. Complaints regarding the service of the building shall be made in writing to the Lessor's managing agent.
26. Any consent or approval given under these house rules by the Lessor shall be revocable at any time.
27. These house rules may be added to, amended, or repealed at any time by resolution of the Lessor's Board of Directors. A.18 Purchase agreement with tenant-stockholder

COMMENT

This is an agreement by which a prospective tenant-stockholder commits himself to purchase the cooperative's shares allocated to a specific apartment. It is in the form of an offer to be accepted by the sponsor and the cooperative corporation. It provides for the payment of the purchase price in installments as various stages in the completion of the building are achieved, with the final installment due after the architect and consulting architect have certified that a temporary certificate of occupancy for the building has been issued. For purposes of the requirement in the Revenue Code that 80% of the cooperative's income must be received from tenant-stockholders, a shareholder does not qualify until his shares are fully paid for. This does not preclude payment in the form of a promissory note. Nor does it prevent a tenant-stockholder from borrowing money from outside sources and pledging his shares and proprietary lease as collateral security.

All payments made on account of the purchase price are to be hold in escrow. At the time of the completion of the building, the purchaser will receive the proprietary lease for the designated apartment, provided he is not in default in his required payments. It should be noted that the basic plan of cooperative organization is incorporated by reference into this purchase agreement (see Form A.14). This assures the purchaser that the various representations in the plan are part of his contract to purchase, and that he can hold the sponsor to those representations. Because cooperative corporations are creatures of statute, it is necessary to review applicable state and local laws and regulations in connection with this Form.

For further information, see Chapters 9 and 16.

FORM

1. *Approval of plan.* The undersigned (the "Purchaser") has read and hereby approves the Plan of Cooperative Organization dated April 1, 2001, and the Schedules and Exhibits attached thereto and the documents referred to therein (collectively the "Plan"), and on file with Harris & Co., Inc. (the "Agent"), and made a part hereof with respect to the land and building ("The Skyline") and by the street number 500 East 68th Street, New York, New York (the "Building").

2. *Desire to participate.* The Purchaser desires (a) to obtain a proprietary lease for Apartment 4E (the "Apartment") in the Building, and (b) to purchase 553 common shares of Skyline Apartments, Inc. (the "Apartment Corporation"), which shares have been allocated to the Apartment.

3. *Purchase price.* The Purchaser hereby irrevocably offers to purchase from the Apartment Corporation 553 of its common shares with a par value of \$1 per share for a total purchase price of \$500 per share payable by good checks drawn to the order of Trust Bank of New York (the "Escrow Agent") and delivered to the Agent as follows:

(a) 10% thereof at the time of execution of this agreement;

(b) 40% thereof after the Plan has been declared operative and the Architect and Consulting Architect have certified that the outside brickwork has been completed (except such portions thereof as are customarily left to be completed after the interior portions are erected) and upon at least 15 days' prior written notice to the Purchaser;

(c) 30% thereof when the Architect and Consulting Architect have certified that the white plaster in the apartments above the ground floor has been completed (except such portions thereof as are left uncompleted due to individual purchasers' changes) and upon at least 15 days' prior written notice to the Purchaser; and

(d) the balance of 20% thereof when the Architect and the Consulting Architect have certified that a temporary certificate of occupancy for the Building has been issued and upon at least 15 days' prior written notice to the Purchaser.

The time of each payment is hereby made the essence of this agreement. The shares shall not be issued and delivered nor shall the Purchaser acquire any rights therein or pertinent thereto until the full payment of all the amounts above provided have been duly made.

The Escrow Agent shall hold and dispose of all such payments made hereunder as provided in an Escrow Agreement in the form of an Exhibit attached to the Plan, and the Purchaser agrees to be bound thereby.

4. *Proprietary lease.* At the time of the completion of the Building, as referred to in the Plan, or as soon thereafter as may be practicable, if the Purchaser shall have made the full payments provided for herein, then the Purchaser shall be entitled to receive a proprietary lease from the Apartment Corporation for the Apartment in the form adopted by the Apartment Corporation as well as a share certificate for the Apartment Corporation's fully paid and nonassessable common shares hereby purchased. The Purchaser shall at the request of the Apartment Corporation, before or after the time of closing, execute such proprietary lease in duplicate. The Purchaser hereby authorizes the Apartment Corporation or the Agent to insert in the proprietary lease the date of the Building's completion as the date of the commencement of the term of such proprietary lease.

5. *Abandonment of plan.* If the Plan is declared abandoned, the Purchaser shall be entitled thereupon to receive back all moneys paid pursuant hereto, without interest, and this agreement shall be deemed terminated and of no further force and effect, and no party shall have any claim against any other party with respect hereto.

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6. *Escrow.* All moneys paid hereunder are to be paid by good checks to the order of the Escrow Agent, which shall hold the proceeds until paid out as provided in this agreement, the Plan, and the Escrow Agreement.

7. *Default by purchaser.* If the Purchaser shall fail to perform any provision of this agreement that he is required to perform, the Apartment Corporation may elect to cancel this agreement by giving the Purchaser written notice of such proposed cancellation. Such notice shall contain the effective date (not less than ten days after the giving of such notice) of such cancellation. If the Purchaser shall cure his default prior to the effective cancellation date the cancellation notice shall be deemed withdrawn. If the Purchaser shall fail to cure his default prior to the cancellation date, then the cancellation shall be effective and the Sponsor named in the Plan shall be entitled to receive all payments made by the Purchaser hereunder and all of the parties hereto shall be relieved and discharged of any further liability and obligation hereunder, except as herein provided. The Sponsor shall then have the right to list the Apartment and to sell the shares and lease covered hereby to any other person at public or private sale, and shall only account to the Purchaser for the net proceeds after payment of all expenses including repairs, decorations, commissions, legal fees, loss of rent, and purchase price.

8. *Default by others.* If the Apartment Corporation, the Sponsor, or the Builder shall have failed to substantially perform their obligations hereunder or under the Plan, the Purchaser's sole rights and remedy shall be to proceed within 12 months from the date of the issuance of the permanent Certificate of Occupancy for the Building against the Apartment Corporation for the return of the moneys paid by the Purchaser for the purchase price of his shares, upon the surrender to the Apartment Corporation of such shares and the accompanying proprietary lease, and possession of the Apartment. The parties hereto waive trial by jury in any action or proceeding hereunder or arising by reason of this agreement or the Plan.

9. *Outside of effective date.* If the Plan is not declared operative by May 1, 2003, then the Purchaser may within 15 days thereafter elect to cancel this agreement by giving written notice to the Apartment Corporation. In that event the Purchaser shall be entitled to receive back all moneys paid hereunder, without interest.

10. *Acceptance of agreement.* This agreement shall not be effective or binding on the Apartment Corporation until it accepts in writing a duplicate hereof, which is approved by the Agent and delivered to the Purchaser.

11. *Notices.* Any notice to be given hereunder shall be made to the Purchaser, in writing, at the address given below, and to the Apartment Corporation, care of Harris & Co., Inc., 500 Fifth Avenue, New York, New York. The date of mailing shall be deemed the date of the giving of such notice.

12. *Errors.* The statements contained in the Plan are believed by the Apartment Corporation, the Sponsor, and the Agent to be correct, and the expressions of opinion therein are likewise believed to be well founded, but no liability shall attach in the event of error.

13. *Assignment.* The Purchaser shall not assign this agreement or the Purchaser's rights hereunder, without the Apartment Corporation's prior written consent.

14. *Examination of facts.* The Purchaser acknowledges that he has had full and free opportunity to investigate and examine all of the facts and documents referred to herein and in the Plan of Organization; and that he has not relied on any representations, warranties, or statements of any nature or kind, including but not limited to estimated date of completion, general description attached to Plan, maintenance charges, or right to any tax deduction, whether contained in any advertisement, selling brochure, or made orally.

15. *Binding effect.* Subject to the provisions hereof, this agreement shall bind and apply to the parties hereto and their respective personal representatives, successors, and permissible assigns.

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16. *Entire agreement.* This agreement contains the full understanding and agreement of the parties and may not be amended, altered, or discharged except by another agreement, in writing, signed by the party sought to be charged therewith.

17. *Purchaser's residence.* The Purchaser represents that he is a resident of the State of New York.

18. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New York.

19. *Non-waiver.* No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

20. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

21. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

Dated: _____

Purchaser

Address

Witness:

Accepted:

Skyline Apartments, Inc.

by _____

Dated:

Approved:

Ace Realty Corp.

by _____

Dated:

A.19 Resale of shares in cooperative corporation--estate sale by executor

COMMENT

The following form is a contract of sale of shares in a cooperative. As such, it deals with the transfer of personal property, i.e., the interest in the shares, and is not a closing of real estate. However, there are ancillary real estate-related documents which must be executed by the parties, such as an assignment and assumption of a proprietary lease referred to in this agreement. Although persons are frequently said to be "owners" of cooperative apartments this is not in fact the case. Purchasers of cooperatives acquire ownership of stock in the corporation that owns the building in which the apartment is located. As stockholders, the purchasers are entitled to lease an apartment to which the stock is allocated.

For further information, see Chapters 9 and 16.

FORM

AGREEMENT, made April 15, 2002, between Paul Richards, as Executor under the Last Will and Testament of Ralph Richards, Deceased, residing at 115 Park Avenue, Rye, New York (the "Seller"), and Morris Monk and Mary Monk, his wife, both residing at 26 West 72nd Street, New York, New York (the "Purchasers").

Whereas the Seller was designated as the Executor under the Last Will and Testament of Paul Richards, Deceased, dated July 25, 1984, who died February 9, 2002; and

Whereas Letters Testamentary were duly issued to the Seller on March 15, 2002, by the Honorable Millard Midonick, a Surrogate of the County of New York, State of New York, authorizing the Seller to administer the estate of the Decedent and such Letters Testamentary have not been revoked; and

Whereas the Decedent at the time of his death was the owner of 221 shares of the capital stock of 165 East End Avenue Corporation (the "Corporation"), of the par value of \$1 per share (the "Stock"), which Stock was allocated to Apartment 17-L (the "Apartment"), in the building owned by the Corporation known as and by the street number 165 East End Avenue, New York, New York, and was the lessee under that certain proprietary lease dated February 1, 1981, between the Corporation, as Lessor, and the Decedent, as Lessee, covering the Apartment for a term commencing on February 1, 1981, and expiring on September 30, 2030 (the "Lease"); and

Whereas the Seller, as Executor under the Last Will and Testament of Ralph Richards, Deceased, has succeeded to the ownership of the Stock and the Lease; and

Whereas the Purchasers desire to purchase the Stock and acquire the Lease from the Seller, and the Seller is willing to sell same to them, for a purchase price of \$500,000, as hereinafter provided.

Now therefore, in consideration of the premises and mutual covenants hereinafter contained, the Seller and Purchasers mutually covenant and agree as follows:

1. *Sale and purchase.* The Seller shall sell to the Purchasers and the Purchasers shall purchase from the Seller, the Stock and Lease for a purchase price of \$500,000.

2. *Seller's representations.* The Seller represents and warrants that, as the Executor under the Last Will and Testament of Ralph Richards, Deceased:

(a) He is the owner of the Stock and Lease;

(b) The Stock is fully paid and nonassessable;

(c) The Stock and Lease are free and clear of all liens, encumbrances, or adverse interests (subject, however, to any liens and mortgages on the underlying real property of which the Apartment forms a part); and

(d) He has the full right and authority to enter into this agreement with the Purchasers and to sell the Stock and Lease to them.

3. *Price.* The purchase price of \$500,000 is payable as follows:

(a) \$50,000 on the execution of this agreement, by check of Purchasers drawn to the order of the Seller, the receipt of

which check, subject to collection, the Seller hereby acknowledges; and

(b) \$450,000 at the Closing in cash or by cashier's check of a New York City bank or by duly certified check of Purchasers drawn to the order of Seller on a bank or trust company which is a member in good standing of the New York City Clearing House Corporation.

4. *Closing.* The closing under this agreement shall take place at 10 a.m. on April 30, 2002, at the offices of Good and Mann, Esqs., the Seller's attorneys, 53rd Floor, 70 Pine Street, New York, New York (the "Closing").

5. *Closing documents; seller.* At the Closing the Seller shall deliver to the Purchasers (against their delivery to the Seller of the balance of the purchase price payable at the Closing and the instrument provided for in paragraph 6 hereof) the following:

(a) *Stock certificate.* Stock Certificate No. 145 of the Corporation issued to the Decedent for the Stock, duly endorsed by the Seller for transfer with all necessary stock transfer stamps duly affixed thereto to cover the transfer to the Purchasers (or, in the alternative, the Seller may at his option deliver to the Purchasers at the Closing cash or his check in the amount necessary to purchase such stamps); and

(b) *Proprietary lease.* A fully executed copy of the Lease and an assignment of proprietary lease in triplicate, duly signed and acknowledged by the Seller, in the form and content of Exhibit A attached hereto and hereby made part hereof; and

(c) *Consents.* A written consent to the transfer of the Stock and assignment of the Lease by the Seller to Purchasers, as provided for in paragraph 5 of Section 6 of Article II of the Proprietary Lease therein.

6. *Closing documents; purchaser.* At the Closing, the Purchasers shall deliver to the Seller (against delivery by the Seller to them of the items provided for in paragraph 5 of this agreement) the following:

(a) *Balance.* The balance of the purchase price payable pursuant to subparagraph (b) of Section 3 hereof; and

(b) *Lease.* An acceptance of assignment and assumption of proprietary lease in triplicate, duly signed and acknowledged by the Purchasers, in the form and content of Exhibit B attached hereto and hereby made part hereof.

On the day of the Closing the Seller shall hand deliver to Brett, Wyckoff and Rudnick, Inc., Managing Agent for the Corporation, fully executed copies of such assignment of proprietary lease and such acceptance of assignment and assumption of proprietary lease.

7. *Effective date; apportionment.* The effective date of the assignment of the Lease by the Seller to the Purchasers shall be the date of the Closing. Rent under the Lease and other charges which have or shall become due and payable under the Lease shall be apportioned as of the date of the Closing, so that the Seller shall bear and pay the portion thereof applicable to the period up to the date of the Closing and the Purchasers shall bear and pay the portion applicable to the period commencing 12:01 a.m. on the date of the Closing. The net amount payable by the Seller to Purchasers, or by the Purchasers to Seller, as the case may be, shall be paid in cash or by check at the Closing.

8. *Subject to board of directors' consent.* This sale is expressly made subject to the granting of written consent by the Corporation, and its Board of Directors, as provided in the Corporation's Bylaws and in the Lease, to the transfer of the Stock and assignment of the Lease by the Seller to the Purchasers. The Purchasers shall submit to the Managing Agent for Corporation and its Board of Directors, in writing, within three days from the date hereof, the names and addresses of persons to whom, and corporations and other entities to which, reference may be had as to Purchasers' social and financial standing. The Purchasers shall also cooperate fully with the Managing Agent and submit to an interview by it

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or by the Corporation's representatives and provide all such information as may be reasonably requested in order for a determination to be made as to the Purchasers' social and financial standing.

If the Seller does not procure the Corporation's written consent provided for in this Section 8 and in Section 5 paragraph (c) hereof at or before the Closing, the downpayment received by the Seller from the Purchasers upon the execution of this agreement shall be returned to the Purchasers and this agreement shall wholly cease and terminate without further liability on either party. In such event neither party shall have any further claim against the other by reason of this agreement.

9. *Acceptance; discharge.* The acceptance by the Purchasers of the instruments referred to in paragraphs (a), (b), and (c) of Section 5 hereof shall be deemed to be full performance and discharge of every agreement and obligation of the Seller to be performed under this agreement or otherwise.

10. *Execution of new proprietary lease.* The Purchasers shall, if the Corporation so requests, surrender the Lease assigned to them and in place thereof enter into a new proprietary lease with the Corporation for the Apartment for the remainder of the term thereof, as more particularly provided in Section 6, paragraph B. 2, and elsewhere of the Proprietary Lease.

11. *Property conveyed.* This sale includes all of the Seller's right, title, and interest, if any, in and to such fixtures, equipment, and items of personal property, including but not limited to kitchen appliances, as may now be contained in the Apartment.

12. *Disclosure and inspection.* The Purchasers represent and warrant to the Seller that they have examined and initialed changes, where appropriate, in the Lease and that they are familiar with the terms, provisions, and conditions contained in the Certificate of Incorporation and Bylaws of the Corporation. The Purchasers further warrant and represent to the Seller that they have inspected the Apartment and the building of which it forms a part, and that they are fully familiar with the condition of the Apartment and of the building. They agree that they are purchasing the Stock and acquiring the Lease for the Apartment in the Apartment's condition "AS IS" on the date hereof and on the date of the Closing (subject to the provisions of Section 14, paragraph (b) hereof). The Purchasers further represent and warrant to the Seller that in the making and execution of this agreement they have not relied upon or been induced by any statements or representations other than those expressly set forth in this agreement, of any person in respect of the Stock, Lease, Apartment, Corporation, or the building, the income, expenses, profit or loss from the operation of the building by the Corporation, or any other matter affecting the building or this sale transaction which might be pertinent in considering the purchase of the Stock and Lease from the Seller or the execution of this agreement. The Purchasers expressly acknowledge that no such representations have been made except as expressly made herein, and they have relied only on such investigations, examinations and inspections, financial and otherwise, as they have chosen to make or have made.

13. *No broker or finder's fee.* The Purchasers warrant and represent to the Seller that they have not negotiated for the purchase of the Stock and Lease with or through any person, firm, or corporation. The Purchasers agree that should any claim be made by anyone for a brokerage commission or finder's fee in connection with this sale transaction by reason of any affirmative act on their part, they will indemnify and hold the Seller free and harmless from any and all liability and expense of any nature in connection therewith.

14. *Events of termination.* This agreement shall terminate forthwith and neither party shall have any rights against the other, except that the Seller shall return to Purchasers the downpayment paid on the execution hereof, if any of the following conditions shall occur prior to the Closing:

(a) The Seller shall be unable, except for his wilful default, to comply with each of paragraphs (a), (b), and (c) of Section 5 hereof;

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(b) The Apartment shall be damaged or injured by fire prior to the Closing so as to render it untenable; or

(c) Prior to the Closing, the Corporation shall have elected to cancel and terminate the Lease under any option or privilege reserved or contained therein;

(d) Prior to the Closing, the Purchasers shall have complied with the provisions of the second sentence of the first paragraph of Section 8 hereof but the Seller shall have been unable to obtain the issuance of the Corporation's written consent to the transfer of the Stock and assignment of the Lease to the Purchasers.

15. *Default; liquidated damages.* If the Purchasers shall fail to take title to the Lease and Stock on the Closing and pay to the Seller the balance of the purchase price and adjustments (if any) for any reason other than one of those set forth in Section 14 hereof, the downpayment paid on the execution of this agreement, and all other sum or sums which may be paid by the Purchasers to the Seller prior to the Closing, may, at the Seller's option, be retained by the Seller as liquidated and agreed damages for the Purchasers' failure to comply with this agreement. In such event neither party shall have any further rights against the other with respect to this agreement. The foregoing liquidated and agreed damage privilege shall not, however, unless so specifically exercised by the Seller, be exclusive of any other right or claim which the Seller shall have against the Purchasers because of any such default.

16. *Joint and several liability.* The Purchasers' liability under this agreement shall be both joint and several.

17. *Time of the essence.* Time shall be of the essence of this agreement with respect to all of the terms hereof. Any delay, however, that shall occur in obtaining the Corporation's written consent to this sale transaction shall permit a reasonable postponement of the Closing until such written consent is obtained. If, however, it is ascertained that no written consent shall be forthcoming, the downpayment shall be returned to the Purchasers.

18. *Corporation consent not unreasonably withheld.* The Purchasers warrant and represent to the Seller that they know of no reason why the Corporation should not consent to their acquiring the Stock and Lease from the Seller.

19. *Notices.* Any notice which either party is required to or desires to give to the other party shall be deemed duly given when mailed by certified mail, return receipt requested, postage charges prepaid, enclosed in an envelope and addressed to the other party at the last address which shall have been designated in writing by the other party as its address for the purpose of receiving notices hereunder. The parties hereby designate for this purpose the following address which is set forth immediately below their name or names:

To Seller: Paul Richards, Executor
c/o Good and Mann
70 Pine Street, New York,

with a duplicate copy sent simultaneously to:

Paul Richards
115 Park Avenue
Rye, New York

To purchasers: Mr. and Mrs. Morris Monk
c/o Louis Loeb, Esq.

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30 Wall Street
New York, New York 10007

20. *Definition.* Whenever the term "other party" is used in this agreement it shall refer to the Seller or to the Purchasers, as the case may be.

21. *Modification.* This agreement may not be changed orally but only in writing signed by all the parties.

22. *Transferability; binding effect.* The Purchasers shall not assign this agreement or their rights hereunder. Subject to the foregoing limitation, this agreement shall be binding upon and inure to the benefit of the parties, the successors and assigns of the Seller, and the heirs, executors, administrators, and personal representatives of the Purchasers.

23. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New York.

24. *Entire agreement.* This agreement contains the entire understanding between the parties and supersedes all prior understandings and agreements between them respecting the within subject matter.

25. *Non-waiver.* No delay or failure by a party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

26. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

27. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

In witness whereof the parties hereto have signed this agreement as of the day and year first above written.

Paul Richards,

as Executor under the L/W/T of Ralph Richards, Deceased, and not individually.

Witnessed by:

Morris Monk

Loui

s

Loe

b

At-

tor-

ney

for

Pur-

chas

ers

Mary Monk

A.20 Contract for sale by tenant-stockholder of cooperative apartment

COMMENT**Consent to sale:**

Under most cooperative plans, the sale of shares and the transfer of the accompanying lease cannot be accomplished without the consent of the cooperative corporation. In the agreement illustrated here, the closing of the contract is predicated upon the seller's obtaining this consent.

For further information, see Chapters 9 and 16.

FORM

AGREEMENT made April 14, 2002, between John Oxman, residing at 1000 Fifth Avenue, New York, New York (the "Seller"), and Robert Robbins, residing at 100 West 38th Street, New York, New York (the "Purchaser").

1. *Sale.* The Seller agrees to sell, transfer, and deliver to the Purchaser and the Purchaser agrees to purchase and take title from the Seller (all subject, however, to the further terms and conditions of this agreement), the following:

(a) 1100 shares of 1000 Fifth Avenue, Inc. (the "Corporation"), which carry the privilege of receiving the proprietary lease hereinafter referred to in subparagraph (b) of this paragraph.

(b) The proprietary lease (the "Proprietary Lease") between the Corporation, as Lessor, and the Seller, as Lessee, covering apartment 5-F in the apartment building known as 1000 Fifth Avenue, New York, New York, with all necessary executed assignments or consents.

(c) The Seller's right, subject to the provisions of the Proprietary Lease, in and to the fixtures, equipment, and personal property now contained in the apartment, other than furniture, furnishings, and personal effects. Neither the Seller nor the Corporation are obligated to install any additional equipment in the apartment.

(d) The Purchaser has inspected the apartment and shall take it in its present condition, normal wear and tear and removal of fixtures and property not included in this sale excepted.

(e) The Purchaser also acknowledges that he has examined the Proprietary Lease covering the apartment, as well as the Corporation's Certificate of Incorporation and Bylaws, and that he is familiar with the terms of each such instrument.

2. *Price.* The purchase price is \$2,500,000, payable as follows:

(a) \$250,000 by check, subject to collection, when this agreement is signed; and

(b) \$2,250,000 in cash, certified check, or cashier's check, drawn on a New York bank or trust company, payable to the order of the Seller, and to be delivered at the closing.

3. *Warranty of seller.* The Seller warrants and represents that he is the owner of the shares in the Corporation, the Proprietary Lease, and the fixtures, equipment, and personal property heretofore set forth; that the same are free and clear of all liens, encumbrances, and adverse interests, subject, however, to any liens or mortgages on the real property of which the apartment forms a part. The shares in the Corporation are duly paid for and are nonassessable.

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4. *Date of transfer.* The effective date of the assignment of the Proprietary Lease shall be June 16, 2002. Maintenance or rent and other charges which shall have become due and payable under the provisions of the Proprietary Lease shall be apportioned as of such effective date of the assignment, so that the Seller shall bear and shall have paid the portion thereof applicable to the period up to the effective date of the assignment and the Purchaser shall bear and pay the portion applicable to the period commencing with such effective date.

5. *Closing.* The transfer of title hereunder shall be closed and the papers delivered and payments or adjustments made at the office of Jones & Co., Inc., 10 East 42nd Street, New York, New York, on June 15, 2002, at 2 p.m., which date, time, and place are hereby designated as the closing.

6. *Documents to be delivered to purchaser.* At or before the closing the Seller shall deliver to the Purchaser:

(a) Certificate or certificates for the number of shares mentioned in subparagraph (a) of paragraph 1. If the Seller shall be a fiduciary there shall also be delivered all documents necessary or required by the Corporation for the purpose of transferring such shares, including but not limited to wills, waivers by taxing authorities, and certificates of authority to act.

(b) Share transfer power or endorsements on such share certificate or certificates, together with all necessary transfer stamps duly affixed thereto to cover the transfer thereof into the name of the Purchaser.

(c) The Seller's original Proprietary Lease referred to in subparagraph (b) of paragraph 1, together with all such assignments or consents as may have been necessary to transfer the interest of the Lessee named therein to the Seller.

(d) Assignment of the Proprietary Lease, in triplicate, duly executed for the purpose of conveying to the Purchaser all the Seller's right, title, and interest as Lessee in the Proprietary Lease. This assignment shall include a warranty to the effect that good and valid title is being transferred to the Proprietary Lease and the corporate shares above described.

(e) The Corporation's consent to the transfer of such shares and the Proprietary Lease to the Purchaser, or in the alternative, a certificate by an officer of the Corporation that a consent to such assignment is on file with it.

7. *Document to be delivered by purchaser.* At or before the closing the Purchaser, in addition to the payment of the balance of the sale price and adjustments, shall deliver the following:

(a) Agreement signed and acknowledged by the Purchaser in triplicate, in form approved by the Corporation, accepting the assignment of the Proprietary Lease and assuming and agreeing to perform and comply with all of its terms, covenants, and conditions, including observance of house rules and any special provisions with respect to such shares, on and after the effective date of the assignment. One of such executed agreements shall be delivered to the Seller and the other to the Corporation.

(b) If the Corporation so requests, the Purchaser shall surrender the assigned Proprietary Lease and in place thereof shall enter into and execute a new Proprietary Lease with the Corporation in substantially the same form and covering the same apartment as the Proprietary Lease so assigned and surrendered.

8. *References.* The Purchaser shall submit to the Corporation or its managing agent forthwith after the execution hereof adequate references as to the Purchaser's social and financial standing, and shall cooperate in any way reasonably required by the Corporation, including the appearance before any board or committee thereof.

9. *Possession.* The Seller agrees that as of the effective date of the closing the premises will be vacated and possession and keys made available to the Purchaser.

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10. *Termination of agreement.* This agreement shall become null and void and neither party shall have any rights against the other, except that the Seller shall return to the Purchaser the amount paid on the execution hereof, if any of the following conditions shall occur prior to the closing:

(a) The Seller shall be unable, except for his wilful default, to comply with each of subparagraphs (a), (b), (c), (d), and (e) of paragraph 6 of this agreement.

(b) The apartment covered by the Proprietary Lease is damaged or injured by fire between the date of the execution hereof and the date of the closing so as to render it untenable.

(c) Prior to the closing, the Corporation shall have elected to cancel and terminate the Proprietary Lease under any option or privilege reserved or contained therein.

(d) Prior to the closing, the Purchaser shall have complied with the provisions of paragraph 8 of this agreement but the Seller shall have been unable to obtain the Corporation's consent to the transfer of the shares and the Proprietary Lease.

11. *Default by purchaser.* If the Purchaser shall fail to take title to the Proprietary Lease and shares of the Corporation on the closing and pay to the Seller the balance of the sale price and adjustments for any reason other than those set forth in paragraph 10, the amount paid on the execution hereof, and any other sum or sums paid by the Purchaser to the Seller prior to the closing, may at the Seller's option be retained by the Seller as liquidated damages. In such event neither party shall have any further rights against the other with respect to this agreement. The foregoing privilege shall not, however, unless so specifically exercised by the Seller, be exclusive of any right or claim which the Seller shall have against the Purchaser because of any such default.

12. *Broker.* The Purchaser represents to the Seller that Jones & Co., Inc., is the only broker who was instrumental in bringing about this sale. Based upon such representations, the Seller agrees to pay to Jones & Co., Inc. commissions in accordance with a separate agreement made with it.

13. *Annual maintenance.* The seller represents that the annual maintenance for the apartment at the present time is \$100,000.

14. *Time of the essence.* Time shall be of the essence with respect to all terms of this agreement, except that any delay which shall occur in obtaining the Corporation's approval shall permit a reasonable postponement of the closing until such approval is obtained. If it is ascertained, however, that no approval shall be forthcoming, the down payment shall be returned to the Purchaser.

15. *Entire agreement.* This agreement contains the entire agreement between the parties hereto and cannot be changed orally.

16. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New York.

17. *Non-assignment.* The Purchaser shall not assign this agreement or his rights hereunder.

18. *Binding effect.* Subject to the limitation in paragraph 17, this agreement shall bind and apply to both parties and their respective personal representatives and successors in interest.

19. *Non-waiver.* No delay or failure by either party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

20. *Headings for reference only.* Headings preceding the text and sections of this agreement have been inserted solely for convenience and reference, and shall not be construed to affect its meaning, construction, or effect.

21. *Notices.* All notices or other documents under this agreement shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

22. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

In witness whereof the parties hereto have signed this agreement the day and year first above written.

In the Presence of: _____ (L.S.)

Seller

As to _____
the _____
Seller

Purchaser

As to
the
Pur-
chaser

A.21 Declaration of condominium--Florida

COMMENT

The passage in 1961 of legislation allowing the Federal Housing Administration to insure mortgages on condominium units triggered the enactment of enabling legislation in the various states. Today, all 50 states have special condominium statutes relating to this form of ownership.

Basically, a condominium is a system of separate ownership of individual units in multi-unit projects. A purchaser of a condominium unit receives fee title to that unit, as if it were a separate unit of property. In addition, there is appurtenant to each unit an undivided interest in the common areas. The ownership of these common elements, which consist generally of hallways, parking areas, recreation facilities, heating plants, etc., is generally allocated to the owners on the basis of the ratio of the value of the unit to the value of the entire project.

The cooperative form of ownership is quite different. There, ownership of the entire structure is lodged in the cooperative corporation. The cooperative-lessee does not hold any interest in the property itself (other than as tenant under a fairly traditional form of lease). The centralization of ownership precludes the characteristic which gives the condominium its special appeal, namely, the ability of each condominium unit owner to arrange his own financing. If he mortgages his unit, his obligation is confined to that debt alone. In contrast, a mortgage on cooperative property blankets every unit in the structure, so that each tenant-shareholder is concerned and involved with possible defaults by every other tenant-shareholder.

It has also been suggested that the condominium owner has greater freedom with respect to the disposition of his property. It is pointed out that a proprietary lease generally gives the cooperative corporation the right of first refusal if the tenant-shareholder wants to sell his interest in the cooperative venture. In some cases, the sale cannot be made without prior approval of the cooperative's board of

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directors which, by contractual or other stipulation, is not to be withheld unreasonably. In both the cooperative and condominium, there are restraints on transfer (such as by a right of first refusal). So long as such restraints are reasonable and not discriminatory, they are lawful.

For tax purposes, the condominium owner and the cooperative owner are similarly treated. The deduction for taxes and interest for a cooperative owner depends upon compliance with certain special statutory requirements because the taxes and interest are in fact paid by the cooperative corporation. In contrast, condominium owner pays his own taxes and his own interest on his own property. His right to these deductions is as clear as the right of any private homeowner. The income tax consequences upon the sale of a condominium apartment are the same as those applicable upon the sale of any residence. The postponement of gain upon the replacement of property used as a principal residence is allowed if either the old or the new residence is a condominium apartment.

A condominium is established by filing, with the formalities of a deed, a declaration submitting specified land, and the improvements to be erected thereon, to condominium ownership. This document generally is called the "declaration of condominium." The information which must be included in the declaration is specified in the applicable statute. The form which follows is a declaration drafted by reference to the Florida statute, which is fairly representative of condominium legislation. However, because a condominium is a creature of statute even the condominium plan must be drafted with due respect to applicable state laws and regulations. Under the Florida statute, the following items are to be set forth in the declaration:

- (1) a statement submitting the property to condominium ownership;
- (2) the name by which the condominium is to be identified, which must include the word "condominium," or must be followed by the words "a condominium";
- (3) a legal description of the land on which the improvements are to be located;
- (4) a survey of the land and a graphic description of the improvements, certified by an engineer, architect, or surveyor, including the number of stories, number of units, apartment boundaries, materials to be used in construction, and a description of the common elements, illustrated by floor plans, maps, building plans, or other means;
- (5) a designation of each unit by letter, name, or number;
- (6) the share of each owner in the common elements;
- (7) the share of common expenses and common surplus of each owner;
- (8) the voting rights;
- (9) the method of amending the declaration;
- (10) a provision for the enactment of by-laws, to be either included in or annexed to the declaration; and
- (11) the name of the association of owners which is to operate the condominium, and a statement as to whether or not it is to be incorporated. If the association is not incorporated, the name and address of the person designated as agent to receive service of process upon the association.

In addition to these required items, the declaration generally includes various limitations relating to the operation of the condominium. For example, as noted above, the declaration often sets forth the conditions under which an apartment may be sold, leased, or received by gift, inheritance, or devise. Under this declaration, an owner who wishes to sell his apartment must notify the owners' association, and may demand that the association furnish a purchaser if it disapproves of the proposed sale. Other optional provisions customarily relate to restrictions on the use of the premises, the maintenance of insurance, the responsibility for the common elements, and the reconstruction of the building after damage by fire or other causes.

In large measure, the problem of the draftsman is simplified to the extent that he relies on the statutory provisions. For example, the technique employed in this form is to define such terms as "apartment," "apartment owner," and "common elements" by reference to the statute. In the same technique, the statutory provision giving the owners' association a lien for unpaid assessments is not restated in the declaration. Unless this approach is adopted, the declaration can become an even more formidable document than the one illustrated in this form.

In Florida, in addition to the declaration, the basic organization documents consist of the articles of incorporation of the owners' association, the bylaws of that association, the agreement of purchase between the builder and the prospective condominium owner, the agreement relating to the availability of a mortgage loan on each unit, and the form of warranty deed. In other jurisdictions, additional documentation may be required.

For further information, see Chapters 6, 13, and 16.

FORM

DECLARATION OF CONDOMINIUM OF CASTELLE APARTMENTS, A CONDOMINIUM

3000 Seaview Road
Miami, Florida

DECLARATION made December 28, 2002, by the Castelle Development Corporation, a Florida corporation, (the "Developer") for itself, its successors, grantees, and assigns.

1. *Submission to condominium ownership.* The purpose of this Declaration is to submit the lands herein described and the improvements to be constructed thereon to the condominium form of ownership and use in the manner provided by Chapter 711, Florida Statutes, herein called the Condominium Act.

(a) The name by which this condominium is to be identified is Castelle Apartments, a condominium, herein called the condominium, and its address is 3000 Seaview Road, Miami, Florida.

(b) The lands owned by the Developer which are hereby submitted to the condominium form of ownership are the following:

[insert description]

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which lands are herein called the land.

2. *Definitions.* The terms used herein and in the Bylaws (attached as Exhibit E) shall have the meanings stated in the Condominium Act and as follows:

- (a) "Apartment" means unit as defined by the Condominium Act.
- (b) "Apartment owner" means unit owner as defined by the Condominium Act.
- (c) "Association" means the Castle Association, Inc., and its successors.
- (d) "Common elements" shall be all the parts of the condominium property not included within the apartment boundaries as described in paragraph 4.
- (e) "Common expenses" include (1) expenses of administration; expenses of maintenance, operation, repair, or replacement of the common elements, and of the portions of apartments to be maintained by the Association; (2) expenses declared common expenses by provisions of this Declaration or by the Bylaws; and (3) any valid charge against the condominium as a whole, such as ad valorem taxes for the year in which this Declaration is recorded.
- (f) "Utility services" as used in the Condominium Act and construed with reference to the condominium, and as used in this Declaration and the Bylaws, shall include but not be limited to electric power, gas, hot and cold water, heating, refrigeration, air conditioning, and garbage and sewage disposal.

3. *Development plans.* The condominium is being developed according to the following plans:

- (a) A survey of the land to be developed is attached as Exhibit A.
- (b) The improvements shall be constructed by the Developer substantially in accordance with the plans and specifications therefor prepared by Paul J. Fisch, A.I.A., which are attached hereto as Exhibit B. The condominium will include an apartment building consisting of a ground floor, a lobby floor, and 15 additional floors, making a total of 17 floors. The building will contain 127 owners' apartments and a manager's apartment. The condominium will also include storage space for each apartment, gardens and landscaping, a swimming pool, automobile parking areas, and other facilities located substantially as shown in the plans and specifications. Use of parking areas will be permitted according to regulations of the Association.
- (c) This Declaration may be amended by filing such additional plans as may be required to describe adequately the completion of improvements. Such completion may be shown by a certificate of an architect, engineer, or surveyor certifying that the improvements have been constructed substantially as herein represented, or designating any changes made. Such plans or certificate when signed and acknowledged by the Developer shall in themselves constitute an amendment of this Declaration, notwithstanding the procedures for amendment described elsewhere in this Declaration.
- (d) Easements are reserved through the condominium property as may be required for utility services.

4. *Apartment boundaries.* Each apartment shall include that part of the building containing the apartment which lies within the boundaries of the apartment. The boundaries shall be determined in the following manner:

- (a) The upper boundary shall be the plane of the lower surfaces of the ceiling slab.
- (b) The lower boundary shall be the plane of the lower surfaces of the floor slab.

(c) The vertical boundaries of the apartment shall be (1) the exterior of the outside walls of the apartment building bounding an apartment except where there is attached to the building a balcony, loggia, terrace, canopy, stairway, or other portion of the building serving only the apartment being bounded, in which event the boundaries shall be such as will include all of such structures and fixtures thereon, and (2) the center line of the interior walls bounding an apartment.

5. *Description of apartments.* The apartments of the condominium are more particularly described as follows:

(a) There are eight typical apartment floor plans which are designated by the capital letters A, B, C, D, E, F, G, and H. These apartments are generally described below and by the sketches attached hereto as the exhibits indicated in the following schedule. Further details are illustrated by the building plans and specifications attached as Exhibit B.

Apartment	Containing	Exhibit
A	Living-room, dining-room, kitchen, three bedrooms, three bathrooms, and balcony terrace	C-1
B	Living-room, dining-room, kitchen, two bedrooms, two bathrooms, and balcony terrace	C-2
C	Living-room, dining-room, kitchen, two bedrooms, two bathrooms, and balcony terrace	C-3
D	Living-room, dining-room, kitchen, two bedrooms, two bathrooms, and balcony terrace	C-4
E	Living-room, dining-room, kitchen, two bedrooms, two bathrooms, and balcony terrace	(Reverse of Apartment D)

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cony ter- race		
F	Living-room, dining-room, kitchen, two bed- rooms, two bath- rooms, and bal- cony ter- race	r-5
G	Living-room, dining-room, kitchen, one bed- room, and one and one-half bathrooms	C-6
H	Living-room, dining-room, kitchen, three bed- rooms, Apartment A) three bath- rooms, and bal- cony ter- race	(Reverse of

(b) Each apartment is identified by the use of the capital letter designating the typical apartment floor plan utilized, preceded by the number designating the floor upon which the apartment is located, the initial "G" being used for the ground floor. Two apartments located on the ground floor are designated G C and G D. Terraces for these apartments are not balconies. Five apartments located on the lobby floor are designated 1 A, 1 B, 1 C, 1 D, and 1 E. There are one of each of the typical apartments A, B, C, D, E, F, G, and H upon each of the remaining fifteen floors. Such floors are numbered 2 through 16, both inclusive.

(c) The Developer reserves the right to change the interior design and arrangement of all apartments and to alter the boundaries between apartments, so long as the Developer owns the apartments so altered. Any such change shall be reflected by an amendment of this Declaration which may be executed by the Developer alone, notwithstanding the procedures for amendment described in paragraph 21 of this Declaration. However, no such change shall increase the number of apartments nor alter the boundaries of the common elements without amendment of this Declaration in the manner described in paragraph 21 of this Declaration. If more than one apartment is altered the Developer shall appropriately reapportion the shares in the common elements which are allocated to the altered apartments.

6. *Shares of common elements and expenses.* Each apartment owner shall own a share in the common elements and in any surplus possessed by the Association, and be liable for common expenses as follows:

An undivided.92% share to each Apartment A (16 such apartments)	14.72
An undivided.81% share to each Apartment B (16 such apartments)	12.96
An undivided.76% share to each Apartment C (17 such apartments)	12.92

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An undivided.78% share to each Apartment D (17 such apartments)	13.26
An undivided.78% share to each Apartment E (16 such apartments)	12.48
An undivided.75% share to each Apartment F (15 such apartments)	11.25
An undivided.574% share to each Apartment G (15 such apartments)	8.61
An undivided.92% share to each Apartment H (15 such apartments)	13.80
Total	100. 00%

7. *Maintenance and alteration of apartments.* (a) The Association shall maintain, repair, and replace

(1) all portions of an apartment, except interior surfaces, contributing to the support of the apartment building, which portions shall include but not be limited to the outside walls of the apartment building and all fixtures on the exterior thereof; boundary walls of apartments; floor and ceiling slabs; and load-bearing columns and load-bearing walls; and

(2) all conduits, ducts, plumbing, wiring, and other facilities for the furnishing of utility services which are contained in the portions of an apartment maintained by the Association; and all such facilities contained within an apartment which service part or parts of the condominium other than the apartment within which contained.

All incidental damage caused to an apartment by such work shall be promptly repaired at the expense of the Association.

(b) The responsibility of the apartment owner shall be

(1) to maintain, repair, and replace at his expense all portions of his apartment except the portions to be maintained, repaired, and replaced by the Association;

(2) not to paint or otherwise decorate or change the appearance of any portion of the exterior of the apartment building;

(3) to promptly report to the Association any defect or need for repairs the responsibility for which is that of the Association.

(c) Except as elsewhere reserved to the Developer, neither an apartment owner nor the Association shall make any alteration in the portions of an apartment or apartment building which are to be maintained by the Association, remove any portion thereof, make any additions thereto, do anything which would jeopardize the safety or soundness of the apartment building, or impair any easement, without first obtaining approval in writing of owners of all apartments in which such work is to be done and the approval of the Board of Directors of the Association. A copy of plans for all of such work prepared by an architect licensed to practice in this state shall be filed with the Association prior to the start of the work.

8. *Maintenance and alteration of common elements.* (a)

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The Association shall be responsible for the operation and maintenance of the common elements, and shall pay for the cost and expense thereof.

(b) After the completion of the improvements included in the common elements, contemplated by this Declaration, there shall be no alteration or further improvement of the real property constituting the common elements without prior written approval by the owners of not less than 75% of the common elements except as provided by the Bylaws, but no such alteration or improvement shall interfere with the rights of any apartment owner. The cost of such work shall not be assessed against a bank, life insurance company, or federal savings and loan association which acquires its title as the result of owning a mortgage upon an apartment unless such an owner shall approve the alteration or improvement, regardless of whether the title is acquired by deed from the mortgagor or through foreclosure proceedings. The share of any cost not so assessed shall be assessed to the other apartment owners in the proportions which their shares in the common elements bear to each other. There shall be no change in the shares and rights of an apartment owner in the common elements which are altered or further improved, whether or not the apartment owner contributes to the cost thereof.

9. *Assessments.* (a) Assessments against apartment owners for common expenses shall be made pursuant to the Bylaws and shall be allocated as set forth in paragraph 6 of this Declaration. However, if services are furnished to apartment owners beyond the maintenance and operation of the condominium property, such as operation of a restaurant or bar, no assessment on account of such services shall be made against a bank, life insurance company, or federal savings and loan association which acquires its title as a result of owning a first mortgage upon an apartment, unless the occupant of the apartment owned by such an institution voluntarily accepts such services. This shall be so whether the title is acquired by deed from the mortgagor or through foreclosure proceedings. The shares of any cost or loss not so assessed shall be assessed to the other apartment owners in the proportions which their shares in the common elements bear to each other.

(b) Assessments and installments thereon paid on or before ten days after the date when due shall not bear interest, but all sums not paid on or before ten days after the date when due shall bear interest at the rate of 10% per annum from the date when due until paid. All payments upon account shall be first applied to interest and then to the assessment payment first due.

(c) The lien for unpaid assessments provided by Florida law shall also secure reasonable attorneys' fees incurred by the Association incident to the collection of such assessment or enforcement of such lien.

(d) In any foreclosure of a lien for assessments the owner of the apartment subject to the lien shall be required to pay a reasonable rental for the apartment, and the Association shall be entitled to the appointment of a receiver to collect such rental.

10. *Association.* The operation of the condominium shall be by Castle Association, Inc., (the "Association") a corporation not for profit under the laws of Florida, which shall be organized and shall fulfill its functions pursuant to the following provisions:

(a) The members of the Association shall be the apartment owners.

(b) The Association shall be incorporated under Articles of Incorporation in the form attached as Exhibit D.

(c) The Bylaws of the Association shall be in the form attached as Exhibit E.

(d) Notwithstanding the duty of the Association to maintain and repair parts of the condominium property, the Association shall not be liable for injury or damage, other than the cost of maintenance and repair, caused by any latent condition of the property that it is required to maintain and repair, nor for injury or damage caused by the elements or

other owners or persons.

(e) The share of a member in the funds and assets of the Association cannot be assigned, hypothecated, or transferred in any manner except as an appurtenance to his apartment.

(f) Whenever the decision of an apartment owner is required upon any matter, whether or not the subject of an Association meeting, such decision shall be expressed by the same person who would cast the vote of such owner if in an Association meeting, unless the joinder of record owners is specifically required by this Declaration.

11. *Insurance.* (a) The Association shall purchase insurance policies upon the condominium property covering the items described in subparagraph (b) of this paragraph, for the benefit of the Association and the apartment owners and their mortgagees as their interests may appear. Provision shall be made for the issuance of certificates of mortgage endorsements to the mortgagees of apartment owners. Such policies and endorsements shall be deposited with the Insurance Trustee, which shall hold them subject to the provisions of paragraph 12.

(b) Insurance shall cover the following:

(1) all buildings and improvements upon the land and all personal property included in the common elements in an amount equal to the maximum insurable replacement value, excluding foundation and excavation costs, as determined annually by the Board of Directors of the Association. Such coverage shall afford protection against loss or damage by fire and other hazards covered by a standard extended coverage endorsement, and such other risks as are customarily covered with respect to buildings similar to the buildings on the land, such as vandalism and malicious mischief;

(2) public liability in such amounts and with such coverage as shall be required by the Board of Directors of the Association, including but not limited to hired automobile and nonowned automobile coverages, and with cross liability endorsement to cover liabilities of the apartment owners as a group to an apartment owner;

(3) workmen's compensation as required by law;

(4) such other insurance as the Board of Directors of the Association shall determine from time to time to be desirable.

(c) Premiums upon insurance policies purchased by the Association shall be paid by the Association as a common expense.

(d) The Association is hereby irrevocably appointed agent for each apartment owner to adjust all claims arising under insurance policies purchased by the Association, and to execute and deliver releases upon the payment of claims.

12. *Responsibilities of insurance trustee.* (a) All insurance policies purchased by the Association shall provide that proceeds covering property losses shall be paid to any bank in Florida which is selected by the Board of Directors of the Association as a trustee, which bank is herein referred to as the Insurance Trustee. The Insurance Trustee shall not be liable for payment of premiums, for the renewal or the sufficiency of policies, or for the failure to collect any insurance proceeds.

(b) The Insurance Trustee shall receive such proceeds as are paid and hold them in trust for the benefit of the apartment owners and their mortgagees as follows. An undivided share of such proceeds on account of damage to common elements shall be allocated to the apartment owners according to their shares of the common elements set forth in paragraph 6. Proceeds on account of apartments shall be held for the owners of damaged apartments in proportion to the cost of repairing the damage suffered by each apartment owner, which cost shall be determined by the Association. If a mortgagee endorsement is issued as to an apartment, the share of the apartment owner shall be held in trust for the mortgagee and the apartment owner as their respective interests may appear.

(c) Proceeds of insurance policies received by the Insurance Trustee shall be distributed as follows:

(1) All expenses of the Insurance Trustee shall be first paid.

(2) If the damage for which the proceeds are paid is to be repaired or reconstructed, the remaining proceeds shall be expended as provided in paragraph 14. Any proceeds remaining after defraying such costs shall be distributed to the beneficial owners, remittances to apartment owners and their mortgagees being payable jointly to them. This is a covenant for the benefit of any mortgagee of an apartment and may be enforced by such mortgagee.

(3) If it is determined as provided in paragraph 14 that the damage for which the proceeds are paid shall not be reconstructed or repaired, or if there are excess proceeds remaining after a reconstruction and repair, the remaining proceeds shall be distributed to the beneficial owners, remittances to apartment owners and their mortgagees being payable jointly to them. This is a covenant for the benefit of any mortgagee of an apartment and may be enforced by such mortgagee.

(4) In making distribution to apartment owners and their mortgagees, the Insurance Trustee may rely upon a certificate of the Association as to the names of the apartment owners and their respective shares of the distribution, and as to whether or not the building is to be reconstructed or repaired.

13. *When damaged property is to be reconstructed or repaired.* (a) If common elements are damaged, they shall be reconstructed or repaired, unless it is determined under paragraph 22 that the condominium shall be terminated.

(b) If the damaged property is the apartment building, and if apartments to which 50% or more of the common elements are appurtenant are found by the Board of Directors of the Association to be tenantable, the damaged property shall be reconstructed or repaired unless within 60 days after the casualty it is determined under paragraph 22 that the condominium shall be terminated.

(c) If the damaged property is the apartment building, and if apartments to which more than 50% of the common elements are appurtenant are found by the Board of Directors to be not tenantable, the damaged property will not be reconstructed or repaired and the condominium shall be terminated under paragraph 22 unless within 60 days after the casualty the owners of at least 75% of the common elements agree in writing to such reconstruction or repair. No mortgagee shall have any right to participate in the determination as to whether damaged property shall be reconstructed or repaired.

(d) Any reconstruction or repair must be substantially in accordance with the plans and specifications for the original building prepared by Paul F. Fisch, A.I.A., or if not, then according to plans and specifications approved by the Board of Directors of the Association, and if the damaged property is the apartment building, by the owners of not less than 75% of the common elements, including the owners of all damaged apartments, which approval shall not be unreasonably withheld.

14. *Responsibilities and procedures as to payment for repairs.* (a) If damage occurs only to those parts of an apartment for which the responsibility of maintenance and repair is that of the apartment owner, such owner shall be responsible for reconstruction and repair after casualty. In all other instances the responsibility of reconstruction and repair after casualty shall be that of the Association.

(b) Immediately after a casualty causing damage to property for which the Association has the responsibility of maintenance and repair, the Association shall obtain reliable and detailed estimates of the cost to rebuild or repair so as to place the damaged property in condition as good as that before the casualty.

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(c) If the insurance proceeds are not sufficient to defray the estimated costs of reconstruction and repair, assessments shall be made against the apartment owners who own the damaged property, and against all apartment owners in the case of damage to common elements, in sufficient amounts to provide funds to pay the estimated costs. Additional assessments may be made at any time during, or following the completion of, construction. Such assessments against apartment owners for damage to apartments shall be in proportion to the cost of reconstruction and repair of their respective apartments. Such assessments on account of damage to common elements shall be in proportion to the owner's share in the common elements.

(d) If the amount of the estimated costs of reconstruction and repairs for which the Association is responsible is more than \$5,000, the Association shall deposit the sums paid upon assessments to meet such costs with the Insurance Trustee. In all other cases the Association shall hold the sums paid upon such assessments and disburse them in payment of the costs of reconstruction and repair.

(e) The proceeds from assessments and insurance received by the Insurance Trustee shall be disbursed as follows:

(1) The portion of insurance proceeds representing damage, the reconstruction and repair of which is the responsibility of the apartment owner, shall be paid by the Insurance Trustee to the apartment owner or, if there is a mortgagee endorsement, then to the apartment owner and the mortgagee jointly, who may use such proceeds as they may be advised.

(2) The portion of insurance proceeds representing damage, the reconstruction and repair of which is the responsibility of the Association, shall be disbursed in payment of the costs of such repair and reconstruction in the manner required by the Board of Directors of the Association and upon approval of an architect qualified to practice in Florida and employed by the Association to supervise the work.

(3) The Insurance Trustee shall not be required to determine whether a disbursement is to be made, the identity of the payee, or the amount to be paid, but may rely upon a certificate of the Association stating such information.

15. *Use restrictions.* The use of the property of the condominium shall be in accordance with the following provisions:

(a) Each of the apartments shall be occupied only by a family, its servants, and guests, as a residence and for no other purpose. Except as reserved to the Developer, no apartment may be divided or subdivided into a smaller unit nor any portion thereof sold or otherwise transferred without first amending this Declaration to show the changes in the apartments to be effected thereby.

(b) The common elements shall be used only for the purposes for which they are intended in the furnishing of services and facilities for the enjoyment of the apartments.

(c) No use or practice shall be permitted on the condominium property which is the source of annoyance to residents or which interferes with the peaceful possession and proper use of the property by its residents. All parts of the property shall be kept in a clean and sanitary condition, and no rubbish, refuse, or garbage allowed to accumulate nor any fire hazard allowed to exist. No apartment owner shall permit any use of his apartment or of the common elements which will increase the rate of insurance upon the condominium property. No immoral, improper, offensive, or unlawful use shall be made of the condominium property or any part thereof. All valid laws, zoning ordinances, and regulations of all governmental bodies having jurisdiction thereof shall be observed. The responsibility of meeting the requirements of governmental bodies which require maintenance, modification, or repair of the condominium property shall be the same as the responsibility for the maintenance and repair of the property concerned. No rooms may be rented or transient guests accommodated.

(d) Neither the apartment owners nor the Association nor the use of the condominium property shall interfere with the

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completion of the contemplated improvements and the sale of the apartments until the Developer has completed and sold all of the apartments. The Developer may make such use of the unsold units and common areas as may facilitate such completion and sale, including but not limited to the maintenance of a sales office, the showing of the property, and the display of signs.

(e) The Association may make and amend, from time to time, reasonable regulations concerning the use of the condominium property. Such regulations shall be made and amended in the manner provided in the Association's Articles of Incorporation and Bylaws. The Association shall furnish copies of such regulations and amendments thereto to all apartment owners and residents of the condominium, upon their request.

16. *Approval of transfer or lease.* (a) No apartment owner may effectively dispose of an apartment or any interest therein by sale or lease, except to another apartment owner in the condominium, without approval of the Association. If any apartment owner shall acquire his title by gift, devise, or inheritance, the continuance of his ownership of his apartment shall be subject to the approval of the Association.

(b) An apartment owner intending to make a bona fide sale or lease of his apartment or any interest therein shall give to the Association notice of such intention, together with the name and address of the intended purchaser or lessee, and such other information concerning the intended purchaser or lessee as the Association may reasonably require. In the case of a prospective sale, such notice may include the apartment owner's demand that the Association furnish a purchaser if the proposed purchaser is not approved; and if such demand is made, the notice shall be accompanied by an executed copy of the proposed contract to sell. An apartment owner who has obtained his title by gift, devise, or inheritance shall give to the Association notice of the acquisition of his title, together with such personal information as the Association may reasonably require, and a certified copy of the instrument evidencing his title. If the notice to the Association is not given, then at any time after receiving knowledge of a transaction or event transferring ownership or possession of an apartment, the Association at its election and without notice may approve or disapprove the transaction or ownership.

(c) Within 30 days after receipt of the notice described in subparagraph (b) of this paragraph the Association must either approve or disapprove the proposed transaction or the continuance of ownership, as the case may be. If approved, the approval shall be stated in a certificate executed by the President and Secretary in recordable form, and shall be delivered to the purchaser, lessee, or new owner and shall be recorded in the public records of the county (except that a lease need not be recorded).

17. *Disapproval of transfer or leases.* (a) If the Association disapproves a proposed sale and if the notice of sale given by the apartment owner shall so demand, within 30 days after receipt of such notice and information the Association shall deliver or mail by registered mail to the apartment owner an offer to purchase by a purchaser approved by the Association who will purchase and to whom the apartment owner must sell the apartment. At the option of such purchaser, to be stated in his offer, the price to be paid shall be that stated in the disapproved contract to sell or shall be the fair market value determined by arbitration in accordance with the then existing rules of the American Arbitration Association, except that the arbitrators shall be two appraisers appointed by the American Arbitration Association who shall base their determination upon an average of their appraisals of the apartment; and a judgment of specific performance of the sale upon the award rendered by the arbitrators may be entered in any court of competent jurisdiction. The expense of the arbitration shall be paid by the purchaser. The purchase price shall be paid in cash, and the sale shall be closed within 30 days after the delivery or mailing of such offer to purchase, or within ten days after the determination of the sale price if such is by arbitration, whichever is the later.

(b) If the proposed transaction is a lease, the apartment owner shall be advised of the disapproval in writing, and the lease shall not be made.

(c) If the Association disapproves the acquisition of title by gift, devise, or inheritance, the provisions of subparagraph

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(a) of this paragraph shall apply (except that the purchase price shall be at fair market value determined by arbitration).

(d) If the Association shall fail to provide a purchaser as required in subparagraphs (a) and (c) of this paragraph, then notwithstanding the disapproval, the sale or ownership, as the case may be, shall be deemed to have been approved, and the Association shall furnish a certificate of approval as provided in paragraph 16.

18. *Mortgage and acquisition by mortgagees.* (a) No apartment owner may mortgage his apartment or any interest therein without the approval of the Association, except to a bank, life insurance company, or a federal savings and loan association. The approval of any other mortgagee shall be subject to conditions determined by the Association.

(b) The provisions of paragraphs 16 and 17 shall not apply to a transfer to or purchase by a bank, life insurance company, or federal savings and loan association which acquires its title as the result of owning a mortgage upon the apartment concerned, whether the title is acquired by deed from the mortgagor or through foreclosure proceedings. Nor shall such provisions apply to a transfer, sale, or lease by a bank, life insurance company, or federal savings and loan association which so acquires its title. Neither shall such provisions require the approval of a purchaser who acquires title to an apartment at a duly advertised public sale with open bidding which is provided by law, such as, but not limited to, execution sale, foreclosure sale, judicial sale, or tax sale.

19. *Notice of lien or suit.* (a) An apartment owner shall give notice to the Association of every lien upon his apartment, other than for permitted mortgages, taxes, and special assessments, within five days after the attaching of the lien. Failure to comply with this subparagraph will not affect the validity of any judicial sale.

(b) Notice shall be given to the Association of every suitor other proceeding which may affect the title to his apartment within five days after the apartment owner receives knowledge thereof.

20. *Compliance and default.* (a) Each apartment owner shall be governed by and shall comply with the terms of this Declaration, the Articles of Incorporation, Bylaws, and regulations adopted pursuant thereto, and by such documents and regulations as they may be amended from time to time. A default shall entitle the Association or other apartment owners to the relief described in subparagraph (b) of this paragraph in addition to the remedies provided by the Condominium Act.

(b) An apartment owner shall be liable for the expense of any maintenance, repair, or replacement rendered necessary by his act, neglect, or carelessness or by that of any member of his family or his or their guests, employees, agents, or lessees, but only to the extent that such expense is not met by the proceeds of insurance carried by the Association. Such liability shall include any increase in fire insurance rates occasioned by use, misuse, occupancy, or abandonment of an apartment or its appurtenances. In any proceeding arising out of an apartment owner's alleged default, the prevailing party shall be entitled to recover the costs of the proceeding and such reasonable attorneys' fees as may be awarded by the court.

(c) The failure of the Association or any apartment owner to enforce any covenant, restriction, or other provision of the Condominium Act, this Declaration, the Articles of Incorporation, the Bylaws, or the regulations adopted pursuant thereto, shall not constitute a waiver of the right to do so thereafter.

21. *Amendments.* This Declaration may be amended in the following manner:

(a) Notice of the subject matter of a proposed amendment shall be included in the notice of any meeting at which a proposed amendment is considered.

(b) Either the Board of Directors or the members of the Association may propose a resolution adopting a proposed resolution. Directors and members not present in person or by proxy at the meetings considering the amendment may

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express their approval in writing, providing such approval is delivered to the Secretary at or prior to the meeting. Except as elsewhere provided, such approvals must be either by (1) not less than 75% of the entire membership of the Board of Directors and by not less than 75% of the votes of the entire membership of the Association; or (2) not less than 80% of the votes of the entire membership of the Association; or (3) until the first election of directors, only by all of the directors, provided the amendment does not increase the number of apartments nor alter the boundaries of the common elements.

(c) No amendment shall discriminate against any apartment owner or against any apartment or class or group of apartments unless the apartment owners so affected shall consent. No amendment shall change any apartment nor the share in the common elements appurtenant to it, nor increase the owner's share of the common expenses, unless the record owner of the apartment and all record owners of liens thereon shall join in the execution of the amendment.

(d) A copy of each amendment shall be certified by the President and Secretary of the Association as having been duly adopted and shall be effective when recorded in the Public Records of Dade County, Florida.

22. *Termination.* The condominium may be terminated in the following manner in addition to the manner provided by the Condominium Act:

(a) If it is determined under paragraph 13(c) that the apartment building shall not be reconstructed because of major damage, the condominium plan of ownership will be thereby terminated without agreement.

(b) The condominium may be terminated at any time by the written approval of all of the owners of the condominium, and by all record owners of liens thereon. If the proposed termination is submitted to a meeting of the members of the Association, the notice of which meeting gives notice of the proposed termination, and if the approval of the owners of not less than 75% of the common elements, and of the record owners of liens upon the same 75% of the common elements, are obtained not later than 30 days from the date of such meeting, then the approving owners shall have an option to buy all of the apartments of the other owners during the period ending on the 60th day from the date of such meeting.

(c) The option described in subparagraph (b) of this paragraph shall be exercised by delivery or mailing by registered mail to each of the record owners of the apartments to be purchased of an offer to purchase signed by the record owners of apartments who will participate in the purchase. Such offer shall indicate which apartments will be purchased by each participating owner and shall offer to purchase all of the apartments owned by owners not approving the termination, but the offer shall effect a separate contract between each seller and his purchaser.

(d) The sale price for each apartment shall be the fair market value determined by agreement between the seller and purchaser within 30 days from the delivery or mailing of such offer, and in the absence of agreement by arbitration in accordance with the then existing rules of the American Arbitration Association, except that the arbitrators shall be two appraisers appointed by the American Arbitration Association who shall base their determination upon an average of their appraisals of the apartment; and a judgment of specific performance of the sale upon the award rendered by the arbitrators may be entered in any court of competent jurisdiction. The expense of the arbitration shall be paid by the purchaser. The purchase price shall be paid in cash, and the sale shall be closed within ten days following the determination of the sale price.

(e) The termination of the condominium shall be evidenced by a certificate of the Association executed by the President and Secretary certifying as to facts effecting the termination, which certificate shall become effective upon being recorded in the public records of Dade County, Florida.

(f) After termination of the condominium the apartment owners shall own the condominium property and all assets of the Association as tenants in common in undivided shares, and their respective mortgagees and lienors shall have

mortgages and liens upon the respective undivided shares of the apartment owners. Such undivided shares of the apartment owners shall be the same as the undivided shares in the common elements appurtenant to the owners' apartments prior to the termination.

23. *Severability.* The invalidity in whole or in part of any covenant or restriction, or any section, subsection, sentence, clause, phrase, or word, or other provision of this Declaration and the Articles of Incorporation, Bylaws, and regulations of the Association shall not affect the validity of the remaining portions thereof.

In witness whereof the Developer has executed this Declaration the day and year first above written.

Castelle Development Corporation

Signed, sealed, by _____

and delivered in President
the presence of:: Corporate Seal

Attest:

Secretary

(Acknowledgment)

A.22 Articles of incorporation: association of condominium owners

COMMENT

Since there is no single owner of the entire condominium to whom the responsibility for maintenance and operation can be directly traced, condominium enabling statutes provide for the administration of the condominium by a representative group of owners. In general, the formation and conduct of such an owners' organization are governed by bylaws that are required to be filed with the declaration of condominium.

Basic provisions:

The articles of incorporation state that the association is organized for the purpose of conforming to that provision of the condominium statute requiring that an entity be formed to operate the condominium. All the record owners of apartments are to be members of the association. Since the association is organized as a nonprofit corporation, the articles must provide that no distributions of income are to be made to members, directors, or officers.

Association powers:

The articles of incorporation must grant to the association sufficient powers to operate the condominium, including the following:

- (1) To maintain, replace, and operate the condominium property;

- (2) To make and collect assessments against members for costs, expenses, and losses;
- (3) To contract for the management of the condominium, and to employ necessary personnel;
- (4) To purchase insurance on condominium property for the protection of the association and its members;
- (5) To make regulations as to use of the property, subject to approval by at least 75% of the votes of the entire membership;
- (6) To approve or disapprove the transfer, mortgage, and ownership of apartments, as provided in the declaration of condominium and in bylaws; and
- (7) To enforce the provisions of the condominium act, the declaration of condominium, the bylaws, and regulations for use of the property.

Corporate procedure:

The articles must also set forth the general ground rules for corporate organization. These include provisions with respect to the directors, officers, bylaws, term of the association, and indemnification of directors and officers. These provisions must be drafted with due regard to applicable state statutes and regulations.

Tax aspect:

A condominium management association may qualify as a homeowners' association that is treated generally as a tax-exempt organization, provided that an election is made and certain tests are met as to the function, income, and expenditures of the association. The association must be organized and operated to provide for the acquisition, construction, management, maintenance, and care of association property. Association property includes property owned by the association or its members, either privately or in common with other members. At least 60% of the association's annual gross income must come only from membership dues, fees, or assessments and at least 90% of its annual expenditures must be for the purposes for which it must be organized and operated. The net earnings of the association may not inure to the benefit of anyone except to the extent that the organization performs its required functions; however, members of the organization may receive a rebate of excess dues and assessments.

If a condominium management association complies with the above requirements, and makes a proper election, it will not be taxed on its "exempt function income" (membership dues, fees, and assessments), but all other income will be taxed at a 30 percent rate.

For further information, see Chapter 6, 13, and 16.

FORM

Articles of Incorporation
of
Castelle Association, Inc.

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The undersigned hereby associate themselves for the purpose of forming a corporation not for profit under Chapter 711, Florida Statutes, and certify as follows:

Article I Name

The name of the corporation shall be Castelle Association, Inc., hereinafter called the Association.

Article II Purpose

1. The purpose for which the Association is organized is to provide an entity pursuant to Chapter 711, Florida Statutes, hereinafter called the Condominium Act, for the operation of Castelle Apartments, a Condominium located upon the following lands:

[Insert description]

2. The Association shall make no distributions of income to its members, directors, or officers.

Article III Powers

The powers of the Association shall include and be governed by the following provisions:

1. The Association shall have all of the common law and statutory powers of a corporation not for profit which are not in conflict with the terms of these Articles.

2. The Association shall have all of the powers and duties set forth in the Condominium Act except as limited by these Articles and the Declaration of Condominium (hereinafter called the Declaration), and all of the powers and duties reasonably necessary to operate the condominium as set forth in the Declaration and as it may be amended from time to time, including but not limited to the following:

(a) To make and collect assessments against members to defray the costs, expenses, and losses of the condominium.

(b) To use the proceeds of assessments in the exercise of its powers and duties.

(c) To maintain, repair, replace, and operate the condominium property.

(d) To purchase insurance upon the condominium property and insurance for the protection of the Association and its members.

(e) To reconstruct improvements after casualty and to further improve the property.

(f) To make and amend reasonable regulations respecting the use of the property in the condominium; provided, however, that all such regulations and amendments thereto shall be approved by not less than 75% of the votes of the entire membership of the Association before such shall become effective.

(g) To approve or disapprove the transfer, mortgage, and ownership of apartments as may be provided by the

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Declaration and the Bylaws.

(h) To enforce by legal means the provisions of the Condominium Act, the Declaration, these Articles, the Bylaws of the Association, and the regulations for the use of the condominium property.

(i) To contract for the management of the condominium and to delegate to such contractor all powers and duties of the Association except such as are specifically required by the Declaration to require approval of the Board of Directors or the membership of the Association.

(j) To contract for the management or operation of portions of the common elements susceptible to separate management or operation, and to lease such portions.

(k) To employ personnel to perform the services required for proper operation of the condominium.

3. The Association shall not have the power to purchase an apartment of the condominium. This provision shall not be changed without unanimous approval of the members.

4. All funds and the titles of all properties acquired by the Association and the proceeds thereof shall be held in trust for the members in accordance with the provisions of the Declaration, these Articles, and the Bylaws.

5. The powers of the Association shall be subject to and shall be exercised in accordance with the provisions of the Declaration and the Bylaws.

Article IV Members

1. The members of the Association shall consist of all of the record owners of apartments.

2. Change of membership in the Association shall be established by the recording in the public records of Dade County, Florida, of a deed or other instrument establishing a record title to an apartment in the condominium and the delivery to the Association of a certified copy of such instrument, the owner designated by such instrument thereby becoming a member of the Association. The membership of the prior owner shall be thereby terminated.

3. The share of a member in the funds and assets of the Association cannot be assigned, hypothecated, or transferred in any manner except as an appurtenance to his apartment.

4. The members of the Association shall be entitled to at least one vote for each apartment owned by them. The exact number of votes to be cast by owners of an apartment and the manner of exercising voting rights shall be determined by the Bylaws of the Association.

Article V Directors

1. The affairs of the Association shall be managed by a Board consisting of the number of directors as shall be determined by the Bylaws, but not less than three directors, and in the absence of such determination shall consist of three directors.

2. Directors of the Association shall be elected at the annual meeting of the members in the manner determined by the Bylaws. Directors may be removed and vacancies on the Board of Directors shall be filled in the manner provided by the Bylaws.

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3. The first election of directors shall not be held until after all of the apartments of the condominium have been sold by the developer of the condominium, or until after December 31, 2003, or until such developer elects to terminate its control of the condominium, whichever shall first occur. The directors herein named shall serve until the first election of directors, and any vacancies in their number occurring before the first election shall be filled by the remaining directors.

4. The names and addresses of the members of the first Board of Directors who shall hold office until their successors are elected and have qualified, or until removed, are as follows:

Richard Quinn
400 Clove Road
Miami, Florida

George Champion
400 Clove Road
Miami, Florida

John Preis
400 Clove Road
Miami, Florida

Article VI Officers

The affairs of the Association shall be administered by officers elected by the Board of Directors at its first meeting following the annual meeting of the members of the Association, which officers shall serve at the pleasure of the Board of Directors. The names and addresses of the officers who shall serve until their successors are designated by the Board of Directors are as follows:

President:	Richard Quinn	400 Clove Road Miami, Florida
Vice President and Assistant Secretary:	John Preis	400 Clove Road Miami, Florida
Secretary-Treasurer:	George Champion	400 Clove Road Miami, Florida

Article VII Indemnification

Every director and every officer of the Association shall be indemnified by the Association against all expenses and liabilities, including counsel fees, reasonably incurred by or imposed upon him in connection with any proceeding to which he may be a party, or in which he may become involved, by reason of his being or having been a director or officer of the Association, or any settlement thereof, whether or not he is a director or officer at the time such expenses are incurred, except in such cases wherein the director or officer is adjudged guilty of willful misfeasance or malfeasance in the performance of his duties; provided that in the event of a settlement the indemnification herein shall apply only when the Board of Directors approves such settlement and reimbursement as being for the best interests of

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the Association. The foregoing right of indemnification shall be in addition to and not exclusive of all other rights to which such director or officer may be entitled.

Article VIII Bylaws

The first Bylaws of the Association shall be adopted by the Board of Directors, and may be altered, amended, or rescinded in the manner provided by the Bylaws.

Article IX Amendments

Amendments to the Articles of Incorporation shall be proposed and adopted in the following manner:

1. Notice of the subject matter of a proposed amendment shall be included in the notice of any meeting at which a proposed amendment is considered.
2. A resolution approving a proposed amendment may be proposed by either the Board of Directors or the members of the Association. Directors and members not present in person or by proxy at the meetings considering the amendment may express their approval in writing, providing such approval is delivered to the Secretary at or prior to the meeting.
3. Approval of an amendment must be by not less than 75% of the entire membership of the Board of Directors and by not less than 75% of the votes of the entire membership of the Association, or by not less than 80% of the votes of the entire membership of the Association.
4. No amendment shall make any changes in the qualifications for membership nor the voting rights of members, nor any change in Section 3 of Article III, without approval in writing by all members.
5. A copy of each amendment shall be certified by the Secretary of State and recorded in the public records of Dade County, Florida.

Article X Term

The term of the Association shall be the life of the condominium, unless the Association is terminated sooner by unanimous action of its members. The Association shall be terminated by the termination of the condominium in accordance with the provisions of the Declaration.

Article XI Subscribers

The names and residences of the subscribers of these Articles of Incorporation are as follows:

Richard Quinn	400 Clove Road Miami, Florida
John Preis	400 Clove Road Miami, Florida
George Champion	400 Clove Road Miami, Florida

In witness whereof the subscribers have hereto affixed their signatures on December 28, 2002.

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Richard Quinn _____ (L.S.)

John Preis _____ (L.S.)

_____ (L.S.) George Champion

(Acknowledgments)

A.23 Bylaws of condominium owners' association

COMMENT

To a great extent, the contents of the bylaws will depend upon what has been included in the declaration, since many essentials of condominium operation may be provided for in either instrument.

Condominium statutes generally require that various matters be set forth in the bylaws. Accordingly, due regard should be paid to applicable state statutes. In general, these include matters relating to the organization of the owners' association, the meetings of members, the election of a board of directors, the election of officers, the procedure for collecting assessments against unit owners, the percentage of unit owners required to make decisions, and the procedure for amending the bylaws. Other subjects not required by statute to be included in the bylaws, or in the declaration of condominium, may be in the bylaws if they have not been covered in the declaration.

In drafting the documents for this condominium, the decision was made to treat in the declaration many of the problems which could be covered in either instrument. For example, the declaration deals with limitations on the transfer of a unit, limitations on the use of the premises, responsibility for maintenance of the property, and responsibility for reconstruction after damage. However, the bylaws do cover some matters with respect to the maintenance and operation of the condominium, in addition to the matters required to be included by statute. Thus, the bylaws prescribe certain accounting and budgetary practices, including the establishment of reserves for current operating expenses, for maintenance, and for replacement of improvements. With respect to the annual budget prepared by the board of directors, the bylaws specify certain limitations which cannot be exceeded without approval of the owners. The bylaws also allocate to the owners the voting rights to be exercised at meetings of the association.

For further information, see Chapters 6, 13, and 16.

FORM

Bylaws
of the
Castelle Association, Inc.,
A Corporation Not for
Profit Under the Laws
of the State of Florida

1. *Identity.* These are the Bylaws of the Castelle Association, Inc., (the "Association"), a Corporation not for profit under the laws of the State of Florida, the Articles of Incorporation of which were filed in the office of the Secretary of State on December 28, 2002. The Association has been organized for the purpose of administering a condominium

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pursuant to Chapter 711, Florida Statutes, (the "Condominium Act"), which condominium is identified by the name Castle Apartments, a Condominium, and is located upon the following land:

(Insert description)

The office of the Association shall be at 3000 Seaview Road, Miami, Florida. The fiscal year of the Association shall be the calendar year.

The seal of the Corporation shall bear the name of the Corporation, the word "Florida," the words "Corporation not for profit" and the year of incorporation.

2. *Members' meetings.* (a) The annual members' meeting shall be held at the office of the Corporation at three p.m., Eastern Standard Time, on the second Friday in February of each year for the purpose of electing directors and transacting any other business authorized to be transacted by the members. If that day is a legal holiday, the meeting shall be held at the same hour on the next day.

(b) Special members' meetings shall be held whenever called by the President or Vice President or by a majority of the Board of Directors, and must be called by such officers upon receipt of a written request from members entitled to cast one-third of the votes of the entire membership.

(c) Notice of all members' meetings, stating the time and place and the objects for which the meeting is called, shall be given by the President or Vice President or Secretary unless waived in writing. Such notice shall be in writing to each member at his address as it appears on the books of the Association and shall be mailed not less than ten days nor more than 60 days prior to the date of the meeting. Proof of such mailing shall be given by the affidavit of the person giving the notice. Notice of meeting may be waived before or after meetings.

(d) A quorum at members' meetings shall consist of persons entitled to cast a majority of the votes of the entire membership. If any meeting of the members cannot be organized because a quorum is not present, the members who are present, either in person or by proxy, may adjourn the meeting for at least ten days, and adequate notice of the new date shall be given as described in paragraph (c) of this Section.

(e) In any meeting of members the owners of apartments shall be entitled to cast the number of votes indicated in the following schedule, unless the decision to be made is required to be by the owners of a stated percentage of the common elements:

Number of votes for each Apartment bearing the designation	of such apartments
—	—
A	3
B	2
C	2
D	2
E	2

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F	2
G	1
H	3

If an apartment is owned by one person his right to vote shall be established by the record title to his apartment. If an apartment is owned by more than one person, or is under lease, the person entitled to cast the vote for the apartment shall be designated by a certificate signed by all of the record owners of the apartment and filed with the Secretary of the Association. If an apartment is owned by a corporation, the person entitled to cast the vote for the apartment shall be designated by a certificate of appointment signed by the President or Vice President and attested by the Secretary or Assistant Secretary of the Corporation and filed with the Secretary of the Association. Such certificates shall be valid until revoked, or until superseded by a subsequent certificate, or until a change in the ownership of the apartment concerned. A certificate designating the person entitled to cast the vote of an apartment may be revoked by any owner thereof.

(f) Votes may be cast in person or by proxy. Proxies may be made by any person entitled to vote. They shall be valid only for the particular meeting designated and must be filed with the Secretary before the appointed time of the meeting.

(g) The order of business at annual members' meetings, and as far as practical at all other members' meetings, shall be

- (1) election of chairman of the meeting;
- (2) calling of the roll and certifying of proxies;
- (3) proof of notice of meeting or waiver of notice;
- (4) reading and disposal of any unapproved minutes;
- (5) reports of officers;
- (6) reports of committees;
- (7) election of inspectors of election;
- (8) election of directors (if necessary);
- (9) unfinished business;
- (10) new business; and
- (11) adjournment.

(h) Until the Developer of the condominium (the "Developer"), has completed and sold all of the apartments of the condominium, or until December 31, 1989, or until the Developer elects to terminate its control of the condominium, whichever shall first occur, there shall be no meeting of members of the Association unless a meeting is called by the Board of Directors.

3. *Directors.* (a) The affairs of the Association shall be managed by a board of not more than 11 directors, the exact number to be determined at the time of election. Directors' fees shall be determined by the members.

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(b) Election of directors shall be conducted at the annual members' meeting. A nominating committee of five members shall be appointed by the Board of Directors not less than 30 days prior to the annual members' meeting. The committee shall nominate one person for each director then serving. Additional nominations for directorships and directors may be made from the floor. The election shall be by ballot (unless dispensed with by unanimous consent) and by a plurality of the votes cast, each person voting being entitled to cast his votes for each of as many nominees as there are vacancies to be filled. There shall be no cumulative voting.

(c) Except as to vacancies provided by removal of directors by members, vacancies in the Board of Directors occurring between annual meetings of members shall be filled by the remaining directors.

(d) Any director may be removed by concurrence of two-thirds of the votes of the entire membership at a special meeting of the members called for that purpose. The vacancy in the Board of Directors so created shall be filled by the members of the Association at the same meeting.

(e) Until the Developer has completed and sold all of the apartments of the condominium, or until December 31, 2003, or until the Developer elects to terminate its control of the condominium, whichever shall first occur, the first directors of the Association shall serve, and in the event of vacancies the remaining directors shall fill the vacancies, and if there are no remaining directors the vacancies shall be filled by the Developer.

(f) The term of each director's service shall extend until the next annual meeting of the members and thereafter until his successor is duly elected and qualified or until he is removed in the manner elsewhere provided.

4. *Directors' meetings.* (a) The organization meeting of a newly-elected Board of Directors shall be held within ten days after its election at such place and time as shall be fixed by the directors at the meeting at which they were elected, and no further notice of the organization meeting shall be necessary providing a quorum shall be present.

(b) Regular meetings of the Board of Directors may be held at such time and place as shall be determined, from time to time, by a majority of the directors. Notice of regular meetings shall be given to each director, personally or by mail, telephone, or telegraph at least three days prior to the day named for such meeting.

(c) Special meetings of the directors may be called by the President and must be called by the Secretary at the written request of one-third of the directors. Notice of the meeting shall be given personally or by mail, telephone, or telegraph at least three days prior to the day named for such meeting, which notice shall state the time, place, and purpose of the meeting.

(d) Any director may waive notice of a meeting before or after the meeting and such waiver shall be deemed equivalent to the giving of notice.

(e) A majority of the entire board of directors shall constitute a quorum at directors' meetings. The acts approved by a majority of those present at a meeting at which a quorum is present shall constitute the acts of the Board of Directors, except where approval by a greater number of directors is required by the Declaration of Condominium, (the "Declaration"), the Articles of Incorporation, or these Bylaws. If at any meeting of the Board of Directors less than a quorum is present, the majority of those present may adjourn the meeting from time to time until a quorum is present. At any adjourned meeting any business which might have been transacted at the meeting as originally called may be transacted without further notice. The joinder of a director in the action of a meeting by signing and concurring in the minutes thereof shall constitute the presence of such director for the purpose of determining a quorum.

(f) The Chairman of the Board, if such an officer has been elected, shall be the presiding officer at directors' meetings; otherwise, the President shall preside. In the absence of the presiding officer, the directors present shall designate one of

their number to preside.

(g) The order of business at directors' meetings shall be

(1) calling of roll,

(2) proof of due notice of meeting;

(3) reading and disposal of any unapproved minutes;

(4) reports of officers and committees;

(5) election of officers;

(6) unfinished business;

(7) new business; and

(8) adjournment.

5. *Powers and duties of the board of directors.* All of the powers and duties of the Association existing under the Condominium Act, the Declaration, the Articles of Incorporation, and these Bylaws shall be exercised exclusively by the Board of Directors, its agents, contractors, or employees, subject only to approval by apartment owners if such is specifically required. Compensation of employees of the Association shall be fixed by the directors. A director may be an employee of the Association, and a contract for management of the condominium may be entered into with a director.

6. *Officers.* (a) The executive officers of the Association shall be a President, who shall be a director, a Vice President, who shall be a director, a Treasurer, a Secretary, and an Assistant Secretary, all of whom shall be elected annually by the Board of Directors and who may be removed by vote of the directors at any meeting. Any person may hold two or more offices except that the President shall not also be the Secretary or an Assistant Secretary. The Board of Directors may from time to time elect other officers to exercise such powers and duties as the Board shall deem necessary or appropriate to manage the affairs of the Association. Compensation of officers shall be fixed by the Board of Directors.

(b) The President shall be the chief executive officer of the Association. He shall have all of the powers and duties which are usually vested in the office of president of an association, in order to assist in the conduct of the affairs of the Association, including, without limitation, the power to appoint such committees as he may deem appropriate from time to time from among the members of the Board.

(c) The Vice President shall in the absence or disability of the President exercise the powers and perform the duties of the President. He shall also generally assist the President and exercise such other powers and perform such other duties as shall be prescribed by the directors.

(d) The Secretary shall keep the minutes of all proceedings of the directors and the members. He shall attend to the giving and serving of all notices to the members and directors and other notices required by law. He shall have custody of the seal of the Association and affix the same to instruments requiring a seal when duly signed. He shall keep the records of the Association, except those of the Treasurer, and shall perform all other duties incident to the office of Secretary of an association and as may be required by the directors or the President. The Assistant Secretary shall perform the duties of the Secretary when the Secretary is absent.

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(e) The Treasurer shall have custody of all property of the Association, including funds, securities, and evidences of indebtedness. He shall keep the books of the Association in accordance with generally accepted accounting practices and shall perform all other duties incident to the office of Treasurer.

7. *Accounting.* The funds and expenditures of the Association shall be credited and charged to accounts under the following classifications as shall be appropriate, all of which expenditures shall be common expenses:

(a) "Current expenses," which shall include all funds and expenditures to be made within the year for which the funds are budgeted, including a reasonable allowance for contingencies and working funds, except expenditures chargeable to reserves, to additional improvements, or to operations. The balance in this fund at the end of each year shall be applied to reduce the assessments for current expense for the succeeding year.

(b) "Reserve for deferred maintenance," which shall include funds for maintenance items which occur less frequently than annually.

(c) "Reserve for replacement," which shall include funds for repair or replacement required because of damage, depreciation, or obsolescence.

(d) "Additional improvements," which shall include the funds to be used for capital expenditures for additional improvements or additional personal property which will be part of the common elements.

8. *Budget.* The Board of Directors shall adopt a budget for each calendar year which shall include the estimated funds required to defray common expenses and to provide funds for the accounts listed in Section 7 of these Bylaws. The budget shall take into account the following items:

(a) "Current expense," the amount for which shall not exceed 105% of the budget for this account for the prior year.

(b) "Reserve for deferred maintenance," the amount for which shall not exceed 105% of the budget for this account for the prior year.

(c) "Reserve for replacement," the amount for which shall not exceed 105% of the budget for this account for the prior year.

(d) "Additional improvements," the amount for which shall not exceed \$12,700; provided, however, that in the expenditure of this fund no sum in excess of \$2,500 shall be expended for a single item or purpose without approval of the members of the Association.

(e) "Operations," the amount of which may be to provide a working fund or to meet losses.

The amount for each budgeted item may be increased over the foregoing limitations when approved by apartment owners entitled to cast not less than 75% of the votes of the entire membership of the Association. Until the Developer has completed and sold all of the apartments of the condominium, or until December 31, 1989, or until the Developer elects to terminate its control of the condominium, whichever shall first occur, the Board of Directors may omit from the budget all allowances for contingencies and reserves. Copies of the budget and proposed assessments shall be transmitted to each member on or before December 1 preceding the year for which the budget is made. If the budget is subsequently amended, a copy of the amended budget shall be furnished to each member.

9. *Assessments.* (a) Assessments against the apartment owners for their shares of the items of the budget shall be made on or before December 20 preceding the year for which the assessments are made. Such assessments shall be due in two equal payments on the first day of January and July of the year for which the assessments are made. If an annual

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assessment is not made as required, it shall be presumed to have been made in the amount of the last prior assessment. If the annual assessment proves to be insufficient, the budget and assessments therefor may be amended at any time by the Board of Directors if the items of the amended budget do not exceed the limitations thereon for that year. Any item which does exceed such limitation shall be subject to the approval of the membership of the Association as provided in section 8 of these Bylaws. The unpaid assessment for the remaining portion of the calendar year for which the amended assessment is made shall be due upon the date of the assessment.

(b) If an apartment owner shall default in the payment of an installment upon an assessment, the Board of Directors may accelerate the remaining installments of the assessment upon notice thereof to the apartment owner, and thereupon the unpaid balance of the assessment shall come due upon the date stated in the notice, but not less than ten days after delivery thereof to the apartment owner, or not less than 20 days after the mailing of such notice to him by registered or certified mail, whichever shall first occur.

(c) Assessments for common expenses of emergencies which cannot be paid from the annual assessments for common expenses shall be made only after notice of the need therefor to the apartment owners concerned. After such notice and upon approval in writing by persons entitled to cast more than one-half of the votes of the apartment owners concerned, the assessment shall become effective, and it shall be due after 30 days' notice thereof in such manner as the Board of Directors may require.

(d) The depository of the Association shall be such bank or banks as shall be designated from time to time by the directors and in which the moneys of the Association shall be deposited. Withdrawal of moneys from such accounts shall be only by checks signed by such persons as are authorized by the directors.

(e) An audit of the accounts of the Association shall be made annually by a certified public accountant, and a copy of the report shall be furnished to each member not later than April 1 of the year following the year for which the report is made.

(f) Fidelity bonds shall be required by the Board of Directors from all persons handling or responsible for Association funds. The amount of such bonds shall be determined by the directors, but shall be at least one-half of the amount of the total annual assessments against members for common expenses. The premiums on such bonds shall be paid by the Association.

10. *Parliamentary rules.* Roberts' Rules of Order (latest edition) shall govern the conduct of Association meetings when not in conflict with the Declaration, the Articles of Incorporation, or these Bylaws.

11. *Amendments.* These Bylaws may be amended in the following manner:

(a) Notice of the subject matter of a proposed amendment shall be included in the notice of any meeting at which a proposed amendment is considered.

(b) A resolution adopting a proposed amendment may be proposed by either the Board of Directors or by the members of the Association. Directors and members not present in person or by proxy at the meetings considering the amendment may express their approval in writing, provided such approval is delivered to the Secretary at or prior to the meeting. Except as elsewhere provided, such approvals must be by at least 75% of the entire membership of the Board of Directors and by not less than 75% of the votes of the entire membership of the Association; or by at least 80% of the votes of the entire membership of the Association. Until the first election of directors, all directors must approve any amendment.

(c) No amendment shall discriminate against any apartment owner or against any apartment or class or group of apartments unless the apartment owners so affected shall consent. No amendment shall change any apartment nor the

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share in the common elements appurtenant to it, nor increase the owner's share of the common expenses, nor change the voting rights of members, unless the record owner of the apartment concerned and all record owners of liens thereon shall join in the execution of the amendment.

(d) A copy of each amendment shall be certified by the President and Secretary of the Association as having been duly adopted and shall be effective when recorded in the Public Records of Dade County, Florida.

The foregoing were adopted as the Bylaws of Castelle Association, Inc., a corporation not for profit under the laws of the State of Florida, at the first meeting of the Board of Directors on January 30, 2003.

Secretary _____ (L.S.)

Approved:

President _____ (L.S.)

A.24 Agreement to purchase condominium apartment

COMMENT

As soon as preliminary plans for construction have been completed and the declaration of condominium has been drafted, the developer will normally arrange for the sale of apartments. If the purchase contract is entered into during the early stage of the venture, both the seller and the purchaser are likely to require special protections. The developer may desire to avoid an ironclad commitment to build while he attempts to arrange sufficient sales to insure the profitability of the project. In addition, he may want to screen the various applications for apartments in order to sell only to potentially compatible residents. On the other hand, the purchaser needs protection against the possibility that the developer may abandon the project.

Several of the techniques which have been developed for satisfying these and other basic difficulties are illustrated by this form, which has been cast as an offer by a prospective owner to purchase an apartment in the condominium. Upon acceptance by the developer, this document will serve as the purchase agreement. In the meanwhile, during the period allowed to the developer to consider the offer, it may investigate the personal information submitted by the offeror, and may further evaluate the desirability of completing the venture. If the developer should decide to abandon the project, even subsequent to accepting the offer, he is liable under the agreement only to return the amounts deposited by the purchaser.

As a protection to the purchaser under this agreement, his payments are to be held in trust and are not to be paid to the developer until the developer (1) accepts the offer; (2) gives the purchaser notice of the commencement of construction; (3) gives the purchaser an architect's certificate that he has entered into a general construction contract, and has received a performance bond; (4) gives the purchaser a certificate of a mortgagee that sufficient loans have been extended to cover the general contract price; and (5) obtains commitments for title insurance. There are other protective features for the purchaser. During the initial period when apartments remain unsold, assessments levied upon the purchaser for operating expenses may not exceed a specified amount. All mortgages on the property are to be discharged or released at the closing unless assumed by the purchaser. This affords the purchaser the opportunity to make his own financial arrangements. The developer undertakes to organize an owners' association (as required by the statute), and to arrange for the management of the condominium property.

Dealer treatment:

The tax consequences of selling apartments in a condominium project constructed by a developer can probably be equated with the construction and sale of private homes. Thus, the developer who dedicates property to condominium ownership and sells the apartments to different purchasers is likely to be treated as if he had subdivided real property and developed and sold private homes in separate transactions. Such a developer would be considered a "dealer" in real property and gains realized would be treated as ordinary income. However, if the owner of an apartment building, after holding it several years for the production of income, liquidates his investment by converting it to condominium ownership, there may be some basis for contending that such a liquidation is a capital transaction.

Unit owners' benefit:

The analogy for tax purposes between the condominium apartment and the private home will apply as well to the apartment owner. Any loss realized from the sale of a condominium apartment is nondeductible if the apartment was used solely as a personal residence. On the other hand, if the owner of the apartment had converted it to rental property, he could deduct loss realized upon its sale. But, in such case, the basis for determining loss is the value of the property at the date of the conversion to rental use (but not greater than cost), adjusted for depreciation subsequent to such appropriation. If the owner of a condominium apartment leases it to a tenant, the owner is entitled to depreciation deductions. In computing the depreciation deductions, the basis is the cost of the property or its value at the time of conversion to rental use, whichever is less.

For further information, see Chapters 6, 13, and 16.

FORM

January 15, 2003

The undersigned (the "Purchaser"), herewith pays the sum of \$10,000 to Quinn Management Corp., a real estate broker, ("Quinn"), as earnest money to evidence the Purchaser's good faith, and hereby offers to purchase from Castell Development Corporation, 3000 Seaview Road, Miami, Florida, (the "Developer"), Apartment 4A of Castell Apartments, a condominium, (the "condominium"). The condominium is to be established by the filing of a Declaration of Condominium (the "declaration"). This apartment (the "apartment") is to be subject to the provisions of the declaration, which require the Purchaser to pay .92% of the common expenses. The condominium is to be located upon the following land:

(Insert description)

This offer is subject to the following terms and conditions.

1. *Price and terms of payment.* (a) The purchase price of the apartment is \$460,000, \$10,000 of which is paid herewith, \$200,000 of which is to be paid to Quinn within 15 days after the Developer has given notice to the Purchaser of the beginning of construction of the apartment building, and the balance of which amounting to \$250,000 is to be paid in cash at the time of closing.

(b) All payments made upon the purchase price shall be held in Quinn's Castelle Trust Account until:

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(1) The Developer shall have complied with all of the requirements of paragraph 2 of this agreement, and

(2) The Developer shall have entered into a sufficient number of contracts for the sale of apartments to assure satisfactory condominium operation. This condition shall be satisfied by the making of contracts for the sale of 64 apartments at prices totalling not less than \$3,400,000, or by a determination made by the Developer in its sole discretion that the number of contracts for the sale of apartments which have been made are sufficient for this purpose, whichever shall first occur. The satisfaction of this condition shall be evidenced by the Developer's certificate which shall be delivered to Quinn.

If all of the foregoing conditions are not satisfied before completion of the Purchaser's apartment, or before December 15, 2003, whichever shall first occur, the sums held by Quinn shall be returned to the Purchaser upon demand, and all parties shall be released from all obligations under this agreement.

(c) This offer is conditioned upon the Pruchaser's ability to obtain a mortgage loan upon the apartment in the amount and upon the terms set forth in the supplemental agreement attached hereto.

2. *Performance by developer.* Quinn shall not deliver to the Developer any payments made by Purchaser until such time as the Developer shall have satisfied the following conditions:

(a) The Developer shall have accepted this offer by delivering or mailing to the Purchaser a counterpart of this agreement signed by the Developer.

(b) The Developer shall have given notice to the Purchaser of the start of construction of the apartment building.

(c) The Developer shall have given to the Purchaser a certificate by an architect qualified to practice in Florida certifying that the Developer has contracted with a general contractor for the construction and equipping of the condominium as herein required, and that the Developer has been supplied with a performance bond by the general contractor in the amount of the general contract price.

(d) The Developer shall have given to the Purchaser a certificate of a mortgagee that a construction fund, consisting of the proceeds of mortgage loans and such other funds as may be required for the constructing and equipping of the condominium, has been established in an amount not less than the amount of the general contract price, and that such fund will be disbursed only in a manner approved by the mortgagee.

(e) The Developer at its expense shall have furnished to the Purchaser a commitment by a title guarantor or insurer selected by the Developer and qualified to do business in Florida to guarantee or insure the title of the apartment to the Purchaser in the amount of the purchase price, subject only to the exceptions stated in paragraph 6 hereof and the following exceptions: rights of persons in possession of the property; facts that an accurate survey or personal inspection of the property will disclose; unrecorded labor, mechanic, or materialmen's liens; encumbrances, liens, or conveyances, other than a conveyance to the person to whom such commitment is made, which are recorded, or of which the Purchaser or his attorney acquires knowledge, between the effective date of the commitment and the date of issuance of the opinion and guarantee or insurance policy; and mortgages and liens of record. All mortgages and liens will be discharged or released at the closing unless assumed by the Purchaser.

3. *Approval of purchaser.* The Purchaser understands that the Developer is attempting to create a community of congenial residents, that this offer will be screened with such purpose in view, and that this offer may be arbitrarily rejected. The Purchaser represents that the information he has submitted to the Developer concerning the Purchaser and his family are true. As part of the consideration for this agreement the Purchaser consents that the Developer may make such investigation of the Purchaser as may be deemed desirable, and the Purchaser shall hold the Developer harmless

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and releases the Developer from liability on account of such investigation and the Developer's decision thereon.

4. *Disclosure.* The Purchaser acknowledges having received copies of the following instruments: (a) the Developer's Declaration of Condominium; (b) the Developer's Articles of Incorporation; (c) the Developer's Bylaws; (d) the Developer's deed to the property on which the condominium will be situated; (e) the management contract for the condominium; (f) the projected operating budget for Apartment 4A; and (g) the sales brochure and floor plan for Apartment 4A.

5. *Acceptance of offer.* If this offer is not accepted on or before 60 days after the date hereof by delivery or mailing to the Purchaser of a copy of this agreement executed by the Developer, the Purchaser may elect to withdraw this offer at any time prior to its acceptance. Upon such withdrawal all sums paid hereunder will be paid to the Purchaser forthwith upon demand. If the Developer shall reject this offer, then all sums paid hereunder by the Purchaser shall be returned to the Purchaser forthwith with notice of such rejection. Upon return to the Purchaser of all sums paid hereunder, all parties shall be released from all obligations under this agreement.

6. *The condominium.* (a) The Developer will construct a multi-story apartment building and other improvements substantially in accordance with the plans and specifications therefor prepared by Paul J. Fisch, A.I.A., subject, however, to modifications approved by the Developer. Such plans and specifications are available for inspection by the Purchaser at the office of the Developer.

(b) The wood trim and doors in the Purchaser's apartment will be primed for painting but the apartment will not be otherwise decorated. The Purchaser's apartment is being sold unfurnished but will be equipped in the manner shown by the plans and specifications. The Purchaser will furnish all hanging lighting fixtures.

(c) The declaration will be recorded at or prior to the closing. The Developer reserves the right to make changes in the proposed declaration, a copy of which has been delivered to the Purchaser, providing such changes do not decrease the Purchaser's share in the common elements nor increase the Purchaser's share of the common expenses.

(d) Risk of loss prior to closing shall be borne by the Developer.

(e) The Developer shall cause Castle Association, Inc., a Florida nonprofit corporation, which will be responsible for the operation of the condominium, to contract with Quinn, a corporation owned by the same corporation that owns the Developer, for the furnishing of professional management in the operation of the condominium. This contract will be for the period beginning with the closing of the first sale of an apartment in the condominium and will continue until 90 days after notice of cancellation given by either party to the contract.

(f) The Developer shall cause Castle Association, Inc., to make assessments so that the assessment against the apartment for common expenses for the period beginning with the closing of this sale and ending when the Developer has sold all of the apartments in the condominium, or on December 31, 2005, or when the Developer elects to pay assessments upon the apartments owned by it, whichever shall first occur, shall be at a rate of not more than \$100 per month and shall be payable semi-annually in advance on January 1 and July 1 of each year. The Developer shall be assessed for only that part of the common expenses incurred during such period which in excess of the sums collected by assessments against apartments sold by the Developer. This clause shall survive the closing.

7. *Title to be conveyed.* The Developer shall convey by warranty deed a marketable or insurable fee simple title to the apartment, subject only to the following exceptions:

(a) The provisions of the declaration, including such regulations and service contracts as shall be in force under the declaration.

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(b) Taxes for the year in which the sale is closed, if not paid.

(c) Restrictions of record and such zoning or other restrictions upon the use of the property as may be imposed by governmental authorities having jurisdiction thereof.

(d) Liens for work done or materials furnished at the request of the Purchaser.

8. *Closing.* (a) This sale shall be closed and the balance of the purchase price paid on or before 15 days after delivery or mailing to the Purchaser of a certificate evidencing the completion of construction. Such certificate shall be made by an architect qualified to practice in Florida and shall certify that the Purchaser's apartment has been completed and equipped substantially in accordance with the manner herein described, and that approval of the apartment for occupancy has been obtained from all governmental bodies of which such approval is required.

(b) The closing will be at the office of the Developer, and title to the apartment shall be conveyed by warranty deed subject only to the exceptions herein stated.

(c) The following expenses will be prorated to the date of closing:

(1) Ad valorem taxes. If the taxes for the year in which the sale is closed are assessed against the property as a whole, then the portion of such taxes apportioned to such apartment shall be the same share as the share in the common elements which is appurtenant to such apartment. Such taxes will be paid by Castelle Association, Inc., as a common expense and the taxes apportioned to such apartment shall be assessed to the Developer and the Purchaser in the sums prorated to them. The Developer covenants that the assessment against it for such taxes shall be secured by a lien against all apartments which the Developer then owns. If the Developer shall own less than three apartments at the time of closing, then at the closing the Developer will deposit in escrow with Castelle Association, Inc., a sum which is 150% of the amount of the Developer's estimated share of such taxes on the entire condominium, which escrow shall be used for the payment of the Developer's share of the taxes, and the balance shall be paid to the Developer. This clause shall survive the closing.

(2) The costs of maintenance and operation of the condominium in the amount of the assessments last made against such apartment, or if none, then the assessments which would have been made if the sale had been closed prior to the last assessment date.

(d) The following expenses will be paid by the Purchaser:

(1) Documentary stamps required to be affixed to the deed.

(2) Recording of deed.

(3) Premium for title guarantee or insurance unless such guarantee or insurance is waived by the Purchaser.

(4) All costs required to be paid by the mortgagee if the Purchaser's apartment is to be mortgaged.

(5) Utility deposits apportioned to said apartment.

9. *Default.* (a) If the Developer shall default in the performance of this agreement, the Purchaser may elect to cancel the same by giving written notice to the Developer of the specified default and of such election before the Developer tenders performance of the omitted act, whereupon all sums paid hereunder by the Purchaser shall be returned to him upon demand. Purchaser's failure to give such notice prior to the Developer's tender of performance shall constitute a waiver of Developer's default.

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(b) If this offer is accepted by the Developer and the Purchaser defaults in the performance of the resulting contract, then the Developer, if the Developer is not in default, at its election may terminate this agreement, in which event the value of the option given to the Purchaser by this agreement and the amount of damages suffered by the Developer because of such default shall be liquidated and paid in the following manner: The liquidated sum to be due to the Developer shall be one-half of all sums paid by the Purchaser upon the purchase price, but not more than 10% of the purchase price. All sums paid upon the purchase price in excess of such liquidated amount shall be paid forthwith to the Purchaser, together with a statement of the Developer's election to terminate the agreement and describing the Purchaser's default. If the liquidated sum is held by Quinn, it shall be paid forthwith to the Developer.

(c) Upon the making of the payments provided in the event of default, both parties shall thereby be released from all further obligations under this agreement.

10. *Nonassignability.* This contract cannot be assigned by the Purchaser without approval of the Developer in writing.

11. *Notice.* The delivery of any item and the giving of notice in compliance with this agreement shall be accomplished by delivery of the item or notice to the party intended to receive it, or by mailing the same within the continental United States by certified mail addressed to the address of the recipient herein stated. Notice or delivery by mail shall be effective when mailed.

12. *Broker.* The Purchaser represents that this sale was made by James Macrae of Miami, Florida, and that no other broker has been employed in this transaction.

In witness whereof this offer is signed this January 15, 2003.

**Advance Payments Made Pursuant
To This Contract May Be Used
For Construction Purposes
By The Developer.**

Purchaser _____ (L.S.)

Dated: January 15, 2003

Receipt

Receipt is acknowledged from the Purchaser of a check in amount of \$10,000, subject to the terms of the foregoing offer.

Quinn Management Corp.

President by _____ (L.S.)

Dated: _____

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Acceptance of Offer

The undersigned, called the Developer in the foregoing offer, hereby accepts the foregoing Offer to Purchase and agrees to sell the apartment to the Purchaser at the price and on the terms and conditions therein set forth.

Castelle Development Corporation

by _____

President

Corporate Seal

Attest:

Secretary

Dated: _____

A.25 Condominium warranty deed

COMMENT

This form illustrates a deed conveying an apartment unit in a condominium. The description of the apartment unit is made only by reference to the condominium declaration, which is a document of public record. It should be noted that the grantee obligates himself to comply with the provisions of the condominium declaration, and especially to pay the assessments levied against his apartment for the operation of the property.

For further information, see Chapters 6, 13, and 16.

FORM

INDENTURE made January 2, 2003, between Castelle Development Corporation, a Florida corporation, hereinafter called the Developer, and Paul Nielsen, of 3000 Seaview Road, Miami, Florida, hereinafter called Nielsen.

The Developer, for and in consideration of the sum of ten dollars and other good and valuable consideration to it in hand paid by Nielsen, the receipt and sufficiency of which is hereby acknowledged, has granted and sold to Nielsen, his successors, heirs, legal representatives, and assigns forever, the following described property:

Apartment 4A in Castelle Apartments, a Condominium, hereinafter called the Condominium, according to a Declaration of Condominium dated December 28, 2002, filed for record on December 31, 2002, and recorded in the Public Records of Dade County, Florida; together with the undivided interest in common elements declared in the Declaration of Condominium to be appurtenant to such apartment.

Nielsen, by acceptance hereof and by agreement with the Developer hereby expressly assumes and agrees to be bound by and to comply with all of the covenants, terms, provisions, and conditions set forth in such Declaration of Condominium, including, but not limited to, the obligation to make payment of assessments for the maintenance and operation of the Condominium which may be levied against such apartment.

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This conveyance is made subject to the following:

1. Real estate taxes for the year 2003 and subsequent years;
2. Applicable zoning regulations and ordinances;
3. All of the terms, provisions, conditions, rights, privileges, obligations, easements, and liens set forth in such Declaration of Condominium.
4. Such covenants, conditions, restrictions, and easements of record, if any, which may now affect the above described property; and
5. All facts which may be shown by an accurate survey of the above described property.

The Developer hereby fully warrants the title to the property, and will defend such title against the lawful claims of all persons.

In witness whereof the Developer has caused this warranty deed to be signed in its name by its President, and its corporate seal to be affixed, attested by its Secretary, the date first above written.

Castelle Development Corporation

By _____

President

Corporate Seal

Attest:

Secretary

(Acknowledgment)



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Appendix Forms: CHECKLISTS AND FORMS

2-Forms Federal Taxes Affecting Real Estate Appendix Forms:.syn

§ Forms.syn Synopsis to Appendix Forms: CHECKLISTS AND FORMS

[B] Real Estate Sales & Exchanges



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Appendix Forms: CHECKLISTS AND FORMS

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[B] Real Estate Sales & Exchanges

B.1 Contract for sale of condominium unit--subject to effective offering plan after conversion from rental apartment building--subject to existing tenancy--plain language

COMMENT

This form is a contract of sale for a condominium unit in an apartment building. The contract is subject to the sponsor obtaining an effective offering plan after conversion of the rental apartment building into a condominium.

Unit purchaser and tenant:

This agreement provides that the purchaser will acquire the condominium unit subject to the rights of an existing tenant. Certain jurisdictions have enacted laws protecting the occupancy of tenants in apartments converted to condominium units, and these laws vary in the jurisdictions which have adopted them. If the applicable law permits the tenant to remain indefinitely, the purchaser will be in the position of a landlord rather than an occupant of the unit. This contract contains a provision that the purchaser will acquire the unit subject to the existing tenancy (paragraph 12). The unit may also be purchased by the existing tenant, or by a third party who intends to purchase the unit vacant, free of any tenancy. This form includes provisions for each of these circumstances.

Disclosure of lead-based paint hazards:

Federal law requires the seller of pre-1978 residential housing to disclose known information to the prospective purchaser on lead-based paint hazards. *See* 42 USC §§ 4851-4856; 40 CFR Part 745 and 24 CFR Part 35, Subpart A. The sales contract must include a lead warning statement and certain disclosure information. *See* discussion in comments to Form B.3, *supra*. A sample lead-based paint sales contract rider, including both disclosure under the federal law and a lead-based paint contingency clause, is included in this chapter at Form B.6, *infra*.

For further information, see Chapters 6, 13, and 16.

FORM

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PURCHASE AGREEMENT

THE PARK CONDOMINIUM

Purchaser's Name: John Addison and Ellen Addison, husband & wife

Address: 235 West Elm St., Staten Island, N.Y. 10079

Apartment Unit No. 5-D in Building E-4

1.	Down Payment _____	\$ 490
2.	Balance of 10% Due _____	\$ 4,410
3.	Amount to be Financed _____	\$39,200
4.	Balance Due at Closing _____	\$ 4,900
5.	Total Purchase Price (1 + 2 + 3 + 4) _____	\$49,000

1. *My agreement to purchase.* As Purchaser, I agree to purchase from you, Park Apts. Co., apartment unit No. 5-D in Building E-4 and the appurtenant interest in the common elements of The Park Condominium for the Total Purchase Price shown on line 5, above. I am delivering to you now my \$490 check, subject to collection, for the Down Payment shown on line 1. When you sign this Agreement you acknowledge receiving this check although you will not then have cashed it.

2. *Balance of total purchase price and Closing Expenses.* (a) *Deposit balance.* Upon the Offering Plan of Condominium Ownership of The Park Condominium (the "Plan") being declared effective, you shall advise me in writing when the balance of 10 percent of the Total Purchase Price is due, as shown on line 2, and I will pay it to you within 15 days after I receive your notice.

(b) *Balance due and costs at closing.* You will also write to me at least 15 days (but not more than 90 days, unless you request an adjournment of Closing as provided in paragraph 3) in advance of my closing to tell me the exact scheduled date of Closing. In that notice, you will inform me that I must give you or anyone you designate, not later than 15 days from the date I receive the notice, my certified check or official bank check for the Balance Due at Closing, as shown on line 4, drawn on a New York City bank which is a member of the New York Clearing House Association. You will, however, offset against amounts due at closing the security deposit you hold for me under my lease, if I am a tenant and am not in default under the lease on the closing date. You will also notify me of the date on which common charges will first be due and payable. In the same notice, you will remind me that I must also pay, within the same time period, (i) the expenses shown in the Plan under "Closing Costs and Adjustments" which are my obligations, plus (ii) any amount I owe you as a result of our apportionment of the real estate taxes and common charges for the apartment, so that you pay those real estate taxes and common charges attributable to any period prior to the midnight before the date of closing and I will pay the rest. You agree to pay at Closing the expenses shown in the Plan which are your obligations.

(c) *Bank financing.* If I am taking advantage of Met Bank financing as permitted in the Plan, I will promptly sign and return all documents and instruments required by Met Bank to complete its financing and pay all expenses due by check

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upon demand by Met Bank, or its authorized representatives. I understand that the form of the note, mortgage, deed, and power of attorney is contained in the Plan. I will also execute any other document or instrument that Met Bank deems necessary to complete its loan.

(d) *Sponsor financing.* If I am unable to obtain Met Bank financing, but am entitled to Sponsor-financing, you will also notify me in writing what expenses relating to the loan are payable by me. In addition, you will send me the required Note, Mortgage, Deed, and Power of Attorney in the form contained in the Plan, as well as all other documents that you, your counsel, or the insurance company deem necessary to assure the validity of your mortgage lien and compliance of the loan with law. I will pay the expenses due by check, made payable to anyone you designate, and will sign and return all documents and instruments in appropriate form for recording to the Selling Agent within 15 days after I receive your notice. I authorize the Selling Agent to complete, date and deliver to you or the title company representative the Note, Mortgage, Deed, Power of Attorney and other documents and instruments that are necessary to properly conclude the transaction.

3. *Delivery of deed and marketable title.* Upon my properly paying you the full amount of the Total Purchase Price, the Closing Costs and Adjustments and expenses (as described in the preceding paragraphs) and delivery of the Deed, Power of Attorney, Note, Mortgage and other required documents and instruments, you will execute the deed to my apartment unit and request the Bank or the Selling Agent, whichever is applicable, to deliver all documents and instruments to The Title Security Insurance Company for recording. The proceeds of the Escrow Account may be used to meet the purchase price and such costs, adjustments, and expenses. The deed will be a standard type of deed known as a bargain and sale deed with covenant against grantor's acts, the form of which is shown in the Plan. In any case, you will not deliver to me the deed to my Apartment Unit until all of the events described in the Plan under "Closing of Title to Units" have occurred. I agree to be bound by the Declaration, By-Laws and Rules and Regulations of the Condominium and the Plan.

You will convey to me good and marketable title in fee simple to my apartment unit without any liens or encumbrances other than those shown in the Plan.

I understand that you have the right at any one or more times, by giving me written notice, to adjourn the scheduled closing date for a period of not more than 180 days.

4. *Recording of deed.* I understand that the deed to my apartment unit will be delivered to the title company representative issuing title insurance to me or to you (if I do not obtain title insurance), so that the deed can be recorded in the Office of the New York City Register, Queens County.

5. *My payments to be held in trust.* All monies received from me by you through your agents or employees will be deposited with Met Bank (the "Escrow Agent") at 13-25 Jay Avenue, Queens, New York, in a special account with or without interest under the name of "Park Condominium Escrow Account" or similar name. These funds will be held on the following terms: (a) if the Plan is declared effective and the Closing takes place under this Agreement, you will be paid the monies due you, and the Selling Agent may satisfy expenses I owe from my previous payments and any interest earned thereon, (b) if the Plan is abandoned or the closing does not take place because you fail to keep your promises under this Agreement, I will be paid the monies and any interest earned thereon, and (c) if I fail to keep my promises under this Agreement, you will be paid the monies (not more than 10 percent of the Total Purchase Price, plus any interest earned thereon). The Escrow Agent will pay out the monies only upon written instructions of the attorneys for the Board of Managers, Conrad, Weis & Bok, who may rely upon your written description of the facts when they give the instructions.

I understand that you will have no obligation to place any monies received from me in an interest-bearing account. You will hold all such monies through your agents or employees in trust in accordance with the provisions of Sections 352-h and 352-e(2-b) of the General Business Law until actually employed in connection with the consummation of my

purchase. I understand that Conrad, Weis & Bok may rely on your written description of the facts when they give instructions to the Escrow Agent.

6. *My mortgage loan.* I will not be obligated to purchase my apartment unit from you unless Met Bank (the "Bank") promises in writing to give me a mortgage loan for the same amount shown on page one of this Agreement. The mortgage loan must provide for repayment in full within no more than 30 years and be on the terms regularly offered by Met Bank. I understand that the actual interest rates to be charged on my Mortgage Loan may not be determinable until approximately five days before you give me the deed to my Unit and I sign the documents for this mortgage loan. I also understand that my application may have to be renewed every 90 days, and I agree to do so. I know that each monthly payment I make will be used first to pay the interest I then owe and second to pay back the amount I have borrowed. I may make payments in addition to these monthly payments in the amounts of repayment of principal that would be due in future monthly payments so that I pay back sooner the amount I have borrowed, but I may have to pay any extra fee for making these additional payments depending upon the type of mortgage loan I select among those offered by the Bank. The sample forms of documents which the Bank will require me to sign for this mortgage loan are contained in the Plan, but I understand that these might be different at closing.

I have signed and given you my application for a mortgage loan, which you will send to the Bank promptly. I agree to supply all information which the Bank requests for this application within five business days and to keep you advised of its status. I authorize you to check the status of my application directly with the Bank, and I will tell you when my application has been accepted or rejected. If 45 days from now, the Bank has not given me its then current written promise to make the mortgage loan as described in this Paragraph (or if a commitment is issued and is subsequently withdrawn), and I give you written notice of this fact, either of us may cancel this Agreement, unless within 30 days after my written notice, you arrange for me to receive from a lending institution (including the Bank) or from you the same type of mortgage loan. If no such mortgage loan is available to me, either of us may cancel this Agreement by written notice no later than five days after the 30-day period expires. In that case, all my payments to you under this Agreement and all interest earned on them will be returned to me. However, you may cancel this Agreement and keep my Down Payment and all interest earned on it if either I do not promptly supply the information required for a mortgage application loan within five days after the information is requested, or I do not accept a written promise from the Bank, any other bank, or you to give me the type of mortgage loan described in this Paragraph.

7. *Your rights if I fail to keep my promises and agreements.* You may keep my payments and any interest earned on them if I fail to do any of the following: (a) to pay when due any portion of the Total Purchase Price when notified, (b) to pay when due closing adjustments and expenses, (c) to execute and return within 15 days any document or instrument needed to complete the transaction, including any mortgage application, note, or mortgage, if I elect financing and, in any case, the power of attorney, deed, and New York State gains tax transferee questionnaire, or (d) to keep any other promise under this Agreement.

If I am in default under my lease or the terms of my apartment tenancy, and if I am now a tenant of the apartment unit that I agree to purchase under this Agreement, or become a tenant of the unit before the closing of title on it, you may also keep any payment made by me on account of the Total Purchase Price (but not more than 10 percent, plus any interest earned thereon). I understand that any default in that situation will be treated also as a default under this Agreement. I further understand that my above promise is a separate and material inducement for you to enter into this Agreement with me.

Before you may keep any payment, however, you must first send me a notice stating that you intend to cancel this Agreement and describing each promise you think I did not keep under it. If I do not cause each promise to be kept within 30 days after your notice is sent, you may keep the payments (but not more than 10 percent of the Total Purchase Price, plus any interest earned on it). After that, neither of us will have any further obligations under this Agreement, the Agreement will be considered cancelled without any further action by either of us, and you may sell the apartment unit to any other person.

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8. *No right to assign this agreement.* I understand that I cannot give or sell my rights under this Agreement to anyone else (except my spouse or my adult children), unless I first obtain your written consent.

9. *Survival of seller's obligations.* After you give me the deed to the apartment unit, your only remaining obligations are those set forth in this Agreement and the Plan.

10. *Agreement subject to plan becoming effective.* This Agreement is contingent upon the Plan being declared effective. The Agreement will be cancelled if (a) the Plan is abandoned or does not become effective within 15 months after the Attorney General issues a letter stating that the Plan has been accepted for filing, or (b) the Plan is declared effective within 15 months after the acceptance letter is issued, but the first deed to an apartment unit in the Condominium is not delivered within 21 months after the letter's issuance. Not later than 45 days after cancellation, I will receive a full refund of all my payments to you under this Agreement and all interest earned on them. After I receive this refund, neither of us will have any claim against the other or any further obligation under this Agreement.

11. *My acceptance of the apartment unit.* I have read the Sponsor's Statement of Condition of the Property. I have also examined the apartment unit and agree to accept it, and all fixtures, machinery, equipment, furnishings, appliances, installations and other personal property in the apartment unit in their present condition, except for reasonable wear and tear and natural deterioration between now and the time you give me the deed to the apartment unit. I understand that because of the amount and power of electricity in the Building I will not be able to install air conditioners or other appliances in my unit unless the Board of Managers permits me to do so.

12. *Purchase subject to rights of tenant in occupancy.* I understand that the apartment unit is now occupied by a tenant under a lease expiring on May 31, 1993 (monthly tenancy) at a rent of \$400 per month. If the tenant does not voluntarily move out when his lease expires or his right to occupancy ends, you will have no obligation to obtain possession for me. I also understand that the apartment unit is subject to the Rent Stabilization Law or Rent Control Law and the Omnibus Housing Act of 1983 (as described in the Plan), and I will have all your rights and obligations under the tenant's lease or tenancy after you give me the deed to the apartment unit, including, without limitation, the right to collect all rents (whether more or less than my common charges and assessments and mortgage payments) and the obligations to comply with the applicable law and to repair and maintain the apartment unit for the benefit of the tenant, and the tenant cannot be evicted except for nonpayment of rent or other default under his lease or tenancy or his refusal to renew his lease in compliance with law. I know I cannot evict the tenant for my own occupancy unless allowed under Section 352-eeee of the General Business Law. In addition, I agree that I (and my successors) shall always use the managing agent of the property to manage my unit. I shall deliver promptly to the managing agent and continue to maintain a fund equal to two months common charges to secure my performance of my obligations, and I shall not subject the tenants to unconscionable rent increases if the apartment unit becomes no longer subject to the Rent Stabilization Law and Rent Control Law. This sale is subject to the tenant's right to continue in occupancy as a nonpurchasing tenant in accordance with Section 352-eeee of the General Business Law and as set forth in the Plan. I represent and warrant I have read Section G of the Plan and understand and accept the risks involved in this purchase.

13. *Designation of managing agent.* If this Agreement is for an apartment not occupied by me, I will designate the managing agent of the Property as my agent to provide to the nonpurchasing tenant now in occupancy all services and facilities required by law, as provided in the Plan.

14. *Purchase for personal occupancy.* If this agreement is for an apartment I do not occupy, I represent to you that I am purchasing the apartment for my personal occupancy or for the occupancy of a member of my immediate family and, if requested, I will promptly deliver an affidavit confirming this to you.

15. *Broker.* I did not negotiate for the apartment unit with any broker other than Broderick & Dey, Real Estate Brokers.

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16. *Receipt of documents.* I received at least 72 hours ago a copy of the Plan. I understand that we are treating the contents of the Plan as if it were included in this Agreement. I have also been given an opportunity to examine the apartment unit, the Building and the Property.

17. *No representations.* I have not relied on any statements made by you or any other person except those contained in this Agreement or the Plan. You will have no liability to me if there is a minor error or inaccuracy in the layout or dimensions of the apartment unit or of the common elements of the Condominium as shown on the floor plans (the "floor plans") certified by Vox & Albans, Architects, on file at the office of the Selling Agent and to be filed in the Office of the Register of the City of New York, County of Queens, so long as the layout and dimensions conform substantially to the floor plans, which I have been given the opportunity to examine.

18. *Plain language.* I have read this Agreement, and I understand it. Under New York law (General Obligations Law Section 5-702), I know that as a consumer I have a right to an agreement written in clear and simple language. You and I both think that this is such an agreement.

19. *Notices.* All notices between us (including requests, consents, and other communications) must be in writing and sent by registered or certified mail, to me, at the address shown on page one of this Agreement, and, to you, at 10 East 59th Street, New York, N.Y. 10022. I will send a copy of any notice I give you to your attorneys, Boone & Davis, at 10 East 39th Street, New York, N.Y. 10016, Attention: John Davis, Esq. Either of us can specify a different address by notifying the other, as provided in this paragraph. A notice shall be considered given on the date it is mailed, except that a notice of an address change shall be considered given when it is received.

20. *Jury waiver.* I waive my right to trial by jury in any action, proceeding, or counterclaim in any way connected with this Agreement or the Plan.

21. *No discriminatory inducement.* If I am a tenant, I confirm that I have purchased the apartment unit in good faith and without fraud, discriminatory repurchase agreements or other discriminatory inducements. If requested to do so, I will promptly deliver an affidavit confirming this to you, together with all other documents or instruments you reasonably request.

22. *Acceptance of this agreement.* This Purchase Agreement shall not be binding on me or the Sponsor until it is accepted, as evidenced by endorsement hereon by the Selling Agent, and a fully signed copy is delivered to me. The Purchase Agreement will be deemed accepted if I am not notified within 20 days of the date hereof whether it has been accepted or rejected. If the Purchase Agreement is rejected within the 20-day period, the Down Payment, together with any interest on it, will be refunded to me within 10 days after the rejection.

23. *Headings.* Headings in this Agreement are for convenience and reference only, and may not be used to interpret or construe its provisions.

24. *Binding effect.* This Agreement shall be binding upon both of us and our respective heirs, legal representatives, and assigns.

25. *Non-waiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of any such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

26. *Governing law.* This Agreement shall be construed in accordance with and governed by the laws of the State of New York.

27. *Counterparts.* This Agreement may be executed in two or more counterparts. Each copy shall be deemed an original, but all of them together shall constitute one and the same instrument.

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28. *Time of essence.* Time is of the essence of this Agreement.

29. *Entire agreement.* All prior understandings and agreements between the parties are merged in this contract, which constitutes the entire agreement between the parties. This contract is entered into after full investigation made by Seller, and neither party relies upon any statement or representation made by anyone unless contained herein.

30. *Definitions.* The term "I" shall be read as "we" if more than one person is a purchaser, in which case our obligations shall be considered joint and several. All the terms used in this Agreement shall have the same meanings as in the Plan.

Dated: June 2, 2002

Purchaser

Purchaser

Accepted:

PARK APTS. CO.,

by: _____

Dated: _____

B.2 Option to purchase--annual increasing payments by optionee--escalating purchase price

COMMENT

This option refers to an annexed form of contract of sale. Since both parties are corporations, there are provisions for the exchange of appropriate corporate resolutions authorizing the execution of the option agreement and the sales contract. This option also restricts the assignment of the option to a parent, subsidiary or merged corporation of the optionee.

Increasing option installments and purchase price:

A most distinctive feature of this agreement is an option price which increases during the option period. This device is used because of the relatively long period during which the option may be outstanding. The option is granted for a total of five years, but the optionee must pay additional amounts on the first, second, third, and fourth anniversaries of the option agreement in order to keep the option alive. The purchase price for the property also is increased on each anniversary date from the date that the option is granted. Unlike the usual option agreement, no portion of the consideration paid for the option is credited toward the purchase price.

Lapse of option:

Upon the failure of the optionee to pay any amount required to extend the option period or upon any breach of its obligations after the exercise of the option, all payments made by the optionee are retained as liquidated damages, which would be considered as ordinary income to the optionor. For the optionee, the damages would be considered as a business expense if the optioned property was intended for use in a trade or business, or for the production of income. Whether a liquidated damage clause will be given effect depends upon applicable state law.

For further information, see Chapter 6.

FORM

OPTION AGREEMENT, executed on July 21, 2002, by and between Mainland Corporation, a Texas corporation having its principal office in the County of Dallas, State of Texas ("Optionor"), and Southwest Lands, Incorporated, a Delaware corporation having its principal office in the County of Dallas, State of Texas ("Optionee").

1. *Grant of option and consideration.* (a) In consideration of the following cash payments, made and to be made, to Optionor by Optionee:

(1) \$5,000 at the time of the execution of this Agreement;

(2) \$7,000 on July 21, 2003;

(3) \$9,000 on July 21, 2004;

(4) \$11,000 on July 21, 2005; and

(5) \$13,000 on July 21, 2006.

(b) Optionor grants and gives to Optionee, for the period of five years from the date of the execution of this Agreement and ending at 10 a.m. on July 21, 2007, the right and option to purchase all that certain tract of land lying and being situated in the City of Arlington, County of Tarrant, State of Texas, more particularly described in the annexed Appendix 1 (the "Property"). Notwithstanding any provision in this paragraph to the contrary, Optionee's exercise of this option shall relieve it from making any required payments to Optionor under this paragraph at any date or dates after the "time of closing" (as defined in paragraph 2 below).

(c) Concurrently with the execution of this option:

(1) Optionor shall deliver to Optionee a certified resolution of Optionor's Board of Directors authorizing (i) Optionor to enter into this option, and (ii) its officers to execute this Agreement and do all other things and execute all other documents required to close this transaction if Optionee exercises its option hereunder; and

(2) Optionee shall deliver to Optionor a certified resolution of its Board of Directors authorizing Optionee to enter into this option and its officers to execute this Agreement.

2. *Notice of exercise.* To exercise this option Optionee must deliver a written notice to Optionor fixing a date not more than 60 days in advance for the closing of title to the Property (the "time of closing"). Concurrently with the exercise of the option, Optionee shall deliver to Optionor a certified resolution of its Board of Directors authorizing the exercise of the option and authorizing its officers to execute all documents and do all things necessary to close this transaction. If this option is exercised, Optionor shall sell and Optionee shall buy Property pursuant to the terms and provisions of the attached Agreement set forth in Appendix 2.

3. *Purchase price.* The total purchase price for the land described in Appendix 1 shall be determined at the time of closing as follows:

(a) \$100,000 if the option is exercised on or before July 20, 2003;

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- (b) \$115,000 if the option is exercised after July 20, 2003 and on or before July 20, 2004;
- (c) \$130,000 if the option is exercised after July 20, 2004 and on or before July 20, 2005;
- (d) \$140,000 if the option is exercised after July 20, 2005 and on or before July 20, 2006; and
- (e) \$150,000 if the option is exercised after July 20, 2006 and on or before July 21, 2007.

The total purchase price, as shown above, shall be paid to Optionor in cash at the time of closing. Optionee shall not receive any credit against the purchase price for the amounts paid for this option.

4. *Payment default; liquidated damages.* If Optionee shall fail to pay promptly any payment required under paragraph 1, this option shall automatically terminate on the date specified for the payment and this Agreement shall no longer be effective. In that event, or if Optionee in any manner breaches its obligations hereunder after exercising the option, Optionor may keep all previous payments made for the option as liquidated damages. Both parties agree that the total amount of such payments is a reasonable approximation of the damages that Optionor would sustain if damages were readily ascertainable.

5. *No assignment by optionee.* Optionee may assign this option to any of its subsidiary or parent corporations, to any corporation into or with which Optionee or its subsidiary or parent corporation is duly merged or consolidated, or to anyone to which all or substantially all of Optionee's assets are sold. Except as expressly permitted herein, any direct or indirect assignment of this option shall automatically terminate the option and all of Optionee's rights hereunder.

6. *Binding effect.* This option shall be binding upon and inure to the benefit of the parties and their respective representatives, successors, and assigns.

7. *Headings.* Headings in this Agreement are for convenience only and shall not be used to interpret or construe its provisions.

8. *Governing law.* This Agreement shall be governed by and construed in accordance with the laws of the State of Texas.

9. *Counterparts.* This Agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

10. *Time of essence.* Time is of the essence of this agreement.

11. *Entire agreement.* This Agreement supersedes all prior agreements between the parties with regard to the subject matter hereof and there are no other understandings or agreements between them.

12. *Notices.* All notices hereunder shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

In witness whereof the parties have duly executed this Agreement on the day and year first above written.

Attest:

Mainland Corporation

by _____

Secretary

Vice President

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Attest: _____ Southwest Lands, Incorporated
 _____ by _____
 Secretary President

[Acknowledgments]

B.3 Contract for sale of residence--purchase money mortgage--title subject to existing mortgage--mortgage contingency--settlement adjustments

COMMENT

This contract can be used for a variety of real estate sale transactions. Although practices and legal requirements vary from jurisdiction to jurisdiction, this contract contains many useful sections for dealing with common problem areas, such as financing, title conditions, settlement adjustments, and pest inspections.

Gain or loss recognized on sale:

Most dispositions of real estate result in the realization and recognition of gain or loss to the seller. Gain or loss is the difference between the adjusted basis of the property sold and the consideration received by the seller. The date of the completion of the transaction usually fixes the tax year in which it must be reported by the seller. The nature of the property determines whether capital gain (or loss) or ordinary income (or loss) is realized by the seller.

Time of sale:

The execution of a contract of sale does not in itself result in the realization of gain or loss. Usually, the sale does not occur until the transaction is completed. Generally this is when title passes. In some special situations the transaction may be completed before title passes, for example, when possession is transferred to a buyer under a contract of sale. The date of the completion of the transaction determines the holding period of property.

Adjusted basis:

A seller's adjusted basis of his property, generally, is his original basis (usually cost, which includes the mortgages involved in acquisition) adjusted for improvements, other capital expenditures and for cost recovery or depreciation prior to the sale, if any. Cost recovery or depreciation is taken into account only with respect to real property used in a trade or business or held for the production of income, but not for property used exclusively as a residence. The consideration received by the seller is the cash plus the fair market value of other property received, such as the purchaser's obligations to pay in the future, plus outstanding mortgages which the purchaser assumes or to which the property is subject.

Capital or ordinary gain or loss:

Whether the gain or loss on the sale of real property is capital or ordinary depends upon whether the property is: (1) a capital asset; (2) "Section 1231" property; or (3) dealer property. In general, a taxpayer's own residence is a capital asset, so that gain on its disposition ordinarily qualifies as capital gain.

Deductible and nondeductible loss:

A loss incurred by an individual on the sale of real property is deductible only if the property was held by him in his trade or business or as an investment for a profit. A loss on the sale of the taxpayer's own residence generally is not deductible. However, if the property is leased by the taxpayer prior to its sale, a loss may be deducted if the property is deemed to have been converted into an investment for profit. The basis for determining the loss is the value of the property on the date of its change to rental use, adjusted for cost recovery allowances. Cost recovery is computed on the cost of the property or on its value on the conversion date, whichever is less. When the property is held partly for personal use and partly for income producing purposes, a proportionate part of the loss on its sale is deductible. The deductible loss is computed by apportioning cost, selling price, cost recovery or depreciation, and selling expenses, as if there were two separate transactions.

Reporting gain or loss:

An important question in connection with gain or loss on a sales transaction is the time when it is to be reported. When the purchase price is fully paid in cash, gain or loss is reported when the transaction is completed. However, there are two types of sales in which part or all of the payment is not made at the time of the sale. One class is that which qualifies as an installment sale. The second class includes deferred payment sales.

Information reporting of real estate transactions:

The attorney or title company responsible for closing title is responsible for reporting the real estate transaction to the IRS. In addition a statement must be provided to the customer before January 31 of the year following the closing. If an attorney or title company is not involved in the closing, the information reporting is the responsibility of the mortgage lender.

Plain language laws apply to consumer transactions:

New York, and a few other jurisdictions, have adopted plain language laws which generally require contracts for consumer transactions to be written in plain language. Plain language laws generally provide for damages and penalties for violations; however, such violations do not render the underlying contract void or voidable and are not a defense to an action under the contract. New York's law, similar to other plain language laws, requires the consumer contract to be written in a clear and coherent manner using words with common and everyday meaning, with appropriate divisions and captions. The law applies if the subject of the contract involves money, property, services or leases of personal property used primarily for personal, family or household purposes and a consumer is a party to the agreement. The law does not apply, however, to agreements involving amounts over \$50,000, which exempts most real estate transactions. New York General Obligation Law Section 5-702. Other jurisdictions with plain language laws, however, may not include such an exemption. Because the price exceeds \$50,000, the following contract is not a plain language agreement.

Disclosure of lead-based paint hazards:

Federal law requires the seller of pre-1978 residential housing to disclose known information to the prospective purchaser on lead-based paint hazards. See 42 USC §§ 4851-4856; 40 CFR Part 745 and 24 CFR Part 35, Subpart A. The sales contract must include a lead warning statement and certain disclosure information. The information required by law includes both specific information about the property being sold and general information about lead-based paint hazards. The seller must disclose known lead-based paint and lead-based paint hazards and provide available records and reports to the purchaser.

The seller also must give the purchaser the pamphlet, developed by EPA, HUD, and the Consumer Product Safety Commission (CPSC), titled "Protect Your Family From Lead in Your Home." The purchaser must be given a 10-day period to conduct a lead-based paint inspection or risk management at the purchaser's expense. The parties have flexibility to negotiate the key terms of the evaluation. Finally, the sales contract must include certain notification and disclosure language. The law also does not invalidate a sales contract that does not include the required disclosure; however, any person who violates the lead disclosure requirements may be subject to civil and criminal penalties, as well as treble damages in a private civil suit. A sample lead-based paint sales contract rider, including both disclosure under the federal law and a lead-based paint contingency clause, is included in this chapter at Form B.6, *infra*.

For further information, see Chapters 2 and 9.

FORM

CONTRACT OF SALE made May 1, 2002, between John Curran, residing at 134 E. 67th Street, New York, New York ("Seller"), and Harrison Whitman, residing at 200 Chester Street, New York, New York ("Purchaser").

1. *Sale*. Seller shall sell, and Purchaser shall purchase the property, including all buildings and improvements thereon, erected, situated, lying, and being in the Borough of Manhattan, City, County, and State of New York, more particularly described as follows (the Premises):

(Insert description)

2. *Street rights*. This sale includes all the right, title, and interest, if any, of Seller in and to any land lying in the bed of any street, or highway opened or proposed, in front of or adjoining the Premises, to the center line thereof. It also includes any right of Seller to any unpaid award by reason of any taking by condemnation and/or for any damages to the Premises by reason of grade of any street or highway. Seller shall deliver to Purchaser on demand, at or after closing, and at no additional cost to Purchaser, any document that Purchaser may require in order to collect the award and damages.

3. *Personal property*. All fixtures and articles of personal property, attached to or used in connection with the Premises, are included in the sale unless specifically excluded. Seller represents that the fixtures and personal property are paid for and owned by him free and clear of all security interests or liens other than the existing mortgage(s). The following fixtures and personal property are included in this sale: heating, air conditioning, plumbing, electrical and lighting fixtures, bathroom and kitchen fixtures and cabinets, storm windows and doors, screens, shades, venetian blinds, awnings, window boxes, mail boxes, wall-to-wall carpets, mantels, sump pumps, well pump, shrubbery, fences, exterior sheds, ranges, refrigerators, freezers, washing machines, clothes dryers, dishwashers, garbage disposal units, and drapery and curtain hardware and rods.

Not included in this sale are the following: furniture, household furnishings, drapes, curtains, microwave oven, automatic garage door openers, fireplace equipment, and trash compactor.

4. *Purchase price*. The purchase price is \$250,000, payable as follows:

By check on the signing of this contract, \$ 25,000
subject to collection, to be held in escrow by Seller's attorney

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By allowance for the principal amount remaining unpaid on the Existing Mortgage _____	\$	110,000
By a Purchase Money Note and Mortgage from Purchaser, as assigns, to Seller _____	\$	60,000
Balance due and payable at closing _____	\$	55,000

5. *Purchase money mortgage.* The Purchase Money Note and Mortgage shall be drawn on the standard forms of Central Title Company by Seller's attorney at Purchaser's expense. Purchaser shall pay the mortgage recording tax, recording fees, and the attorney's fee of \$500 for preparation of the mortgage. If this sale is subject to an Existing Mortgage, the Purchase Money Note and Mortgage will state that it is subject to the prior lien of any Existing Mortgage, and to any extension or modification of the Existing Mortgage made in good faith. If any required payments are made on an Existing Mortgage between now and closing, which reduce the unpaid principal amount of an Existing Mortgage below the amount shown in this agreement, the balance of the price payable at closing will be adjusted.

6. *Existing Mortgage.* The Premises will be conveyed subject to the lien of an Existing Mortgage as follows: Mortgage now in the unpaid principal amount of \$110,000 and interest of 12 percent per year payable in monthly installments of \$1,484.35, which include principal, interest, and real property taxes, and with any balance of principal and interest being due and payable on July 31, 2021. If there is a mortgage escrow account that is held for the payment of taxes, insurance or other expenses, Seller will assign it to Purchaser, if it can be assigned, and Purchaser will pay the amount of the escrow account to Seller at the closing. Seller states that:

- (a) The principal amount shown above for the existing mortgage is reasonably correct and only the payments required by the Existing Mortgage will be made;
- (b) No Existing Mortgage contains any provision allowing the holder of the mortgage to require its immediate payment in full or to change any interest rate or other terms by reason of the transfer of title or closing; and
- (c) Any Existing Mortgage will not be in default at the time of closing.

7. *Title conditions.* The premises are sold and are to be transferred subject to:

- (a) Laws and government regulations that affect the use and maintenance of the Premises, if they are not violated by the buildings and improvements existing on the Premises or by their current use;
- (b) Consents by Seller or any former owner of the premises for the erection of any structure or structures on, under, or above any street or streets on which the premises abut;
- (c) Encroachments of stoops, areas, cellar steps, trim, and cornices, if any, upon any street or highway;
- (d) Any state of facts an accurate survey may show, provided that it does not render title unmarketable; and
- (e) Any covenants and restrictions of record, if they are not violated by existing use of the property.

8. *Mortgage estoppel certificate.* If there is a mortgage on the premises Seller shall deliver to Purchaser at closing a certificate dated not more than 30 days before closing signed by the holder of each Existing Mortgage, in form for recording, certifying the amount of the unpaid principal and interest, date of maturity, and rate of interest. Seller will

pay the fees for recording the certificate.

9. *Violations.* Seller shall comply with all notes or notices of violations of law or municipal ordinances, order, or requirements noted in or issued by any governmental department having authority as to lands, housing, buildings, fire, health and labor conditions affecting the premises at the date of this contract, and the premises shall be conveyed free of them. This provision shall survive closing. Seller shall furnish Purchaser with an authorization to make the necessary searches. If the Premises are located within New York City, Seller shall discharge at closing all obligations affecting the Premises incurred under the Administrative Code of the City of New York and payable in money. This provision shall survive closing.

10. *Assessments.* If, at the time of closing, the Premises are affected by any assessment which is or may become payable in annual installments, and the first installment is then a lien, or has been paid, for the purposes of this contract all the unpaid installments shall be deemed to be due and shall be paid by Seller at closing.

11. *Items to be apportioned.* The following are to be apportioned as of midnight of the day before closing:

- (a) Rents as and when collected;
- (b) Interest on existing mortgage(s);
- (c) Premiums on existing transferable insurance policies or renewals of those expiring before the closing;
- (d) Taxes, water charges, and sewer rents, if any, on the basis of the fiscal year for which assessed;
- (e) Fuel, if any; and
- (f) Vault charges, if any.

If the closing occurs before a new tax rate is fixed, the apportionment of taxes shall be upon the basis of the old tax rate for the preceding period applied to the latest assessed valuation.

If there is a water meter on the premises, Seller shall furnish a reading to a date not more than 30 days before closing, and the unfixed meter charge and sewer rent, if any, shall be apportioned on the basis of the last reading.

All errors or omissions in computing apportionments of any of the above items at closing shall be corrected, and this provision shall survive closing.

12. *Lien of purchaser.* All money paid on account of this contract and the reasonable expense of the examination of the title to the premises and of any survey and survey inspection are made liens on and are collectible out of the Premises. However, the lien shall not continue if Purchaser shall default in the performance of this contract.

13. *Purchaser's credit for unpaid items.* As an adjustment to the purchase price, Seller may credit Purchaser with the amount of all unpaid taxes, assessments, water charges, and sewer rents, plus any interest and penalties, to a date not less than five days after the closing, if the official bills, computed to that date, are produced at closing. If Seller is required to pay and discharge at closing anything else affecting the sale, he may use any part of the balance of the purchase price to discharge the same. Alternatively, Seller may deposit money with Purchaser's title insurance company to assure discharge, but only if the company will insure Purchaser's title free and clear of the matter or insure against its enforcement against the Premises. Upon request made within a reasonable time before closing, Purchaser shall provide separate certified checks as requested to assist in clearing these matters.

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14. *Judgment affidavit.* If a title examination discloses judgments, bankruptcies, or other returns against other persons having names the same as or similar to that of Seller, Seller will deliver to Purchaser at closing an affidavit showing that they are not against Seller.

15. *Default by seller.* If Seller is unable to convey title in accordance with the terms of this contract, his sole liability will be to refund to Purchaser the amount paid on account of this contract, plus all charges made for examination of title and all additional searches made under this contract and survey and survey inspection charges. Upon such refund and payment this contract shall be considered cancelled, and neither party shall have any further rights against the other by reason of this contract or transaction.

16. *Closing, deed.* The term "closing" as used in the contract means the settlement of the parties' obligations hereunder to each other. Closing includes the payment of the purchase price to Seller and the delivery to Purchaser of a bargain and sale with covenants against grantor's acts deed in the proper statutory form for recording to transfer full ownership, fee simple title, to the Premises, free of all encumbrances except as stated in this contract. The deed will contain a covenant by Seller required by Section 13 of the Lien Law.

If Seller is a corporation, it will deliver to Purchaser at closing (a) a resolution of its Board of Directors authorizing the sale and delivery of the deed, and (b) a certificate of its Secretary or other authorized officer certifying the resolution and stating the facts showing that the transfer conforms with the requirements of Business Corporation Law Section 909. The deed will contain a recital sufficient to establish compliance with that Statutory section.

The closing will take place at the office of Purchaser's lending institution at 10:00 A.M. on July 1, 2002.

17. *Title.* Seller shall give and Purchaser shall accept any title that a reputable title company which is a member of the New York Board of Title Underwriters will be willing to approve and insure at standard rates with their standard form of title policy, subject only to the matters specifically excepted in this contract.

18. *Payments by acceptable funds.* All money payable under this contract shall be paid, unless otherwise specified, as follows:

(a) Cash, but not over \$1,000,

(b) Good certified check of Purchaser, or an official check of any bank, savings bank, trust company, or savings and loan association having a banking office in New York State, payable to the order of Seller, or to the order of Purchaser duly endorsed to the order of Seller in the presence of Seller or his attorney,

(c) Money other than the purchase price, payable to Seller at closing, may be by Purchaser's check up to the amount of \$500, or

(d) As Seller or his attorney otherwise agrees in writing.

19. *Risk of casualty loss.* Seller assumes the risk of loss or damage to the premises by fire or other casualty until delivery of the deed.

20. *Broker.* Purchaser has not dealt with any broker in connection with this sale other than Wilson Real Estate & Company. Seller shall pay the broker the commission earned under a separate agreement.

21. *Transfer and recording taxes.* Seller will deliver a certified check at the closing payable to the order of the appropriate State, City or County officer in the amount of any applicable transfer tax, recording tax, or both, payable by reason of the delivery or recording of the deed, together with any required tax return. Purchaser shall duly complete the

tax return and cause the check and the tax return to be delivered to the appropriate officer promptly after closing.

22. *"As is" condition.* Purchaser has inspected the buildings on the Premises and the personal property included in this sale and is fully acquainted with their condition. Purchaser shall purchase the Premises, buildings and personal property "as is" and in their present condition subject to reasonable use, wear, tear and natural deterioration between now and closing. Purchaser may, after reasonable notice to Seller, inspect them before closing.

23. *Mortgage contingency.* This contract is conditioned upon Purchaser's ability to obtain, at his expense, a conventional mortgage loan in the principal amount of \$50,000, to be amortized over a period of not less than 25 years, with interest at the prevailing rate at the time of closing. Purchaser shall with due diligence apply to a lending institution or institutions for such a loan and fully cooperate with their procedures in the processing thereof. Purchaser shall have 45 days from the date hereof to obtain a firm commitment for the mortgage loan. If Purchaser does not receive such commitment before the expiration of such period, either party may cancel this contract. Cancellation shall be in writing, by certified mail. Upon cancellation, all money paid hereunder by Purchaser shall be returned to him, and neither party shall have any further rights or obligations hereunder with respect to the other party.

24. *Pest inspection.* Purchaser shall, at his expense, obtain a termite inspection of the Premises within ten days after the date hereof. If the inspection report indicates the presence of termite infestation, Seller may either eliminate the infestation or cancel the contract by returning Purchaser's down payment. If Seller decides to do either, he shall give Purchaser appropriate notice within ten days after the termite inspection report is received. If notice is not given within the ten day period, Seller shall eliminate the reported infestation at his expense. If Seller does not receive the termite inspection report within 15 days after the date hereof, this paragraph shall be unenforceable and void.

25. *Entire agreement.* All prior understandings and agreements between the parties are merged in this contract, which constitutes the entire agreement between the parties. This contract is entered into after full investigation made by Seller, and neither party relies upon any statement or representation made by anyone unless contained herein.

26. *Oral modification.* No provision of this contract may be modified or waived unless in writing and signed by the party against whom the enforcement of such modification or waiver is sought.

27. *Binding effect.* This contract shall be binding upon and inure to the benefit of the parties hereto and their respective executors, administrators, legal representatives, heirs, successors, distributees, and assigns.

28. *Non-waiver.* No delay or failure by either party to exercise any right under this contract, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

29. *Headings.* Headings in this contract are for convenience only and shall not be used to interpret or construe its provisions.

30. *Governing law.* This contract shall be construed in accordance with and governed by the laws of the State of New York.

31. *Counterparts.* This contract may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

32. *Time of essence.* Time is of the essence of this contract.

33. *Notices.* All notices hereunder shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

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In witness whereof this contract has been duly executed by the parties.

Witness:

Purchaser

Seller

(Acknowledgments)

NOTICE:

NO REPRESENTATION IS MADE THAT THIS CONTRACT FOR THE SALE AND PURCHASE OF REAL ESTATE COMPLIES WITH THE PLAIN ENGLISH LAW, SECTION 5-702 OF THE GENERAL OBLIGATIONS LAW OF NEW YORK. CONSULT YOUR LAWYER BEFORE SIGNING IT. B.4 Contract for construction and sale of new home--builder's warranty of major systems--liquidated damages for seller's breach--closing after construction completed

COMMENT

This form is for the construction and sale of a single family home. It includes paragraphs which reflect the interests of the builder-seller, and others which are directed toward the purchaser's interests.

New residential construction warranties:

In almost all states, new residential construction is subject to statutory or common law implied warranties as to condition, habitability or fitness for its intended purpose. Such implied warranties apply to the sale of completed new homes and well as to those under construction at the time of the contract, and usually survive the passing of title. In states where implied warranties do not survive the closing, the purchaser should attempt to negotiate a provision setting forth the seller's liability for defects in construction after the closing.

In general, statutory provisions regarding the condition of newly constructed homes presume certain warranties regarding workmanship and fitness for habitation to be implied in the contract of sale unless they are expressly waived. For example, under such a statute, there may be warranties for a specified or reasonable period of time that the new home will be free from defects due to unskillful construction; that the plumbing, electrical, heating, cooling and ventilation systems will be free from defects due to unskillful installation; and that the home will be free from material defects. In some states, such statutory provisions coexist with a common law implied housing merchant warranty of habitability or fitness.

In most states, the parties may expressly disclaim implied warranties for new construction and substitute specific limited warranties. In this form, there is no express disclaimer of implied warranties, so the specific warranties expressly made in the contract are presumably in addition to implied warranties as to condition, habitability or fitness for intended purpose.

Warranty of major systems by builder:

The builder, in this form, agrees to be responsible for the proper operation of the heating, plumbing, electrical and other major systems for a period of one year. The warranty also extends to roof and basement water leaks. (See paragraph 29 of the form.) This warranty, which clearly benefits the buyer, is not considered a standard provision in new construction contracts. However, similar warranties are included in new home agreements if the builder is willing to take on this additional obligation. This form also includes an agreement by the builder to assign to the buyer any warranties given by appliance suppliers or other parties involved in construction. (See paragraph 25 of the form.)

Liquidated damages for seller-builder's breach:

Another nonstandard provision in this contract is the seller's obligation to pay a specified amount of liquidated damages to the buyer if the seller fails to perform or otherwise breaches the contract. (See paragraph 30 of the form.) A more usual provision is for the seller to return the purchaser's deposit and other money advanced on the contract and a release of the parties. A liquidated damages clause, however, protects the purchaser from the risk of the seller refunding the deposit and selling the new home to a third party for a higher price. Although the seller may be liable for damages in such a case, depending on the contract terms and local law, a liquidated damages provision is more likely to encourage the builder to complete the transaction with the purchaser.

Closing date:

In this form the closing date is agreed upon, but it can be adjourned or advanced based on the completion of construction. (See paragraphs 19, 20, 21, and 33 of the form.) Generally, a builder requires this flexibility in setting the closing date, rather than a set closing date with no adjournments allowed, or a time of the essence closing date. There are numerous possible causes for construction delays: material delivery delays, unavailable subcontractors, bad weather, etc. As additional protection to the builder, cancellation of the contract is allowed if essential construction materials or utility hook-ups become unavailable, or if local ordinances, regulations, or approvals change to bar use of the property for a single family dwelling. (See paragraphs 14 and 18 of the form.)

Additional construction contract terms:

Other terms and conditions in this agreement deal with issues which arise in new construction situations. For example, this contract allows the purchaser to inspect the property during construction and order changes in the work, subject to the builder's right to adjust the price. (See paragraph 23 of the form.) This not only allows the purchaser, or the purchaser's architect or other agent, to see that construction is done according to plans, but also permits changes if they are desirable or necessary.

Because the property will have an increased assessed value for real estate tax purposes after the building is completed and approved, the real estate taxes will increase. This agreement provides that the tax adjustment at the closing will be based on the assessed value as fully determined, even if this determination is made after the closing. (See paragraph 16 of the form.)

For further information, see Chapters 2 and 9.

FORM

CONTRACT OF SALE made September 15, 2002, between Southshore Builders, Inc., a New York corporation having an office at 100 Front Street, Bay Shore, New York ("Seller") and James Perry, residing at 80 Fifth Street, Babylon,

2-Forms Federal Taxes Affecting Real Estate [B]

New York ("Purchaser").

1. *Sale.* Seller agrees to sell, and Purchaser agrees to purchase, the property (the "premises" or "property") described as follows:

(Insert description)

2. *Street rights, easement.* This sale includes all of Seller's right, title, and interest of, in, and to the land lying in the bed of the street, or highway in front of and adjoining the premises to the center line thereof, if such street, or highway in front of and adjoining the premises is, at the time of closing of title, dedicated to, and under maintenance by, the town, city, village, or other municipality in which the premises are situate. If at the time of title, such street or highway is not thus dedicated and maintained, Seller shall grant to Purchaser a good and sufficient easement of ingress and egress to and from the nearest public highway.

3. *Construction of dwelling.* Seller shall, at its expense, erect and complete a one family dwelling on the premises substantially similar to the Model House Type A on exhibit by Seller. Such dwelling shall be constructed in accordance with the requirements as to materials and workmanship of the municipality where it is or will be located, and with the requirements of the lending institution which makes the mortgage loan to Purchaser. Seller reserves the right to make changes or substitutions, or both, in the construction as required, authorized, or approved by Purchaser's lending institution. Seller shall determine the exterior color and design to fit into the general pattern of the development.

4. *Property and work included in sale.* All furniture and furnishings in the Model House are for exhibition purposes only and are not included in this sale. Except as otherwise specifically provided in this contract, Seller shall, at its expense, furnish and perform the following:

(a) Grade the premises and landscape the area in front of the house.

(b) Furnish and install a four-burner range, or if Purchaser furnishes a range before the title closing, install the same and allow Purchaser \$200 as an adjustment.

(c) Furnish and install kitchen cabinets, inlaid linoleum on kitchen floor, electrical fixtures, and plumbing and heating plants and fixtures.

(d) Within ten days of notification, Purchaser shall select wallpaper at a place to be designated by Seller or Seller's painting contractor, at a list price of \$9.50 per roll. The wallpaper will be installed at Seller's expense. If Purchaser selects a more expensive wallpaper he shall pay the additional cost of the wallpaper and of the painting contractor for installing it. Unless the parties specifically agree otherwise, Purchaser may not select more than one design of wallpaper for the walls in any one room.

5. *Purchase price.* The purchase price of the property is \$240,000, payable as follows: \$24,000 on the signing of this contract, receipt of which is acknowledged (subject to collection, if made by check), and \$216,000 in cash, or by good certified or savings bank check or the proceeds of the mortgage loan upon delivery of the deed.

6. *Mortgage loan.* Purchaser shall make diligent, truthful, and proper applications to lending institutions designated by Seller for a loan to be secured by a first mortgage against the premises, and without delay furnish such verifications of bank accounts and employment, and all other instruments or information required by the lending institutions in processing Purchaser's application for the following type of loan:

A first mortgage in the amount of \$192,000, to run for a period of 30 years, to bear interest at the prevailing rate, and to

be payable in monthly installments. The installments may include amortization of principal, interest, taxes, water rates if not a private company, fire and other hazard insurance premiums, and all other provisions required by the lending institution.

7. *Mortgage commitment conditions.* If the application for the mortgage loan is approved and commitment issued, Purchaser shall execute, acknowledge, and deliver any bond, mortgage assumption, extension, and modification agreements, affidavits, statements, or other instruments that are necessary or required by the lending institution to properly place the mortgage loan and any mortgage insurance. If the mortgage loan is granted in a reduced amount and the reduced amount is not more than \$6,000 less than the amount specified for such mortgage loan, Purchaser shall nevertheless accept the mortgage loan in the reduced amount, but the amount of cash to be paid on the closing of title shall be increased by the amount of the reduction. If the lending institution refuses to approve the application for the reduced amount and upon the terms and conditions above described, this contract shall become null and void and upon refunding the deposited money without interest both parties shall be released from any liability under this contract.

8. *Mortgage application.* Purchaser shall make diligent, truthful, and proper application to a lending institution designated by Seller, and without delay furnish all verifications of bank accounts, employment, and other instruments or information required by the lending institution in processing Purchaser's application for the mortgage loan.

9. *Subordination to building loan mortgage.* All terms and provisions of this contract are and shall be subject and subordinate to the lien of all present or future building loan mortgages and advances made thereon, without the execution of further legal documents by Purchaser.

10. *Mortgage costs and fees.* Seller shall pay the following costs and fees in connection with the mortgage loan: title examination fee and title policy premium to insure the mortgagee; attorney's fees for drawing the mortgage instruments; mortgage taxes; recording fees of the mortgage instruments; and survey, inspection, and approval fees. Purchaser shall pay Seller, at the time of closing title, the sum of \$1,200, to cover all of the foregoing costs and fees advanced by Seller. In addition, Purchaser shall pay the lending institution at title closing all origination, appraisal, and service charges and all points in connection with the mortgage loan.

11. *Closing adjustments.* Purchaser shall apportion with Seller and pay all taxes, water rates, and insurance premiums on existing policies determined to be due at closing of title. Purchaser shall also make the usual and required adjustments with and prepayments to the lending institution.

12. *Closing before completion.* The fact that the dwelling or its environs are not fully completed at the time set by Seller for closing of title shall not constitute an objection to the closing if Purchaser's lending institution issues an inspection report, Seller deposits an escrow fund with the institution (if the report so requires), and a certificate of occupancy has been issued for the dwelling.

13. *Title exceptions.* Purchaser shall accept the premises subject to:

(a) Municipal building restrictions and regulations and all amendments and additions in effect at the date of closing of title.

(b) Any state of facts an accurate survey may show if title is not rendered unmarketable thereby.

(c) Encroachments of stoops, area ways, steps, trim and cornices, retaining walls, party walls and extensions thereof, if any.

(d) Sewer, water, electric, gas, telephone, railroad, and other public utility consents and easements now or hereafter recorded.

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(e) Covenants, agreements, and restrictions now or hereafter recorded against or affecting the premises if they do not prohibit the erection or maintenance of the structures as a single family residence.

(f) Local, municipal, town, county, and state zoning ordinances and resolutions if they do not prohibit use of the property as a single family dwelling.

14. *Local ordinances; approvals and regulations contingency.* If at any time on or before closing of title any zoning or building ordinance or regulation, or required approval, prohibits or will prohibit Purchaser from using the property as a single family dwelling, this contract shall become null and void, Seller shall return to Purchaser the amount paid under the contract, and neither party shall have any further obligation or liability to the other by reason of hereof.

15. *Assessments.* If, upon delivery of the deed, all or any part of the premises is or has been affected by an assessment or assessments which are or may become payable in annual installments, and the first installment is then a charge or lien or has been paid, for the purpose of this contract all the unpaid installments of the assessments, including those which are to become due and payable after delivery of the deed, shall be deemed to be due and payable and to be liens upon the premises, and shall be paid and discharged by Seller upon delivery of the deed.

16. *Unpaid or unassessed taxes.* The existence of unpaid taxes at closing of title shall not constitute an objection to title if Seller deposits a sufficient amount with the title company and the company insures against the collection of such taxes from the premises. If the closing of title occurs before the tax rate is fixed, the tax apportionment shall be made when the valuation is fully determined, and this sentence shall survive delivery of the deed. The parties intend that the apportionment of taxes be based on the assessed value of the property with the completed dwelling and other improvements.

17. *Seller's inability to deliver title.* If for any reason Seller is unable to deliver title to the premises in accordance with this contract, Seller's liability shall be limited to the return of Purchaser's payments together with the net bulk rate cost of title examination without title insurance as actually charged to Purchaser by the title company engaged in making a search of the premises for the lending institution. Upon the return of such sum, this contract shall be and become null and void.

18. *Seller's inability to obtain construction materials.* Seller shall endeavor to complete the construction of the dwelling on the premises before the date set for the closing of title. Nevertheless, Seller may cancel this contract by forwarding its check in the full amount paid by Purchaser on the execution of this contract, together with a notice in writing, addressed to Purchaser if any of the following events occur: (a) a governmental bureau, department, or subdivision imposes restrictions on the manufacture, sale, distribution, or use of materials necessary in the construction of residential housing, (b) Seller is unable to obtain materials from its usual sources due to strikes, lockouts, war, military operations, abnormal prices and requirements, or National emergencies, or (c) the installation of public utilities is restricted or curtailed.

19. *Adjournment of closing.* Closing of title shall be adjourned to a date fixed by Seller if final action on the mortgage applications is not taken, final inspection or other necessary instruments or reports are not made or issued, or the dwelling is not ready for occupancy at the date set for title closing. However, the adjourned date shall not be later than one month after the dwelling is ready for occupancy and all necessary reports, inspections, and instruments are made or issued.

20. *Construction delays; adjourned closing.* The closing date shall be extended for up to one month after the dwelling can be completed, as provided above, if completion of the dwelling is delayed due to inclement weather; strikes, lockouts, or other disputes affecting either Seller or any of its suppliers of material or labor; delay in issuance of certificates, permits, or licenses; delayed inspections; acts of war or civil commotion; emergency proclamation;

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governmental regulations; changes ordered by Purchaser in the construction; or any reason beyond Seller's control.

21. *Early completion and closing.* If the house is completed before the closing date specified herein, Purchaser shall accept title five days after he receives written notice thereof from Seller's attorneys.

22. *Unauthorized possession; purchaser's default.* Purchaser shall in no event take possession of the premises before delivery of the deed and full compliance with the terms of this contract. If Purchaser violates this provision, Seller may dispossess him from the premises as a squatter and intruder by summary proceedings. If Purchaser fails to take title at closing or there is an unauthorized possession, this contract shall be deemed cancelled without further notice by Seller, and the amount paid hereunder shall belong to Seller as liquidated damages.

23. *Inspection by purchaser; change orders.* Purchaser or his agent shall have access to the dwelling at reasonable times during progress of the construction for the purpose of examining the work. Purchaser may order reasonable changes in the work, and the purchase price shall be adjusted accordingly. All such change orders and price adjustments shall be in writing and signed by Purchaser.

24. *Certificate of occupancy, permits.* On the closing of title, Seller shall deliver to Purchaser a certificate of occupancy issued by the proper authorities, and the certificate shall be in full force and effect at that time. Seller shall secure all permits and licenses, and pay all fees, necessary for construction of the dwelling.

25. *Appliance warranties and operating systems.* Seller will transfer to Purchaser all warranties given to Seller by any contractor, subcontractor, supplier, or third party for any portion of the building, fixtures, or appliances included in this sale. At the closing date, all water, heating and electrical services will be turned on and in good working order.

26. *Risk of loss.* Seller assumes all risk of loss or damage to the premises by fire or other casualty until delivery of the deed.

27. *Type of deed.* The deed shall be a bargain and sale deed with covenants against grantor's acts in proper statutory short form for record and shall contain the covenant required by Section 13. The deed shall be duly executed and acknowledged by Seller at its expense, so as to convey to Purchaser the fee simple of the premises free of all encumbrances, except as herein stated. The deed shall contain any description of the premises accepted and approved by the lending institution or the title company insuring it.

28. *Seller's full performance on delivery of deed.* This contract is a single, indivisible contract. The delivery to and acceptance of the deed by Purchaser shall be deemed and considered as full performance and compliance by Seller of all the terms of this contract, and as a release by Purchaser of all rights, obligations, claims, or causes of action against Seller. No provision of this contract, unless otherwise herein expressly provided, and no promise, representation, agreement, or obligation of Seller or its agents, employees, or representatives, shall survive the delivery and acceptance of the deed, unless the same is fully set forth in writing together with an express provision that it shall survive delivery of the deed, and is signed by Seller.

29. *One year builder's warranty.* In order to assure the proper care of the dwelling, Seller assumes responsibility for the proper operation, under normal conditions for a period of one year from the date of closing of title, of the following major systems: maintenance of the roof and roof flashings against leaks, except if caused by an act or event beyond Seller's control; service of the basement against water conditions resulting from seepage or pressure if such conditions develop; the heating unit and heating system that it is sufficient to heat the building when it is zero degrees outside with a five m.p.h. wind to a 70 degree temperature inside (Fahrenheit degrees); and the electrical system and interior plumbing. Seller's responsibility under this paragraph is subject to the condition that the above major systems are properly maintained. Seller's obligations and warranties under this paragraph shall survive delivery and acceptance of the deed.

30. *Liquidated damages for seller's breach.* If Seller breaches this contract or refuses to complete the sale of the property to Purchaser as herein provided, Purchaser may recover from Seller the amount paid hereunder, together with the sum of \$6,000 as liquidated damages. Such amount is agreed upon as the damages that Purchaser will sustain from Seller's breach, it being impractical and extremely difficult to fix actual damages at this time. The foregoing shall be in addition to all other remedies which Purchaser shall have either at law or in equity.

31. *Assignment.* Seller may assign this contract to any building corporation that assumes construction and completion of the dwelling and complies with all other terms and provisions hereof. Purchaser shall in no event make such assignment without Seller's written consent.

32. *Broker.* Thomas Cowan is the broker for this transaction, and his commission shall be paid by Seller as set forth in a separate agreement. However, Seller warrants and represents that no commission shall be due and payable unless until title closes hereunder.

33. *Closing.* The closing of the within transaction shall be held at Seller's office, or at the office designated by the lending institution which accepts the mortgage on the premises, at 10 a.m. on February 10, 2003.

34. *Binding effect.* This contract shall be binding upon the parties and their respective heirs, executors, administrators, successors, and assigns.

35. *Headings.* Headings in this agreement are for convenience and reference only and shall not be used to interpret or construe its provisions.

36. *Non-waiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of any such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

37. *Governing law.* This contract shall be construed in accordance with and governed by the laws of the State of New York.

38. *Counterparts.* This contract may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

39. *Time of essence.* Time is of the essence of this contract.

40. *Entire agreement.* All prior understandings and agreements between the parties are merged in this contract, which constitutes the entire agreement between the parties. This contract is entered into after full investigation made by Seller, and neither party relies upon any statement or representation made by anyone unless contained herein.

41. *Notices.* All notices hereunder shall be in writing and sent by registered or certified mail, postage prepaid, to the respective parties at their address shown above.

In witness whereof the parties have signed this contract.

Attest:

Southshore Build-
ings, Inc.

by

Secretary

President

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Witness

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B.5 Contract for sale of tract of land--release of subdivided parcels on specified payments--purchase money deed of trust and guarantee to seller

COMMENT

In this form a developer buys a tract of land which will be subdivided into residential lots after the acquisition. Payment of most of the purchase price is deferred. Frequently a developer in these circumstances intends to pay part of the purchase money debt as each subdivided lot is sold. To allow this, the deed of trust, which will secure the balance of the purchase price due to the seller, will provide that certain portions of the property are released from the seller's lien as the indebtedness is reduced by specified amounts. This type of release provision is a common device when the purchaser is planning to subdivide the property or otherwise intends to improve the property in parcels.

Tax aspects:

The release provision has no effect on basic tax consequences. The purchaser's cost basis and the amounts realized by the seller are established at the time of the sale. Subsequent releases from the lien do not affect these items, except to the extent that the purchaser's original allocation of his cost among the various parcels may have to be modified if a default occurs after some parcels have already been released from the seller's lien. The year in which payments are received by the seller will affect the seller's taxable income for that year. If the seller is a dealer, installment sale tax treatment generally is not available. The lien is released as the purchaser pays the deed of trust for each lot. Each lot is not sold separately by the seller receiving the installment payments.

Information reporting of real estate transactions:

The attorney or title company responsible for closing title is required to report the real estate transaction to the Service. In addition, a statement must be provided to the customer before January 31 of the following year. If an attorney or title company is not involved in the closing, the information reporting is the responsibility of the mortgage lender.

For further information, see Chapters 2 and 11.

FORM

AGREEMENT made and entered into February 6, 2002, by and between Graham Corporation, a California corporation ("Seller"), Central Housing Corporation, a California corporation ("Buyer"), and William Doyle ("Guarantor").

1. *Sale of property.* Seller shall sell and Buyer shall buy the following described real property located in the County of Los Angeles, State of California.

(Insert description)

2-Forms Federal Taxes Affecting Real Estate [B]

2. *Purchase price.* The total purchase price of the property shall be \$200,000. Buyer shall deposit \$10,000 of the purchase price in escrow at the opening of the escrow provided for below and an additional \$75,000 of the purchase price in escrow before the close of escrow. The balance of the purchase price of \$115,000 shall be payable in 10 equal annual installments, plus interest at the rate of 12 percent per annum, commencing one year after the close of escrow. If Buyer fails or refuses to pay the \$75,000 by the close of escrow, the initial deposit of \$10,000 shall immediately become Seller's property and be paid to it. Buyer may make additional payments of principal at any time before maturity, which shall be applied against the payment of future principal installments in the inverse order of their maturity. In such event, the balance of the unpaid purchase price shall continue to be payable in equal annual installments, plus interest of 12 percent per annum, for the remainder of the above ten year period.

3. *Note, guarantee, deed of trust.* The total unpaid balance of the purchase price of \$115,000 shall be evidenced by Buyer's promissory note providing for payment upon the terms set forth in Section 2. The note shall be guaranteed by Guarantor, as provided in Section 5. The note shall be secured by a deed of trust on the property, which shall be prior to any other deed of trust, mortgage, lien, or encumbrance on the property.

4. *Release of parcels from deed of trust.* One third of the total property then subject to the deed of trust referred to in Section 3 shall be released therefrom when all of Buyer's payments of principal after the close of escrow, including all elective prepayments referred to in Section 2, equal \$40,000. One half of the total property then subject to the deed of trust shall be released when the principal payments total an additional \$40,000. The balance of the property shall be released from the deed of trust as soon as the remaining unpaid balance of the purchase price is paid in full. For this purpose, the property, which has a 450 foot frontage along Holmes Avenue in Van Nuys, California, shall be divided into three equal parcels, each having a frontage of 150 feet along Holmes Avenue. The three parcels shall be referred to as follows: the most northerly parcel as Parcel A; the most southerly parcel as Parcel B; and the remaining portion of the property between Parcels A and C as Parcel B. Buyer may select Parcel A or Parcel C as the first parcel to be released in accordance with the above. If either parcel is released upon total payments of \$40,000 as set forth above, and Buyer makes additional payments of \$40,000 in accordance with the provisions of this Section, Parcel B shall be the second parcel released.

5. *Guaranty.* Guarantor personally guarantees all of Buyer's obligations under the terms of this agreement, including but not limited to the guarantee of the payment of the purchase price as provided in Sections 2 and 3. Guarantor shall execute a written guarantee of payment of Buyer's note evidencing the unpaid balance of the purchase price. Guarantor shall reimburse Seller, and its successors and assigns, for all damages sustained by Seller by reason of Buyer's breach of any term of this agreement.

6. *Escrow.* The sale shall be completed through an escrow to be opened at Central Title Insurance Company, 3000 Wilshire Boulevard, Los Angeles, California. The escrow instructions shall be in the standard form used by the Central Title Insurance Company, but shall be consistent with the terms and conditions of this agreement. The escrow shall be for a period of 120 days.

7. *Title to property.* At the close of escrow Seller shall convey to Buyer title to the property subject to all covenants, conditions, restrictions, easements, and rights of way of record, all of which shall be subject to Buyer's approval within ten days after receipt of a preliminary title report, and subject to any current unpaid real property taxes which are a lien on the property.

8. *Title insurance policy.* Seller shall provide Buyer with a C.L.T.A. standard coverage policy of title insurance in an amount equal to the total sales price.

9. *Taxes, insurance, and costs.* Any real property taxes and insurance shall be prorated as of the close of escrow. Escrow costs and recording fees shall be divided between the parties according to the normal practice in connection with escrows in Los Angeles County, California.

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10. *Commissions.* A commission of five percent of the total purchase price is payable by reason of this sale to Harris & Company, 1000 Van Nuys Boulevard, Van Nuys, California. Seller shall pay this commission.

11. *Binding effect.* This agreement shall be binding upon the parties hereto and their respective legal representatives, successors, and assigns.

12. *Headings.* Headings in this agreement are for convenience and reference only and shall not be used to interpret or construe its provisions.

13. *Non-waiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of any such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

14. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of California.

15. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

16. *Time of essence.* Time is of the essence of this agreement.

17. *Entire agreement.* All prior understandings and agreements between the parties are merged in this contract, which constitutes the entire agreement between the parties. This contract is entered into after full investigation made by Seller, and neither party relies upon any statement or representation made by anyone unless contained herein.

18. *Notices.* All notices hereunder shall be in writing and sent by registered or certified mail, postage prepaid, addressed to the respective parties at their addresses shown above.

In witness whereof the parties have executed this agreement the day and year first above written.

Attest:

Graham Corporation

by _____

Secretary

Attest:

Central Housing
Corporation

Secretary

by _____

President

William Doyle, Guarantor

B.6 Contract rider for residential sales contracts containing lead-based paint disclosures and lead-based paint contingency

COMMENT

Disclosure of lead-based paint hazards:

Federal law requires the disclosure of lead-based paint hazards to individuals who are renting, buying or renovating pre-1978 residential housing. *See 42 USC §§ 4851-4856; 40 CFR Part 745 and 24 CFR Part 35, Subpart A.* Lead-based paint and paint dust often found in housing built before 1978. Lead is very dangerous, especially to young children and pregnant women. Sellers of pre-1978 housing must disclose known information on lead-based paint hazards before selling a house, and landlords must disclose such information before leases take effect. Both sales contracts and leases must include a lead warning statement and disclosure information. Renovators must provide information about lead-based paint before starting work.

The seller and the broker are responsible for providing lead-based paint information to the purchaser before the sale. The information required by law includes both specific information about the property being sold and general information about lead-based paint hazards. The seller must disclose known lead-based paint and lead-based paint hazards and provide available records and reports to the purchaser. The seller also must give the purchaser the pamphlet, developed by EPA, HUD, and the Consumer Product Safety Commission (CPSC), titled "Protect Your Family From Lead in Your Home." The purchaser must be given a 10-day period to conduct a lead-based paint inspection or risk management at the purchaser's expense. The parties have flexibility to negotiate the key terms of the evaluation. Finally, the sales contract must include certain notification and disclosure language.

Note that the law does not require the seller to test for lead-based paint or to remove such paint if it is known to exist. The law also does not invalidate a sales contract that does not include the required disclosure. However, any person who violates the lead disclosure requirements may be subject to civil and criminal penalties, as well as treble damages in a private civil suit.

Lead testing contingency:

To protect against the dangers of lead, many purchasers desire a provision making the contract of sale contingent upon the outcome of lead-based paint testing. A lead paint contingency should be included in any contract for the sale of a structure built before 1978, especially if the structure is a residence and the purchaser or anticipated tenant has small children. A commercial property contract should contain a contingency that at least provides for testing for lead dust, which is harmful to people of any age.

The contingency should specify the method of testing and analysis to be used and should require that multiple samples be taken in each room, as well as soil samples from outdoors. The contingency should provide for repair of the sampled areas. The lead paint contingency also should specify the qualifications and credentials of the party performing the sampling and analysis. It is important to be sure that the inspector is qualified and has received training in sampling and spectrography techniques.

The lead paint contingency should allow the purchaser to terminate the contract if any lead paint or dust is found, or if the soil around the premises is found to be contaminated with lead. Alternatively, the contingency may provide that the agreement will be modified to provide for the remediation of any lead problem. Upon receipt of the test results, the purchaser will have to decide whether remediation is required under the circumstances. If the purchaser has no small children and none are expected, he or she may decide against the expense. If the purchaser has small children or is purchasing a building where children may live or visit, he or she may be advised to seek another property.

Lead-based paint testing techniques and remedies:

Lead paint problems can be determined by visual inspection of paint condition and location, surface dust tests, spectrography or chemical tests of samples. Home test kits generally are not considered to be

reliable.

Lead paint can be handled in three ways: removal of the surface containing the paint, encapsulation (*i.e.*, by sheetrocking over the surface), or by sanding the surface. Removal is the most permanent and most expensive method, and it causes the least amount of lead dust. Encapsulation may not be permanent and is moderately expensive. As the seams age, lead dust may escape. Encapsulation may not be performed by painting alone. Sanding is not recommended, as it produces high quantities of lead dust; however, sanding is a lower cost alternative and deemed permanent.

For further information, see Chapters 4, 9, and 11.

FORM

Lead-Based Paint Rider to Contract of Sale

between _____, as Seller, and _____, as Purchaser

Property address: _____

☐ Disclosure of Information on Lead-Based Paint and Lead-Based Paint Hazards

Lead Warning Statement: Every purchaser of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead Poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women. The seller of any interest in residential real property is required to provide the buyer with any information on lead-based paint hazards from risk assessments or inspections in the seller's possession and notify the buyer of any known lead-based paint hazards. A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.

Seller's Disclosure (initial)

_____ (a) Presence of lead-based paint and/or lead-based paint hazards (check one below):

☐ Known lead-based paint and/or lead-based paint hazards are present in the housing (explain):

☐ Seller has no knowledge of lead-based paint and/or lead-based paint hazards in the housing.

_____ (b) Records and reports available to the seller (check one below):

☐ Seller has provided the purchaser with all available records and reports pertaining to lead-based paint and/or lead-based paint hazards in the housing (list documents below):

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☐ Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Purchaser's Acknowledgment (initial)

_____ (c) Purchaser has received copies of all information listed above.

_____ (d) Purchaser has received the pamphlet *Protect Your Family from Lead in Your Home*.

_____ (e) Purchaser has (check one below):

☐ Received a 10-day opportunity (or mutually agreed upon period) to conduct a risk assessment or inspection for the presence of lead based paint and/or lead-based paint hazards; or

☐ Waived the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

Agent's Acknowledgment (initial)

_____ (f) Agent has informed the seller of the seller's obligations under 42 U.S.C. 4582(d) and is award of his/her responsibility to ensure compliance.

☐ **Exclusion from Disclosure.** Seller hereby represents that this property is excluded from the legal requirement to disclose the existence of lead-based paint and/or lead-based paint hazards in housing because this housing was constructed after 1978. (Initial _____)

Lead-Based Paint Contingency: This contract is contingent upon a risk assessment or inspection of the property for the presence of lead-based paint and/or lead-based paint hazards at the purchaser's expense within _____ days after the signing of this contract. If the risk assessment or inspection report shows no lead-based paint or lead-based paint hazards to be present, this contract is binding and effective. If the report shows the presence of lead-based paint and/or lead-based paint hazards, Purchaser (or Purchaser's agent) will deliver to Seller (or Seller's agent) a written list of the specific existing deficiencies and correction needed, together with a copy of the inspection and/or risk assessment report. Within _____ days after delivery of the list, Seller will notify Purchaser in writing whether Seller elects to correct the condition(s) before the closing of title, or to cancel this contract and cause the return of Purchaser's deposit money. If Purchaser accepts the deposit refund, this contract will be terminated and unenforceable. If Seller will correct the condition, Seller will furnish Purchaser with certification from a risk assessor or inspector demonstrating that the condition has been remedied before the closing of title. Purchaser may waive this contingency at any time without cause, either by stating so in writing or by refusing the deposit refund, in which event this contract will be binding and enforceable.

The risk assessor or inspector shall be fully qualified to conduct the risk assessment or inspection, and shall meet the standards for such professionals promulgated by the State of _____. The risk assessment or inspection shall include a visual inspection of paint condition and location, lab tests of multiple paint samples taken in each room, surface dust tests, lab tests of outdoor soil samples, and examination by a portable x-ray fluorescence machine.

Certification of Accuracy

The following parties have reviewed the information above and certify, to the best of their knowledge, that the information provided by the signatory is true and accurate.

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Seller	Date	Seller	Date
_____	_____	_____	_____
Agent	Date	Agent	Date
_____	_____	_____	_____
Purchaser	Date	Purchaser	Date
_____	_____	_____	_____

B.7 Sale of garden apartment complex--purchase price allocation between personal and real property--assignment and assumption of leases--apartment unit and parking space leases

COMMENT

This agreement involves the sale of a four-unit garden type apartment complex with the purchase price to be allocated as to personal and real property in each unit. The personal property is to be conveyed by general warranty bills of sale. There is a warranty as to minimum amount of rent roll. The leases are to be assigned to and assumed by purchaser.

Allocation of purchase price:

In this contract not only is there a separate allocation of price for each of four parcels, but also sub-allocations, on each parcel, for both personal property and real property. (See paragraph 3 of the contract.) The cost recovery allowance each tax year for personal property and real estate does vary substantially and will, therefore, have an effect on the buyer's taxable income. The allocation also establishes a separate basis in each parcel of land and the personalty.

Lease provisions:

The contract contains specific provisions relating to the unit leases. The seller not only provides the purchaser with a "rent roll" showing the annual gross rent, but also represents and warrants a minimum amount of rent. (See paragraph 7(f).) The leases are to be assigned to the purchaser, and the purchaser agrees to indemnify the seller against claims and liabilities which may arise from the leases. The seller represents and warrants that there are no defaults in the leases to be assigned. (See paragraphs 7(g) and 12.)

Mortgage commitment:

The purchaser, in this contract obtained a commitment for financing prior to entering the agreement. This contract contains a relatively unique representation and warranty that the purchaser does in fact have a mortgage commitment. Also included is the representation and warranty that the purchaser will meet all conditions in the commitment. (See paragraph 4.)

Closing documents:

Paragraph 7 lists each document needed at closing and requires seller to deliver them to the escrow agent not later than five days before the closing date. This can serve as a preclosing checklist and should prevent disputes as to what documents are required at the closing. Specific items required for each unit include security deposit schedule, lease assignments, rent roll certification, employee list, and bills of

sale on personal property used in connection with the operation of complex. (See paragraph 7.)

Real estate tax litigation:

Another relatively unique clause in this contract acknowledges pending litigation challenging the existing tax assessment, and provides for the allocation of the tax savings in the event that the challenge is successful. Tax savings by reason of taxes due prior to closing are to be paid over to the seller. (See paragraphs 8 and 10(c).)

Seller's representations:

Several representations and warranties made by the seller upon which the purchaser relies in entering the contract are listed. Included are representations that the property is free of mechanic's liens, that the property (real and personal) will be in good condition on closing date, and that the various systems will be in good working order. There are no pending law suits, violations, or condemnation proceedings outstanding. (See paragraph 13.) These statements provide the buyer with a remedy in the event that any representations are not fulfilled at closing. The purchaser can claim breach of contract and sue for damages, or holding the threat of such a suit, renegotiate the relevant terms of the transaction at or prior to closing.

Disclosure of lead-based paint hazards:

Federal law requires the seller of pre-1978 residential housing to disclose known information to the prospective purchaser on lead-based paint hazards. *See 42 USC §§ 4851-4856; 40 CFR Part 745 and 24 CFR Part 35, Subpart A.* The sales contract must include a lead warning statement and certain disclosure information. *See* discussion in comments to Form B.3, *supra*. A sample lead-based paint sales contract rider, including both disclosure under the federal law and a lead-based paint contingency clause, is included in this chapter at Form B.6, *supra*.

For further information, see Chapters 2, 4, 6, 19, and 20.

FORM

1. *Purchase.* John E. Dowell, located at 700 Lakeside Tower, Toledo, Ohio ("Purchaser") agrees to purchase from Rosewood, Inc., Rosewood, Inc., No. 2, Rosewood, Inc., No. 3, and Rosewood, Inc., No. 4, each an Ohio Corporation (collectively, "Seller") certain real property, including certain premises identified collectively as 13755-13829 Cedar Road, City of Toledo, County of Lucas, State of Ohio, and certain personal property located thereon, appurtenant and/or relating thereto, and Seller agrees to sell the property to Purchaser.

2. *Property.* The property to be purchased and sold includes the following:

(a) *Lot 10, Block 1035.* From Rosewood, Inc., certain premises commonly known as 13755-773 Cedar Road, Toledo, Ohio, and more particularly described in Exhibit A;

(b) *Lot 11, Block 1035.* From Rosewood, Inc., No. 2, certain premises commonly known as 13775-791 Cedar Road, Toledo, Ohio, and more particularly described in Exhibit B;

(c) *Lot 12, Block 1035.* From Rosewood, Inc., No. 3, certain premises commonly known as 13793-811 Cedar Road, Toledo, Ohio, more particularly described in Exhibit C;

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(d) *Lot 13, Block 1035.* Rosewood, Inc., No. 4, certain premises commonly known as 13813-829 Cedar Road, Toledo, Ohio, and more particularly described in Exhibit D;

(e) *Appurtenances.* For each of the properties described in subparagraphs (a) through (d), all easements, rights of way, privileges, appurtenances and rights to the same belonging to and inuring to the benefit of the premises; and

(f) *Fixtures and equipment.* For each of the properties described in subparagraphs (a) through (d) all of the fixtures and articles of personal property, including, but not limited to, furniture, furnishings, gas and electric apparatus and equipment, engines, radiators, heating, ventilating and air-conditioning units, furnaces and equipment, steam and hot water boilers, stoves, ranges, refrigerating plant and refrigerators, cooking apparatus and appurtenances, shades, awnings, screens, blinds, carpeting, drapes, curtains, flowers, trees, shrubs, linoleum, storm windows and storm doors, and all other machinery, vehicles and equipment, attached to or appurtenant to the premises or used in connection with the maintenance or operation of the premises, and owned by Seller.

3. *Purchase price.* The purchase price for the properties described in paragraph 2 is as follows:

(a) *Lot 10.* For the property hereinabove described as Lot 10, Block 1035.

Personal Property	\$ 7,500.00
Land and Building	930,000.00
Total	\$ 937,500.00

(b) *Lot 11.* For the property hereinabove described as Lot 11, Block 1035.

Personal Property	\$ 8,000.00
Land and Building	940,000.00
Total	\$ 948,000.00

(c) *Lot 12.* For the property hereinabove described as Lot 12, Block 1035.

Personal Property	\$ 10,000.00
Land and Building	1,200,000.00
Total	\$1,210,000.00

(d) *Lot 13.* For the property hereinabove described as Lot 13, Block 1035.

Personal Property	\$ 9,000.00
Land and Building	1,100,000.00
Total	\$1,109,000.00

(e) *Earnest money.* Purchaser shall pay Seller or Seller's nominee \$25,000 as earnest money concurrently with the

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execution hereof by Seller; and

(f) *Balance*. The balance of the purchase price and/or bona fide commitments for payment shall be paid to the Escrow Agent not later than ten days before the time of closing.

4. *Mortgage commitment*. Purchaser represents and warrants that The Charleston Life Insurance Company of America has issued to Purchaser its commitment for a first mortgage loan on the property for \$3,000,000, that the commitment is in full force and effect, and that Purchaser is ready, willing and able to meet all of the conditions of the commitment, including providing for the payment of the balance of the purchase price over and above the sum total of the first mortgage loan and the earnest money deposit.

5. *Cash prior to closing*. Purchaser shall deliver into escrow the balance of the purchase price not less than ten days before the Closing Date.

6. *Closing date*. The sale described herein shall be consummated on the date all of the required deeds are recorded with the Lucas County Recorder, which shall be the same date on which possession is transferred to Purchaser. This date shall be no later than July 1, 2002 (the "Closing Date"), but the Closing Date may be any earlier date specified by Purchaser provided that Purchaser gives Seller at least ten days' prior written notice thereof.

7. *Closing documents*. Except for subparagraph (b) below, not later than five days before the Closing Date, Seller shall deliver to White Title & Trust Company (the "Escrow Agent") the following documents:

(a) *Deed*. Full warranty deeds conveying to Purchaser and/or Purchaser's grantee in deeds fee simple title to the real property. The title shall in each instance be free and clear of all encumbrances, except:

(i) zoning ordinances and conditions;

(ii) any reservations, easements, and restrictions of record approved by Purchaser;

(iii) taxes and assessments which are a lien but not yet due and payable;

(iv) leases to occupying tenants, whether of record or not; and

(v) matters which would be disclosed by a physical examination or accurate survey of the properties.

However, if Purchaser reasonably objects to any of the above conditions, reservations, easements, or restrictions of record, this Agreement shall be null and void and the parties shall be returned to their prior positions without penalty or cost to them.

(b) *Title report*. Notwithstanding any provisions to the contrary herein contained, Seller will cause to be delivered to Purchaser, within 30 days after this agreement is executed, a Preliminary Title Report prepared by White Title & Trust Company, together with copies of the most recent real estate tax bills and a tax search prepared by the Escrow Agent.

(c) *Bill of sale*. General warranty bills of sale including all personal property described herein and in the Exhibits, to be conveyed in accordance with this Agreement.

(d) *Security deposit schedule*. A schedule, which Seller represents and warrants and which Seller shall on the Closing Date represent and warrant to be accurate and complete, of all security deposits received to the Closing Date by or for Seller from or on account of the rental and/or occupancy of each dwelling unit in the garden-type apartment complex and/or on account of parking privileges exercised or to be exercised by persons in the parking facility situated on the

premises.

(e) *Insurance documents.* True copies of policies plus endorsements and riders, if any, and assignments thereof from Seller to Purchaser or his nominee of all insurance contracts relating to the premises, whether casualty, liability, or any other form of insurance coverage. The assignments shall be effective as of the Closing Date. Seller shall also furnish to Purchaser satisfactory evidence that the issuer of each insurance contract has consented to each assignment. Purchaser may obtain all or part of his own insurance coverage, in which event Seller shall retain its policies and cause them to be cancelled. The parties shall prorate, as of the Closing Date, the costs of all insurance contracts for which Purchaser accepts assignment from Seller.

(f) *Rent rolls.* A copy of the rent rolls reflecting annual gross rentals in an amount which Seller represents and warrants to be not less than \$686,400. Seller also represents and warrants that on the Closing Date, an accurate and complete copy of the rent rolls will be delivered to Purchaser for all of the 320 suites and 300 parking spaces conveyed under the terms of this Agreement, which shall reflect all rentals in effect at the Closing Date.

(g) *Lease assignments.* Written assignments from Seller to Purchaser of leases and leasehold interests, under the provisions of paragraph 12. As soon as the lease assignments become effective, Purchaser shall assume the leases and leasehold interests and indemnify Seller from all claims and liabilities subsequently arising from or on account of the leases and leasehold interests.

(h) *Corporate authority.* An opinion letter from Seller's counsel stating that Seller has full and complete authority to take all actions and make all conveyances and assignments required by this Agreement.

(i) *Corporate resolution.* Certification by Seller's secretary or other appropriate officer that Seller's Board of Directors and shareholders have authorized the sale in accordance with the terms of this Agreement to Purchaser and/or his grantee in deeds and/or nominee of the real and personal property which is the subject matter of this Agreement.

(j) *Employee list.* A schedule, which Seller represents and warrants on the Closing Date to be accurate and complete, of all maintenance and custodial employees presently engaged on a regular basis, whether by contract or otherwise, in, on, or for the benefit of the premises.

(k) *Miscellaneous contracts.* Copies, which Seller represents and warrants and shall on the Closing Date represent and warrant to be accurate and complete, of all contracts, whether for labor, materials, services or otherwise, which relate to the operation of the premises and/or which reasonably might become a liability of or a lien against the premises.

8. *Tax complaints.* Any proceeds realized from real estate tax complaints pending for periods preceding the date of closing shall belong to Seller.

9. *Brokers.* Purchaser represents and warrants that Peter John and Sarah Stine are the only real estate brokers or persons with whom he has dealt in this transaction who may have reason to make a claim for a sales commission. Seller shall indemnify and hold harmless Purchaser from and against losses and expenses arising out of, by reason of, or in connection with, claims asserted by any person for a broker's commission in this transaction and arising from any broker's contacts with Seller.

10. *Real estate taxes.* (a) *Adjustment.* All general and special real estate taxes and assessments on the property conveyed or to be conveyed under this Agreement shall be prorated as of the date of transfer of title, based upon the most recently available tax duplicate.

(b) *Payment.* Seller represents and warrants, and shall on the Closing Date represent and warrant, that all assessments and respreads of assessments, both general and special, on the property have been paid to the extent due as of the

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Closing Date or paid through the Escrow Agent.

(c) *Readjustment.* If any real estate tax controversy pending as of the Closing Date is successfully resolved, with the result that Seller would have been entitled to additional funds on the Closing Date due to the proration of taxes at Closing, Purchaser shall remit the additional funds to Seller as if they were included in the proration.

11. *Maintenance expenses.* (a) *Indemnity.* Seller shall indemnify and hold harmless Purchaser and his nominee for all claims by employees, including any wages and holiday or sick pay arising out of employment occurring before the Closing Date.

(b) *Utility and rental charges.* Utility charges and rent paid or payable on account of the apartment suites or the rental of parking space in the parking facility shall be prorated as of the date of transfer of title.

(c) *Rent prepayment prohibited.* Seller has not collected, and shall not at any time before the Closing Date collect, from any person more than one month's rental in advance, including apartment and parking rent.

12. *Lease assignment.* Seller shall assign to Purchaser or his nominee, or both, on or before the Closing Date, every lease of space, whether residential, parking, or otherwise, affecting the premises. Seller does not know, and has no reason to know, of any defaults presently existing on any lease. If any default of which Seller knows or should know occurs between the Acceptance Date and the Closing Date, Seller shall so notify Purchaser in writing on or before the Closing Date and shall promptly take all usual, necessary, and lawful steps to correct the default.

13. *Warranties.* Seller represents and warrants, and shall on the Closing Date represent and warrant, as follows:

(a) *No liens.* The premises are free and clear of all mechanics' liens and all other liens, except as recited in this agreement;

(b) *No defects.* All property, whether real or personal, which is conveyed or to be conveyed under the terms of this Agreement is and shall be on the Closing Date in good condition, except for ordinary wear and tear, and there are no structural defects of any kind or any latent defects of which Seller knows or should have known in the property;

(c) *Good working order.* The heating and cooling system, plumbing and sprinkler system, and roof are and at the time of closing shall be in good working order and condition, except for ordinary wear and tear, with valid permits outstanding where required;

(d) *Occupancy regulations.* All occupancy and fire regulations of the City of Toledo have been and, on the Closing Date shall have been, to the extent that Seller knows or should have known, fully complied with for each building on the premises;

(e) *No condemnations.* Seller has received no written notice nor official notice of any condemnation proceedings against the whole or any part of the premises;

(f) *No violations.* Seller does not know or have reason to know of any substantial violations of law or municipal ordinances affecting the premises. Seller shall, by the Closing Date, cure all violations of which it knows or should have known that occur between the Acceptance Date and the Closing Date;

(g) *Lawful occupancy.* Seller does not know, nor has it received written or official notice, of any violation of laws or ordinances governing occupancy of the premises;

(h) *No pending suits.* No lawsuits are presently pending or have been threatened in writing concerning the property to be

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conveyed hereunder. Seller does not know of any claims or liens against the property, other than those set forth herein;

(i) *Good title.* Seller now has and on the Closing Date shall have good, clear, and sufficient title, free from all liens, security interests, and encumbrances, to all fixtures and articles, including, but not limited to, furniture, furnishings, gas and electric apparatus and equipment, engines, radiators, heating and ventilating and air-conditioning units, furnaces and equipment, steam and hot water boilers, stoves, ranges, refrigerating plant and refrigerators, cooking apparatus and appurtenances, shades, awnings, screens, blinds, carpeting, drapes, curtains, flowers, trees, shrubs, linoleum, storm windows and storm doors, and all other machinery, vehicles, and equipment attached to or appurtenant to the premises or used in connection with the maintenance or operation of the premises, and owned by Seller;

(j) *Copies of contracts.* Seller has delivered and as of the Closing Date shall have delivered copies of every contract which it is required to deliver to the Escrow Agent under the provisions of paragraph 7(k);

(k) *Maintenance.* Seller has maintained, is continuing to maintain, and as of the Closing Date shall have maintained the premises in good condition and continued normal operations on the premises. Seller shall not, between the Acceptance Date and the Closing Date, incur any new indebtedness, enter into any new lease, or renew any existing lease, except in the ordinary course of business and on terms at least as favorable as those in effect on the Acceptance Date.

(l) *Possession.* Seller shall on the Closing Date transfer actual possession of premises to Purchaser or his grantee in deeds; and

(m) *Documents.* All documents that Seller has delivered or will deliver hereunder to Purchaser are and shall remain wholly accurate at closing. Seller shall immediately notify Purchaser, in writing, of every material change of which Seller knows or should have known in the facts, circumstances, or subject matter of every statement, assertion, schedule, or warranty made by Seller or under the terms hereof.

14. *Earnest money.* On or before the date all documents are required to be delivered to the Escrow Agent, Seller shall deliver to the Escrow Agent the \$25,000 earnest money deposit which Purchaser has delivered to Seller under the provisions of paragraph 3(e).

15. *Escrow agent.* A copy of this Agreement shall serve as instructions to the Escrow Agent. The Escrow Agent shall, under the terms of this Agreement, receive and accept not later than ten days before the Closing Date originals of all documents that Seller is required to deliver to it. On or before the Closing Date, the Escrow Agent shall perform the following acts:

(a) *Real estate taxes.* Prorate between the parties as of the Closing Date all real estate taxes, based on the most recently available tax duplicate, in accordance with paragraph 10, and other applicable taxes on the premises;

(b) *Utility charges.* Prorate between the parties as of the Closing Date all utility charges applicable to the premises;

(c) *Rent.* Prorate between the parties as of the Closing Date all rentals. Seller shall deliver all security deposits to Purchaser under the terms and definitions of this Agreement;

(d) *Purchase price.* Receive from Purchaser or his nominee the balance of the purchase price required under this Agreement;

(e) *Title guarantee.* Prepare and issue to Purchaser or his nominee, or both, a title guarantee in the amount of the purchase price, showing fee simple title in Purchaser or his grantee in deeds, subject only to those exceptions for liens for taxes and assessments, both general and special, not yet due and payable, zoning ordinances, and conditions, reservations, easements, restrictions and leases of record, if any, approved by Purchaser, and charge their costs to Seller.

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(f) *Documents*. Deliver to Purchaser or his nominee, or both, all documents that Seller is required to deliver to the Escrow Agent under this Agreement, except the warranty deeds, the disposition of which is described in paragraph 15(h);

(g) *Closing statement*. Deliver to Seller, after application of all debits and credits, the purchase price paid to the Escrow Agent under this Agreement; and

(h) *Recording of deeds*. Cause all four full warranty deeds to be filed concurrently for record on the Closing Date in the appropriate place in Lucas County and in the appropriate manner, all as provided by law, and charge their cost to Purchaser.

(i) *Escrow fee*. Each party shall pay one half of the escrow fee charged by the Escrow Agent. The above escrow instructions may be supplemented as required to comply with the normal standard form of escrow instructions used by the Toledo Real Estate Board.

16. *Possession conditional*. Seller shall transfer actual possession of the premises on the Closing Date, if the purchase price has been paid to Seller under the terms of this Agreement.

17. *Casualty*. Seller assumes all risks and liability for loss, damage or injury by fire, windstorm, accident, or other cause to the premises until the Closing Date. Moreover, if the premises suffer any damages beyond ordinary wear and tear, Seller shall make repairs before the Closing Date. If, however, the damages exceed \$100,000, Purchaser may, within 10 days after Seller notifies him of the damages, declare in writing to Seller that this agreement is null and void. If Purchaser does so, all documents and monies delivered to the Escrow Agent up to that date shall be returned to the parties who sent them. If Purchaser elects not to declare this agreement null and void, Seller shall assign to him all insurance proceeds payable on account of the damages, except to the extent required and used to make necessary repairs to the premises. If the damages do not exceed \$100,000, Seller may either retain the insurance and make or agree to make all necessary repairs before the Closing Date, or assign the insurance proceeds to Purchaser on the Closing Date and instruct him to make the repairs if he chooses to do so. If any damage occurs to the property before the Closing Date, Seller shall, not later than 10 days before that date, exercise in writing the option with regard to repairs of damage not exceeding \$100,000. If, however, the damage occurs less than 10 days before the Closing Date or Seller reasonably believes that repairs cannot be made before that date, Seller shall then so notify Purchaser and deliver written evidence of the exercise or disposition of the option at the time of closing.

18. *Nominees*. Purchaser reserves the right to designate the name of his grantee or grantees in deeds at a reasonable time before the Closing Date.

19. *Survival*. The parties' representations, warranties, covenants and agreements in this Agreement shall survive the closing.

20. *Time of essence*. All matters pertaining to the closing shall take place on the Closing Date at the office of the Escrow Agent. Time is of the essence of this Agreement.

21. *Notice*. All notices shall be in writing and shall be sent by First Class Mail, postage fully prepaid. If to Seller, they shall be addressed:

[Insert Address]

and if to Purchaser:

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[Insert Address]

Either party may at any time, by written notice addressed to the other party, change its address for sending notices.

22. *Binding effect.* This Agreement shall be binding upon and inure to the benefit of the parties and their respective heirs, personal representatives, successors, and assigns.

23. *Governing law.* This Agreement shall be construed in accordance with and governed by the laws of the State of Ohio.

24. *Interpretation.* Where necessary or appropriate to the meaning of this agreement, the singular shall be deemed to include the plural, the plural to include the singular, the masculine to include the feminine and neuter, the feminine to include the masculine and neuter, and the neuter to include the masculine and feminine.

25. *Entire agreement.* This contract contains the entire agreement between the parties. Neither party has made any representations or promises with respect to the premises other than those expressly set forth herein.

26. *Headings.* Headings in this agreement are for convenience and reference only and shall not be used to interpret or construe its provisions.

27. *Non-waiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of any such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

28. *Counterparts.* This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

In witness whereof, the parties hereto have set their hands on April 7, 2002.

Signed in the presence of:

John E. Dowell (Purchaser)

Rosewood, Inc.

by: _____

Rosewood, Inc. No. 2

by: _____

Rosewood, Inc. No. 3

by: _____

Rosewood, Inc. No. 4

by: _____

(Seller)

B.8 Sale of office building--assumption of leases and other contracts by buyer--transaction closed in escrow

COMMENT

This is a contract for sale of an office building. After the initial contract deposit, the buyer is required to pay the balance of the purchase price in cash at the closing. The purchaser has examined the leases, service contracts, and other documents prior to signing of the contract, and agrees to assume each of them listed in an exhibit to the contract. The buyer agrees to indemnify the seller against matters arising after the closing, and the seller indemnifies the buyer against matters arising prior to the closing. The contract specifies the documents to be delivered at the escrow closing and the closing adjustments. The seller must maintain and operate the property until title is transferred.

For further information, see Chapters 2, 4, 6, 11, 19, and 20.

FORM

AGREEMENT made in Los Angeles, California, by and between the Camelot Building Corporation, a California corporation ("Seller") and James Warren ("Buyer").

1. *Purchase and sale.* Buyer agrees to buy, and Seller agrees to sell, the property more particularly described in Schedule A attached (the "property"), together with all items of personal property owned by Seller and located in or used in connection with the operation of the subject property.

2. *Purchase price.* The purchase price for the property shall be \$2 million.

3. *Terms of payment.* The purchase price shall be paid as follows:

(a) \$200,000 to be paid to Seller upon the execution of this agreement.

(b) \$1.8 million to be deposited in the escrow referred to in paragraph 5, before the closing.

4. *Inspection of documents and premises and assumption of obligations.* (a) Buyer acknowledges that, prior to the execution of this agreement, he has inspected each of the instruments listed on attached Exhibit B. Seller warrants that Exhibit B is a complete list of all leases and contracts under which it has any obligation or benefit. Buyer approves each of the instruments on Exhibit B. Seller represents that no tenant is entitled to any rebate, concession, or other benefit except as set forth in the leases referred to in Exhibit B, and that the rentals due or to become due under such leases and other tenancies will not be assigned, encumbered, or subject to liens at the close of the escrow. Buyer expressly accepts, assumes, and agrees to all of Seller's terms, provisions, covenants and conditions contained in each such instrument. Buyer shall also indemnify and hold Seller harmless from any claim, demand, or cause of action asserted against Seller arising from a breach, violation, or failure to perform any provision of any such instrument that allegedly occurred after the closing date of the escrow. Seller shall indemnify and hold Buyer harmless from any claim, demand, or cause of action asserted against Buyer arising from a breach, violation, or failure to perform any provision of any such instrument that allegedly occurred before the closing date of the escrow.

(b) Buyer has inspected a preliminary report of title issued by the Title Insurance Company of Los Angeles, California, dated July 2, 2002, bearing Order Number 50132, as to the status of the fee title of the property. This report is annexed and marked Exhibit C. If the extended coverage policy of title insurance fails to show any exception not shown in the preliminary report, or exceptions 4 through 10 of the report, Buyer expressly approves the report of title and agrees to accept title subject to exceptions 1, 2, and 3 of the report.

(c) Buyer has examined Seller's books and records, and is relying on such examination and not upon any representations made by Seller or its agents concerning the income or expense of the property. Seller warrants and represents that the

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books and records furnished to Buyer are kept and maintained by Seller in its ordinary and normal course of business and used by it in computing its federal income tax returns.

(d) Buyer has inspected the property during January 1992, and agrees to accept it at the close of escrow in the same condition as it was at the time of inspection, reasonable wear and tear excepted.

5. *Escrow.* (a). Within ten days after the execution hereof, the parties shall cause an escrow ("escrow") to be opened at the Title Insurance Company of Los Angeles, California, at its main office, 500 South Water Street, Los Angeles, for the purpose of carrying out the provisions hereof.

(b) Each party shall execute escrow instructions and all other necessary instruments to consummate the transaction and effectively convey and assign the property from Seller to Buyer. Each party shall also deposit into escrow all sums and documents required from time to time by the escrow instructions.

(c) Seller shall deposit the following documents into escrow on or before the escrow closing date:

(1) The original, or duplicate original, of each instrument listed in Exhibit B.

(2) All documents and data necessary to determine the prorations to be made, as set forth in paragraph 6.

(3) A grant deed to the property, duly executed and acknowledged and in sufficient recordable form to convey the required fee title.

(d) If for any reason Seller is unable to convey and assign all or any part of the property in accordance with the terms hereof, Buyer may purchase all rights, title, and interest Seller is able to convey and assign, without abatement of any part of the purchase price. Nothing in this subparagraph, however, shall relieve Seller of any of its obligations under this agreement.

(e) On the close of the escrow, Seller shall furnish, at its expense, a policy of title insurance issued by the Title Insurance Company of Los Angeles, California, in its extended coverage form, in the amount of \$2 million, insuring Buyer's title to the property, subject only to exceptions 1, 2, and 3, as they appear on Exhibit C, as provided in subparagraph 4(b).

(f) Each party will pay the portion of the escrow costs and charges which are normally charged to it, respectively, under existing escrow practices in the City of Los Angeles, California. Seller will pay the cost of the title policy to be furnished by it.

(g) The closing date of the escrow shall be on or before July 1, 2002. Buyer shall designate the closing date, by giving the Title Insurance Company, as escrow holder, and Seller, written notice at least ten days before the designated date. Time is of the essence with regard to the closing date. If the escrow fails to close on or before the above date for any reason other than Seller's default, this agreement shall terminate.

(h) At the close of the escrow, Seller will deliver to Buyer all documents, correspondence, lease files, and related records pertaining to the leases and contracts listed on Exhibit B.

(i) Seller shall pay a real estate broker's commission of \$35,000 to Harrison & Co., Inc., 100 State Street, Los Angeles, California, from the proceeds of the escrow, when the escrow is closed.

(j) The escrow instructions are not intended to supersede this agreement, but are deemed merely to be supplemental hereto and a means of carrying out and consummating the provisions hereof.

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6. *Prorations.* The following items shall be prorated as of the close of the escrow:

(a) Rents, other than delinquent rents under the leases and tenancies listed on Exhibit B. If any lease set forth in Exhibit B provides for a minimum basic rent, plus an additional rent to be computed on the basis of a stated percentage of the tenant's monthly or annual revenue or volume of business, then for the purpose of prorating such additional rents, it shall be assumed that the revenue for each month or each year for which additional rent is to be computed is the same as the revenue for the last calendar month or last calendar year, as the case may be, immediately before the close of escrow. Delinquent rents are rents which are not paid within ten days after they are due. Delinquent rents shall not be prorated and shall remain the property of Seller, except that Buyer shall be entitled to receive and retain all rents allocable to the period after the close of escrow.

(b) All security deposits and lease considerations then held by Seller. Seller shall, on the close of escrow, represent and warrant that such security deposits or lease considerations are the only ones in its possession.

(c) Garage parking and service income.

(d) City and county real and personal property taxes.

(e) Salaries of employees (not including management employees). Attached Exhibit D is a list of the names of such employees, their positions and salaries.

(f) Union welfare and pension fund contributions, social security payments, Christmas bonus payments (based on a calendar year on the amounts paid in 2001), and vacation payments accruing since the last previous vacation of the employees shown on Exhibit D or of employees replacing them.

(g) Exhibit E is a list of insurance policies showing the name of the insuring company, the policy number, the term and expiration date of the policy, the premium charged, and the general nature and the type of policy. Premiums on such policies shall be prorated. Seller shall maintain such policies in full force and effect until close of escrow.

(h) Charges under the service contracts listed on Exhibit B. The net balance of the foregoing prorations, if in favor of Seller, shall be added to the cash required to be paid by Buyer, before the close of escrow; or, if in favor of Buyer, shall be deducted from such cash required. No prorations will be made of public utilities but, in lieu thereof, Seller will cause the respective utility companies to read the gas, water, electric, and power meters on the morning of the close of escrow, and will pay such invoices when rendered. Seller will also pay any telephone charges allocable to the period before the close of escrow.

7. *Possession and use of building name.* Possession of the property shall be delivered to Buyer upon conveyance of title and the close of escrow. Seller will assign to Buyer its right to use the name "Camelot Building."

8. *Conduct of business during escrow.* (a) Seller shall continue to maintain, repair, manage, and operate the property in the same manner as it is now conducted, reasonable wear and tear excepted, and shall perform all obligations under the leases and contracts referred to in Exhibit B until the close of escrow and the delivery of possession of the property to Buyer. Except as provided in subparagraph (b) of this paragraph, Buyer shall have no rights with respect to the management, operation, or conduct of the property until the close of escrow.

(b) Seller shall submit to Buyer, for his approval, after the execution hereof, any contract or lease relating to the property which Seller contemplates executing. Seller shall not execute any such contract or lease until it is first approved in writing by Buyer. Seller, however, shall not be required to execute a contract or lease because it has been submitted to Buyer for approval and approved by him. Buyer will not unreasonably withhold approval of any contracts

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or leases submitted to him for approval by Seller. Seller shall not modify, extend, renew, cancel, or surrender any of the existing leases or contracts in Exhibit B without Buyer's written consent in each instance.

(c) If Buyer approves any such contract or lease, in writing, and it is subsequently executed by Seller, an executed copy of the contract or lease shall be deposited by Seller into the escrow.

(d) Buyer shall accept and assume all of the terms, provisions, covenants and conditions which Seller is required to observe, perform and keep in each contract or lease that Buyer approves under subparagraph (c) of this paragraph, and which is executed by Seller. Buyer shall indemnify and hold Seller harmless from and against any claim, demand, or cause of action asserted against Seller arising from a breach, violation, or failure to perform any provision of any such contract or lease that allegedly occurs after the closing date of the escrow. Seller shall hold Buyer harmless from any claim, demand, or cause of action asserted against him arising from any breach, violation, or failure to perform any provision of any such contract or lease that allegedly occurs before the closing date of the escrow.

9. *Passage of title.* Until the closing of escrow, the parties do not intend that title to the property pass from Seller to Buyer, that title to the funds to be deposited in escrow hereunder pass from Buyer to Seller, or that this agreement be deemed consummated. Seller's warranties, covenants, and representations contained in paragraphs 4(a) and (c), in paragraph 6(a), in the last two sentences of paragraph 6, and in paragraphs 8(a) and (d), shall survive the closing of escrow.

10. *Fire, earthquake, or other casualty.* If, at any time before the close of escrow, the property is destroyed or damaged by fire, earthquake, or other casualty, and the damage cannot be repaired for less than \$100,000, Buyer may terminate this agreement and be released from all obligations hereunder. If Buyer elects to terminate, he shall be entitled to the return of all monies paid hereunder and deposited in escrow. If Buyer does not elect to terminate, Seller shall assign to him any insurance proceeds paid on account of the casualty, or any claims under the insurance policies. In that event, Buyer shall complete the purchase of the property and accept the same in its damaged condition. If, at any time before the close of escrow, the property is damaged by fire, earthquake, or other casualty and the damage can be repaired for less than \$100,000, Seller shall repair the damage at its expense but may retain the insurance proceeds.

11. *Default.* The \$200,000 that Buyer is to pay Seller upon the execution hereof shall become Seller's property immediately upon payment. Seller shall apply the \$200,000 toward payment of the purchase price of the property upon the close of escrow. Buyer acknowledges that he has no right to the return any portion of the \$200,000, unless either Seller defaults or Buyer becomes entitled to the return of the money under the provisions of paragraph 10. If Buyer shall be in default of its obligations hereunder, Seller's sole remedy shall be to retain the foregoing sum of \$200,000 as liquidated damages.

12. *Assignment.* Buyer may assign this agreement and it shall be binding upon and inure to the benefit of the legal representatives, successors and assigns of both parties.

13. *Entire agreement; modification.* This contract constitutes the entire agreement between the parties. It may not be modified except by an instrument signed by the party against whom the enforcement of such modification is sought.

14. *Nonwaiver.* No delay or failure by either party to exercise or enforce any right hereunder, and no partial or single exercise of any such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

15. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

16. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of

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California.

17. *Counterparts.* This agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

18. *Time of essence.* Time is of the essence of this agreement.

19. *Notices.* All notices hereunder to Seller shall be given by certified mail, addressed to:

Camelot Building Corporation
100 Wilshire Boulevard
Los Angeles, California

All notices to Buyer under this agreement shall be given by certified mail, addressed to:

James Warren
200 State Street
Denver, Colorado

In witness whereof the parties have executed this agreement January 15, 2002, in the City of and County of Los Angeles, State of California.

Attest _____ Camelot Building Corporation
by _____

—
Secretary President, Seller

James Warren, Buyer

B.9 Sale of operating hotel--liquor license transfer contingency--closing adjustments and other payments--assessed value reduction sought

COMMENT

This form is an agreement for the sale of an operating hotel. The sale includes not only the real property, but also the business, inventory, other personal property, and additional items related to the hotel. The contract contains terms, therefore, covering matters usually found in contracts for the sale of real estate as well as terms related to the sale of a business.

Closing adjustments and other payments under this contract include a number of hotel items (paragraph 4). The purchaser will pay an additional amount for inventory items certified by accountants, including new and unused furniture and furnishings, supplies, food and liquor. The purchaser pays sales tax for the personal property items (paragraph 15). The apportionment of rent covers percentage rent due from hotel shops as well as guest rentals. The contract contains specific procedures for the transfer of custody of safe deposit boxes (paragraph 6), guest baggage (paragraph 7), and tenant security deposits (paragraph 8). The contract is contingent on governmental approval of the transfer of the hotel's liquor license to the purchaser (paragraph 36).

In this agreement, the seller seeks a reduction in the hotel property's assessed valuation for lower real

property taxes. The reduced taxes, if any, and the costs of seeking the reduced assessed value are to be apportioned between the buyer and seller (paragraph 26). A seller oriented provision contained in this contract is the parties' waiver of the Uniform Vendor and Purchaser Risk Act, coupled with detailed procedures in the event of a casualty loss (paragraph 17). Under the Uniform Vendor and Purchaser Act, which has been adopted in a minority of states, the risk of loss transfers on the earlier of the transfer of possession or the transfer of title. As in this contract, the parties may waive the statute and allocate the risk of a casualty loss as they see fit.

For further information, see Chapters 2, 4, 6, 11, 19, and 20.

FORM

AGREEMENT, made January 30, 2002, by and between Carson Hotel, Inc., a New York corporation, having its principal place of business at 100 East 42d Street, in the City, County, and State of New York ("Seller"), and Central Realty Corporation, a New York corporation, having its principal place of business at 500 Fifth Avenue, in the City, County, and State of New York ("Purchaser").

1. *Description of property.* Seller agrees to sell and convey, and Purchaser agrees to purchase, all that lot or parcel of land, with the buildings and improvements thereon, in the Borough of Manhattan, City, County, and State of New York, bounded and described as follows:

(Insert description)

Such premises being known as and by the street numbers 100-112 East 68th Street.

Together with Seller's entire right, title, and interest:

- (1) of, in, and to any land lying in the bed of the street in front of or adjoining such premises to its center line; and
- (2) to the name "Carson" and all trade names used in connection with the hotel.

Also together with all fixtures, chattels, and articles of personal property that are now, or later may be, placed upon, attached to, or used in connection with or in the operation of the premises, regardless of whether enumerated herein, including, among other items, furnaces, boilers, oil burners, radiators and piping, plumbing and bathroom fixtures, refrigeration, air conditioning and sprinkler systems, washtubs, sinks, gas and electric fixtures, stoves, ranges, awnings, screens, window shades, elevators, motors, dynamos, refrigerators, kitchen cabinets, incinerators, and all furniture, fixtures, silverware, linen, china, glassware, napery, and all other articles of personal property owned by Seller and used in connection with that portion of the premises used and operated as a hotel.

Seller represents that it owns all of the above property free from liens and encumbrances, except as set forth hereinafter. Expressly excluded, however, are the following:

- (a) Fixtures, chattels, and articles of personal property in that portion of the premises known as 102 East 68th Street, all of which are owned by the tenant in possession.
- (b) Furniture, furnishings, and articles of personal property owned by tenants or occupants of rooms, apartments, or other areas in that portion of the premises used and operated as a hotel; and

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(c) Television sets and antenna owned by James Television, Inc. and leased to the hotel under the lease agreement set forth on Schedule B.

2. *Subject clauses.* The premises and personal property are sold and are to be conveyed and transferred, subject to the following:

(a) State of facts as shown on survey made by Herbert C. George, dated April 20, 2001, to any changes since the date of the survey, and to any state of facts the survey brought down to date will show, if such additional facts do not render title unmarketable.

(b) To leases and tenancies as set forth in the annexed Schedule A, and to all tenancies that exist on closing. Purchaser acknowledges that it has examined all leases referred to in Schedule A and has initialled each one for identification.

(c) A mortgage, now a lien of record originally given to secure the principal sum of \$1.3 million, which will have been reduced by payments at or before the date set for closing, to the sum of \$660,000 bearing interest at 12 percent per annum, requiring payments of \$12,500 on the first day of each month, applicable first to interest and the remainder to amortization of the principal balance, until December 1, 2004, when the balance of principal then remaining unpaid becomes due and payable. Seller represents that the last monthly payment on such mortgage was made to the Central Savings Bank.

(d) Zoning regulations and ordinances of the City of New York, now in force, which are not violated by existing structures.

(e) Covenants, restrictions, easements, and reservations of record, if any, if they are not violated by existing structures.

(f) Party walls, and party wall and sewer agreements, if any.

(g) Possible encroachments of retaining walls, foundations, cellar doors, gratings, water tables, trim, cornices, sidewalk, elevator, fences, copings, and variations between record lines and fences or retaining walls.

(h) Rights, if any, acquired by any utility company to maintain and operate lines, wires, cables, pipes, poles, and distribution boxes, in, over, or upon such premises.

3. *Purchase price.* The purchase price is \$4 million, which is payable as follows:

(a) \$340,000 on the signing of this agreement, by check subject to collection, the receipt of which is acknowledged.

(b) \$660,000 by taking title subject to the existing first mortgage now a lien on the premises. Receipts or letters signed by the mortgagee, its agent or attorney, evidencing the payment of installments of principal and interest or reciting the present status of the mortgage as to principal and interest, shall be sufficient evidence of the reduction of principal and the payment of interest.

(c) \$3 million in cash or by certified check, drawn by the grantee named in the Deed, on a New York Clearing House bank, to the direct order of Seller as payee, on delivery of the Deed.

4. *Apportionments and additional payments.* The following apportionments and payments are to be made:

(a) Rents. The rental paid by the tenant who occupies the portion of the premises known as 102 East 68th Street is measured in part by a percentage of the tenant's sales, the tenant being required to pay or adjust the rental at a date after the closing of title. The fixed and percentage rental shall be apportioned between the parties as at the closing date on the

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basis of a monthly rental accrual of \$3,000 for each month of the leased term, notwithstanding any contrary provision of the lease regarding fixed or percentage rental, even if payment or adjustment of rent by the tenant is after the closing.

(b) Interest on the mortgage.

(c) Premiums on existing transferable insurance policies or renewals of those expiring before the closing.

(d) Taxes and sewer rents, if any, on the basis of the fiscal year for which assessed. If the closing of title occurs before the tax rate is fixed, the apportionment of taxes shall be upon the basis of the tax rate for the preceding year applied to the latest assessed valuation.

(e) Water charges on the basis of the calendar year. If there is a water meter on the premises, the unpaid meter charge and unpaid sewer rents for the time intervening between the date of the last reading and the date of closing shall be apportioned on the basis of such last reading. If any tenant in possession is required to pay for water meter charges under the terms of a lease, Seller shall not be required to pay any portion thereof. Purchaser will take title subject to any unpaid water meter charges owing by any tenant, and Purchaser shall look solely to the tenants who are obligated to pay the same for payment.

(f) Employees' vacation pay, if any, and other fringe benefits under a collective bargaining agreement.

(g) One year after date of closing the accounting firm of Williams & Company shall determine whether Purchaser has failed to pay beneficiary employees the accruals for vacation pay charged against Seller, and if so, the unpaid amounts. On the basis of such determination, and within ten days thereafter, Purchaser shall pay Seller the amount charged against Seller but not paid out by Purchaser. In addition, Williams & Company shall determine whether, as a result of negotiations currently pending between the union representing Seller's employees and the hotel association of which Seller is a member, any wage increases are effective retroactively for any period before the date as of which closing adjustments are made. If there are, Seller shall pay Purchaser the retroactive wage adjustments determined to be due.

(h) All rents and charges payable under servicing and maintenance contracts to which Seller is a party, including those set forth on the annexed Exhibit B. The contracts shall be assigned Purchaser, who shall assume the obligations to be performed after the closing.

(i) Employees' accrued wages or salaries and wages and salaries of employees up to 7 a.m. on the day of closing shall be charged to Seller.

(j) Charges for the consumption of electricity, steam, gas, and telephone services.

(k) Telephone equipment rental.

(l) If the payment does not violate state and federal rules and regulations governing liquor sales, at the closing Purchaser shall pay Seller, in cash or by certified check, a sum equivalent to the cost of all foodstuffs, in good, wholesome condition and liquor inventories consisting of bottled or canned goods on hand at the hotel premises owned and operated by Seller, computed at cost and certified to by Williams & Company, whose certification shall be final, conclusive, and binding upon the parties.

(m) At the closing Purchaser shall pay Seller, in cash or by certified check, a sum equivalent to the cost of the following inventories and operating supplies, regardless of whether such inventories or supplies have been issued from storerooms to operated departments, computed at cost and certified to by Williams & Company, whose certification shall be final, conclusive, and binding upon the parties:

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- (1) food inventory, cooked or raw;
- (2) linen, glass, china, and silverware in unbroken packages;
- (3) guests' cleaning and paper supplies and stationery in unbroken packages;
- (4) printing and stationery, such as front office bills, menu stock, and advertising matter, in unbroken packages;
- (5) upholstery material in full bolts;
- (6) new and unused carpets and rugs on hand or in storage;
- (7) new and unused furniture, fixtures, and equipment;
- (8) new and unused engineers' supplies and equipment;
- (9) new and unused paint and painters' supplies and equipment;
- (10) new and unused employees' uniforms.

(n) At the closing Purchaser shall pay Seller, in cash or by certified check, a sum equivalent to all monies in house banks. The house banks shall be counted jointly by the parties' representatives on the day of closing.

(o) Transient rentals for guests for the night on the day of the closing shall be apportioned equally between the parties.

Except as otherwise provided herein, all apportionments provided for in this agreement shall be made as of the close of business of the day preceding the closing date. If any questions arise with respect to the amount of apportionments, the decision of Williams & Company shall be final, conclusive, and binding upon the parties. Closing adjustments shall be determined by Williams & Company tentatively at the closing and payment of the net figure resulting from such adjustment shall be made by Purchaser to Seller by check at the closing. A final closing adjustment shall be made by Williams & Company within 30 days after the closing, and to the extent that any additional payment or repayment is indicated on the final closing adjustment, the payment or repayment shall be made within five days after the final adjustment is made.

5. *Past due rents and past due accounts.* The following shall apply to past due rents and other customary hotel charges:

- (a) Seller's accountants shall, as at the close of business set forth as the closing date, prepare a listing of all accounts receivable balances originating before the closing date and due to Seller from tenants, guests, and patrons of the hotel for rents and other customary hotel charges.
- (b) Purchaser shall take over and exercise all reasonable diligence to collect for the account of Seller all balances contained in such listing. The first moneys received after the title closing from debtors owing such accounts receivable balances shall be received in trust for Seller on account of such accounts receivable for rents and other customary hotel charges and shall be remitted to Seller, together with a listing of such collections at ten-day intervals from the closing date.
- (c) Any credit balance of guests shall be credited to Purchaser.
- (d) Seller's accountants may review accounts receivable collections whether for rent or from other sources after the closing date at least once in each month following the closing date.

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(e) All past due accounts not collected by Purchaser within six months from the date of closing shall be turned back to Seller who, as the exclusive owner, may institute any proceedings and take any steps to effect collection.

6. *Safe deposit boxes.* Seller shall send written notice to guests who have safe deposit boxes advising of the sale of property to Purchaser and requesting the removal and verification of the contents within five days after the closing. Seller, at its expense, shall have a representative on the premises during such five-day period for this purpose. Boxes of guests not responding to written notice shall be listed at the end of the five-day period, and Seller shall have no responsibility to them in connection with the safe deposit boxes. Purchaser shall indemnify Seller against any such liability, unless Seller's representative is present when the box is finally opened.

7. *Baggage inventory.* All baggage checked or left in Seller's care shall be listed in an inventory to be prepared in duplicate and signed by the parties' representatives on the day before closing. Purchaser shall be responsible from and after the closing for all baggage listed in such inventory. All baggage or other property of guests retained by Seller as security for unpaid accounts receivable may be left on the hotel premises without any responsibility or liability therefor by Purchaser, for a period not exceeding six months from the closing date, within which time Seller shall remove or otherwise dispose of the baggage or other property.

8. *Security deposits.* Schedule A contains the names of all tenants who have deposited securities and the amounts deposited. At the closing, Seller shall deliver the security deposits to Purchaser (if not prohibited by the terms of the lease), after which Purchaser shall hold and apply the security for the purpose contained in the lease, and shall indemnify and hold Seller harmless against any liability in connection therewith.

9. *Fuel.* Purchaser shall purchase from Seller, at Seller's cost, all fuel on the premises at the time of delivery of the Deed, and shall pay Seller for the fuel upon such delivery. The parties shall accept as conclusive the written estimate of a reputable dealer as to the amount of oil on the premises at such time.

10. *Violations.* Seller shall furnish Purchaser, upon written request, with authorization to make the necessary searches for violations. All notices of violations of applicable federal, state, or municipal zoning ordinances, health codes, multiple dwelling laws, building codes, fire ordinances, and the like, against or affecting the premises at the date hereof shall be removed by Seller before the closing, or within a reasonable time thereafter, if Purchaser gives Seller written and detailed notice of the violations not later than ten days after the date hereof. Such violations shall not be objections to title. Seller, however, may cancel this agreement by notifying Purchaser in writing, if the reasonable cost of removal exceeds \$10,000 or if such compliance is affected by any governmental law, regulation, requirement, or limitation order in such a manner that, in the sole opinion of the architect named below, the violation cannot be removed within a reasonable time and with reasonable certainty. If Seller elects to terminate, this agreement shall be null and void and the parties shall be released from all further obligations hereunder, except that Seller shall refund to Purchaser the amount of the down payment. Seller's written election to terminate shall be given not later than ten days after it receives Purchaser's written notice. The written estimate of Harris & Johnson, Architects, 111 Fifth Avenue, New York, of the reasonable cost of such compliance shall be conclusive on the parties. Radio and television antennae violations shall be no objection to title and Purchaser will take title subject thereto. Violations which a tenant is required to comply with or remove pursuant to the terms of a lease shall be no objection to title and Purchaser will take title subject thereto. Notwithstanding anything in this paragraph, Purchaser may elect to close the contract and pay the purchase price in full without abatement, taking subject to the violations which Seller is not obligated to correct hereunder.

11. *Special assessments.* (a) If, at the time of delivery of the Deed, the premises, or any part thereof, shall be or has been affected by an assessment or assessments which are or may become payable in annual installments, of which the first installment is then a charge or lien, or has been paid, then, for the purposes of this agreement, all the unpaid installments of any such assessment, including those which are to become due and payable after delivery of the Deed, shall be deemed to be due and payable and to be liens upon the premises affected thereby and shall be paid and discharged by

Seller upon such delivery.

(b) Purchaser shall have ten days after the date of this agreement within which to examine the records with regard to any assessments, other than those referred to in subparagraph (a) above. If the examination discloses any assessments subject to which Purchaser is unwilling to take title, it shall so notify Seller in writing within the ten-day period and request Seller to discharge them. Within ten days after receiving the notice, Seller shall notify Purchaser whether Seller is willing to discharge the assessments. If Seller is not willing to do so, Purchaser may, within five days after notification by Seller, cancel this agreement. In that event, both parties shall be released from any further obligation hereunder, and Seller shall immediately return to Purchaser the amount paid upon the execution and delivery of this agreement. If Purchaser does not cancel, the assessments shall not be the subject of adjustment of the purchase price, and Purchaser shall be deemed to have waived the assessments as an objection to closing and for all purposes of this agreement.

12. *Encumbrances to be removed at closing.* If, at closing of title, the premises are affected by any liens which Seller is required hereunder to discharge or satisfy, Seller shall be deemed to have discharged or satisfied the same if proper instruments of satisfaction or discharge are delivered to Purchaser at title closing and reasonable allowances are made to Purchaser for the estimated charges for recording. Purchaser shall advance at title closing, in cash or by certified check satisfactory to Seller, drawn to the order of a payee or payees named by Seller, any amount (not exceeding the cash balance of the purchase price) required to discharge the liens, and the amount so advanced shall be credited against the cash balance of the purchase price due at title closing. Lien or liens dealt with as herein provided shall not be an objection or objections to title. Violations filed in any county, city, state, or federal department which Seller is required to remove shall not be objections to title if Seller deposits with its attorney a sufficient sum to secure the performance of the work and provide the necessary materials to remove such violations and agrees to remove such violations within 90 days from the closing date.

13. *Amortization payments by the seller.* Any installment of principal, including the portion which represents principal of a combined payment of principal and interest on the first mortgage, between the date hereof and the closing of title, and paid by Seller, which reduces the unpaid principal of such mortgage below \$660,000, shall be repaid to Seller by Purchaser, in cash or by certified check, at title closing.

14. *Deed.* The Deed shall be the usual bargain and sale deed with covenants against grantor's acts, in proper statutory form for recording, duly executed and acknowledged, so as to convey to Purchaser the fee simple of the premises, free of all encumbrances, except as herein stated, and shall also contain the covenant required by subdivision 5 of Section 13 of the Lien Law.

15. *Sales tax.* Purchaser shall pay Seller, in cash or by certified check, the amount that Williams & Company estimates Purchaser to owe for New York City and state sales and use tax. Such payment shall not be, or construed to be, part of the purchase price. Purchaser shall reimburse Seller for any additional amount Seller is required to pay for sales and use tax in connection with the sale. The final audits of the state and City of New York, Sales Tax Division, determining the amount of sales and use tax in connection with this purchase, together with receipted bills showing payment, shall be final and conclusive evidence of the amount of the additional tax and the fact of payment. The provisions of this paragraph shall survive the delivery of the Deed, Bill of Sale, and other instruments.

16. *Deposit a lien.* All sums paid on account of this agreement and the reasonable expenses of the cost of title examination are made liens on the premises, but such liens shall not continue after Purchaser's default under this agreement.

17. *Destruction of premises and eminent domain.* (a) The parties waive the provision of Section 5-1311 of the General Obligations Law, the New York Uniform Vendor and Purchaser Risk Act, if, before the date for closing title (1) all or a material part of the hotel building on the premises is destroyed by fire or the elements or by any cause beyond either

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party's control, or (2) all or a material part of the premises is taken by eminent domain. In either such event, neither party may cancel this agreement, and upon the closing of title, and the receipt of the purchase price, Seller shall pay Purchaser any money collected by Seller under the insurance policies or renewals thereof, listed on the annexed Schedule D, insuring against the loss in question, after deducting any amounts which Seller has agreed or become obligated to pay for repairs or restoration of the damage. In addition, Seller shall assign to Purchaser all of its right, title, and interest in and to such policies and any further sums payable under them, and, if any part of the premises is taken by eminent domain, in and to any awards made for such taking.

(b) If, before closing of title, (1) an immaterial part of the hotel building on the premises is destroyed by fire or the elements or by any cause beyond either party's control, or (2) an immaterial part of the premises is taken by eminent domain, neither party may cancel this agreement, and Purchaser shall be entitled to an equitable abatement of the purchase price, to the extent of the destruction or taking.

(c) Any dispute as to (1) the materiality of any part of the building destroyed or of the premises taken by eminent domain, or (2) the amount of any equitable abatement of the purchase price to which Purchaser is entitled, shall be referred to Harris & Johnson, Architects, whose written determination of the questions in dispute shall be final and conclusive as if rendered by a court of competent jurisdiction. If necessary, the closing date shall be adjourned until the dispute is fully resolved.

18. *Broker.* Purchaser represents to Seller that this sale was brought about by James Stoner & Company and Smith & Baron, as brokers, and that all negotiations with respect to the terms of this agreement were and are conducted exclusively by or through such brokers. If any claim is made for commissions by any broker other than James Stoner & Company or Smith & Baron, by, through, or on account of any acts of Purchaser or its representatives, Purchaser will hold Seller free and harmless from all liability and expenses in connection therewith. Purchaser shall pay the brokerage commission to James Stoner & Company and Smith & Baron if and when title passes hereunder. The provisions of this paragraph shall survive delivery of the Deed.

19. *Waiver, change, or modification.* This agreement may not be modified or terminated except by an instrument signed and executed by both parties.

20. *Unmarketable title.* If Seller is unable to convey a marketable title, subject to and in accordance with this agreement, its sole obligation shall be to refund Purchaser's down payment and to reimburse Purchaser for the cost of title examination. Upon the making of such refund and reimbursement, this agreement shall terminate and neither party shall have any further claim against the other by reason thereof, and Purchaser's lien, if any, against the premises shall wholly cease. Seller shall not be required to bring any action or proceeding or otherwise to incur any expense to render the title to the premises marketable. Purchaser may, nevertheless, accept such title Seller is able to convey, without any reduction of, or credit or allowance against, the purchase price and without any other liability against Seller. Purchaser's acceptance of a Deed shall be deemed to be a full performance and discharge of all of Seller's obligations hereunder, except any specifically stated herein to survive delivery of the Deed.

21. *Cost of title examination.* The term "cost of title examination" is defined, for the purposes of this agreement, as the expense actually incurred by Purchaser for title examination. Such cost, however, shall not exceed the net amount that would be charged by a title company in the City of New York for title examination of the premises, without issuance of policy, plus the cost to Purchaser of any survey actually obtained, such cost, however, not to exceed the amount which would be charged by such title company for a similar survey.

22. *"As is" condition.* Purchaser represents that it has inspected the premises and the personal property included in the sale and is purchasing them "as is."

23. *Unpaid franchise tax.* The nonpayment by Seller of the New York State franchise tax due at any time during the

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current year and its omission to file a franchise tax return during the current year shall not constitute an objection to Seller's title or a ground for the rejection of title. Seller shall hold Purchaser harmless from the collection of such franchise tax out of the premises. The provision of this paragraph shall survive delivery of the Deed. Unpaid franchise taxes of any corporation in the chain of title shall be no objection to title if Seller deposits with its attorney, in escrow, a reasonable amount to secure the payment of such unpaid franchise taxes within 60 days from the date of closing title.

24. *Other unpaid liens.* Unpaid liens for taxes, water charges, and assessments shall not be objections to title, but their amount, plus interest and penalties, shall be deducted from the cash consideration to be paid by, and allowed to, Purchaser, subject to the provisions for apportionment of taxes and water charges.

25. *Seller's right to summary proceedings.* Seller may institute summary proceedings against any tenant based on the tenant's default or failure to perform before the title closing.

26. *Seller's right to proceedings for reduction of assessed values.* Purchaser recognizes that there are currently pending proceedings instituted by Seller in connection with applications for the reduction of assessed values of the premises. Seller expressly reserves the right to continue such proceedings, to prosecute them through judgment, or to settle on any terms that it deems advisable. All refunds or tax savings resulting from such proceedings shall be apportioned between the parties as of the date of adjustments. Purchaser shall assume the legal retainer agreement with respect to required fees for such proceedings and such fees shall be apportioned between the parties as of the date of adjustments. Purchaser consents to any action so determined to be taken by Seller with respect to such proceedings.

27. *Agreement indivisible.* This agreement for the sale of Seller's real and personal property is indivisible even though separate considerations have been stated for the property. An election by either party under any provision hereunder shall be an election as to all such property, subject to the rights of election as set forth herein.

28. *Entire agreement.* This instrument constitutes the entire agreement between the parties. Seller is not liable or bound in any manner, except as otherwise expressly set forth herein, by express or implied warranties, guaranties, promises, statements, or representations pertaining to the premises or personal property or their condition, the rentals, or any other matter made or furnished by any real estate broker, agent, employee, or other person representing or purporting to represent Seller.

29. *Survival of warranties.* All warranties, representations, promises, covenants, and agreements specifically set forth in this agreement shall survive the acceptance of the Deed by Purchaser and payment made at the closing.

30. *Notices.* All notices under this agreement shall be in writing and sent by registered or certified mail, return receipt requested, postage prepaid, addressed, if to Seller, to Carson Hotel, Inc., c/o Nathan & Adams, Esqs., 200 Fifth Avenue, New York, New York; and if to Purchaser, to Central Realty Corporation, c/o John Banner, Esq., 500 Fifth Avenue, New York, New York. Either party may, at any time and from time to time, in the manner set forth for the giving of notices, change the address designated in this paragraph.

31. *Closing.* The closing shall take place at the offices of Nathan & Adams, Esqs., Seller's attorney, at 10 a.m. on the fifth day after the New York State Liquor Authority takes final action on Purchaser's application or May 30, 2002, whichever date is later.

32. *Seller's documents at the closing.* At the closing, Seller shall deliver to Purchaser the following:

- (a) Deed to the real property;
- (b) Bill of Sale to the personal property;

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(c) Assignment of leases set forth in Schedule A, together with the leases referred to in such assignments and any security deposits provided for in such leases;

(d) Assignment of any licenses that may be lawfully assigned;

(e) Assignment of service contracts set forth in Schedule B;

(f) Assignment of insurance policies on which apportionments were made;

(g) Certified copy of minutes of Seller's directors and shareholders authorizing the sale; and

(h) Assignment of service and maintenance contracts.

33. *Purchaser obligations at the closing.* At the closing, Purchaser shall deliver the following:

(a) The consideration set forth in paragraph 3;

(b) An amount for New York City and state sales tax set forth in paragraph 15;

(c) An assumption agreement assuming all of the service contracts set forth in Schedule B;

(d) Certified copy of minutes of Purchaser's directors and shareholders authorizing the purchase; and

(e) Sales tax payment.

34. *Assignment by purchaser.* Purchaser may not assign this agreement without Seller's prior written consent.

35. *Headings.* Headings in this agreement are for convenience and reference only and shall not be used to interpret or construe its provisions.

36. *Liquor license.* (a) This sale is conditional upon the approval of the New York State Liquor Authority of Purchaser's application for a license to dispense alcoholic beverages for on-premises consumption for the premises and the issuance of an appropriate license.

(b) Purchaser represents and warrants as follows: that neither it nor any officers, directors, or shareholders owning 10 percent or more of it have ever been convicted of a crime; that the State Liquor Authority has never disapproved of an application of Purchaser or of its officers, directors, or shareholders; that neither Purchaser nor any of its officers, directors, or shareholders has ever had a license revoked, cancelled, or suspended; that Purchaser is not borrowing money from any brewery, wholesaler, or dispenser of wines and liquors for the purpose of investing it in the business being purchased; that the funds to be paid under this agreement are from sources acceptable to the State Liquor Authority; and that Purchaser knows of no reason why its application for a liquor license should be denied.

(c) Any refund that the State Liquor Authority or another governmental agency returns to Seller on its unexpired portion of a license shall fully belong to Seller.

(d) Purchaser shall make diligent effort to procure a license by, among other things, executing and filing an appropriate application within five days after this agreement is executed, and attending all hearings and interviews required by the Alcoholic Beverage Control Board and the State Liquor Authority. If the State Liquor Authority disapproves the application, and the disapproval is not due to Purchaser's omission or other fault under the representations made in subparagraph (b), this agreement shall terminate, the deposit shall be returned to Purchaser, and neither party shall have

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any claim against the other.

(e) Purchaser shall deliver to Seller a photocopy of each communication from the State Liquor Authority within 24 hours after receipt by Purchaser or its representative, and Purchaser authorizes Seller to make inquiries as to the status and progress of the application.

(f) Purchaser shall be deemed in default hereunder if (1) the State Liquor Authority disapproves of Purchaser's application for a liquor license because of any act, omission, or other fault of Purchaser under the representations made in subparagraph (b), or (2) Purchaser withdraws its application for the license. If Purchaser is in default for either reason, Seller shall retain, as liquidated damages, the monies paid by Purchaser on the signing of this agreement.

(g) If Purchaser is unable, not through its fault, to obtain the State Liquor Authority's approval of its application for an appropriate liquor license within 180 days from the date hereof, Seller may cancel this agreement by giving Purchaser written notice. If Seller elects to cancel, this agreement shall immediately terminate, the deposit made herein shall be returned to Purchaser, and neither party shall have any claim against the other.

37. *Seller's representations.* Seller has not made and does not make any representations as to the physical condition, income, expense, operation, or any other matter or thing affecting or related to the premises, except as herein specifically set forth, and Purchaser acknowledges that no such representations have been made. Seller is not liable or bound in any manner by any verbal or written statements, representations, real estate broker's "set ups," or information pertaining to the premises furnished by any real estate broker, agent, employee, servant, or other person, except as specifically set forth herein.

38. *Lease renewals and rentals.* (a) Seller makes no representations as to the continued occupancy by any tenant or tenants.

(b) Seller does not undertake, represent, or guarantee that any leases or tenancies currently in effect will be in effect at closing.

(c) Seller reserves the right to terminate any lease or tenancy by agreement or through summary proceedings.

(d) Seller may rent any space now vacant or which may become vacant and may extend or renew leases. However, all rentals, leases, extensions, or renewals shall be for a period of not more than two years from the date of making and at rentals consistent with those currently existing for comparable space in the premises.

(e) Seller represents that no concessions for free rent or otherwise have been given to any tenant or occupant of the premises.

39. *Purchaser's inspections.* From the date of this agreement Purchaser may have its representatives upon the premises, but they shall not in any manner interfere with the operation of the hotel.

40. *Purchaser's right to designate nominee.* At the closing, Purchaser may require Seller to convey the land to one of Purchaser's nominees and the building and personal property to Purchaser or another nominee.

41. *Binding effect.* This agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns.

42. *Nonwaiver.* No delay or failure by either party to exercise or enforce any right hereunder, and no partial or single exercise of such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

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43. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New York.

44. *Counterparts.* This agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

45. *Time of essence.* Time is of the essence of this agreement.

In witness whereof the parties have caused this agreement to be signed the day and year first above written by their respective duly authorized officers.

Attest:	Carson Hotel, Inc.
_____	by _____
Secretary	President
Attest:	Central Realty Corporation
_____	by _____
Secretary	President

B.10 Exchange agreement--three-party exchange, two-party agreement--third property and owner to be located--alternative exchange and sale timing and methods

COMMENT

In this agreement two parties agree to exchange property. One party owns land which the other party wishes to acquire. This is a three party transaction because other property or properties are to be located, and the owner or owners are to agree to sell or exchange it with one of the parties to the agreement. The completion of this agreement, therefore, depends upon locating and acquiring other satisfactory property. This agreement intends that one of the parties to the agreement will purchase the third party's property and then exchange it for the property owned by the other party to the agreement. If this cannot be arranged, the agreement provides for a direct exchange between the property owner in the agreement and the third party. The third party will then sell the property acquired in the exchange to the other party to the agreement. Under either transaction, the property owner who enters into this agreement should qualify for nonrecognition of gain as a result of the like kind exchange. Also under either transaction, the party wishing to acquire the owner's property completes the transaction with title to the other party's property. An owner who engages in a triangular exchange secures the benefit of a "like-kind" tax-free exchange, if, among other requirements, his intention was only to make an exchange and if he did not have a binding agreement to sell for cash.

Exchange preceded by third party sale:

There are two basic patterns for triangular exchange transactions. In the first, the owner causes a third party (who wants to sell his property rather than exchange it) to make a sale of his property to the purchaser. The owner then exchanges his property for the property acquired by the purchaser from the third party. A variation of this pattern occurs where the owner agrees to transfer his property to the purchaser if the purchaser will arrange to have the third party's property transferred to the owner. In this latter situation there is usually a sufficient "exchange" even though the purchaser causes a direct conveyance to the owner from the third party. While in these cases the owner does not make a direct exchange with the third party (because the owner conveys his property to the purchaser), the effect of the over-all arrangement is a like-kind exchange by the owner. This latter technique of exchange is provided in this form as an alternative method to be followed by the parties for making an exchange if the parties'

preferred exchange method cannot be completed.

Exchange followed by third party sale:

The second pattern for a triangular exchange transaction, and the one described as the basic or preferred method in this form, is one in which the owner exchanges his property with a third party, but arranges as part of the exchange to have the third party sell the owner's property to the purchaser. The net effect is the same as under the first pattern: the owner makes an exchange; the third party makes a sale; and the purchaser acquires the owner's property. Here the owner's intention to make an exchange is carried out directly, and he himself is never obligated to sell for cash. Such a transaction by the owner should, therefore, fall within the tax-free exchange provision.

Tax free exchange time limitations:

Any property received by the taxpayer more than 180 days after the date on which the taxpayer transfers property, or after the due date of the taxpayer's tax return for the taxable year in which the transfer occurs if earlier, is not to be treated as like-kind property. Thus, tax-free treatment will be unavailable for exchanges not completed within this time period. In addition, property which was not designated as the property to be received by the taxpayer on or before the day which is 45 days after the date the transferred property was relinquished will not qualify as like-kind property. In this agreement, the transfers and exchanges all occur well within these time limitations.

Form combines option with three party exchange:

In this form the owner grants an option to purchase to an optionee, i.e. the purchaser. If this option is exercised, the owner has the right to exchange his property with a third party, but is obligated to find and commit a third party to sell the owner's property to the optionee-purchaser. If the owner is unable to effect an exchange within a prescribed period, he is then obligated to sell his property directly to the optionee-purchaser. Thus, in this agreement an option and a third-party exchange are combined. Also in this agreement, the optionee-purchaser is given two successive options, one exercisable after the other, and a third-party exchange is to be used in each instance.

Recognized gain or loss for third party:

The position of the third party in these transactions is fairly clear. Under the first pattern (exchange preceded by third party sale), the third party has plainly been involved only in a sale of his property. Under the second pattern (exchange followed by third party sale), although the third party appears to engage in an exchange, it is not a tax-free exchange because the property received is not intended to be held either in business or for investment. In any event, the immediate sale by the third party of the property received by him will result, most likely, in tax gain or loss.

For further information, see Chapters 2 and 12.

FORM

AGREEMENT entered into October 15, 2001, by and between Mountain Bank and Trust Company, as Trustee under Trust 500 ("Owner"), and Smith Realty Company, a corporation ("Optionee").

Recitals

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Owner is the owner in fee of certain real property in Orange County, California, comprising approximately 400 acres, more or less (the "Subject Property"), which is bordered by a yellow line and shown on a map prepared by Kay Engineering, Map No. K425, dated March 15, 2001. A copy of this map is attached as Exhibit A and made a part hereof as fully as though set out at length herein. For purposes of this agreement, the Subject Property is divided into two parcels which shall be referred to as follows: Parcel A, comprising 160 acres, and Parcel B, comprising 240 acres.

Owner has made available to Optionee copies of the attached map, which Optionee has examined. Optionee acknowledges that the boundaries bordered by a yellow line on such map are acceptable to it.

Owner wishes to exchange Parcels A and B of the Subject Property for other property of like kind and having these transactions qualify as Exchanges under *Section 1031 of the Internal Revenue Code*.

The Subject Property is the only land to which Optionee acquires any rights hereunder. All other property shown on the map is excluded.

Now, therefore, it is mutually agreed as follows:

1. *Grant of first option.* In consideration of \$50,000 paid by Optionee to Owner, the receipt of which is acknowledged, Owner grants to Optionee the sole and exclusive option to acquire Parcel A of the Subject Property. This option shall automatically terminate at 5 p.m. on June 15, 2002. If Optionee does not duly exercise this option to acquire Parcel A, Owner may retain the \$50,000 paid to it by Optionee as consideration for the option, without any obligation or liability to Optionee, and this agreement shall automatically terminate.

2. *Exercise of first option.* Optionee shall exercise the option for Parcel A of the Subject Property by delivering written notice thereof to Owner, no earlier than June 15, 2002, but no later than 5 p.m. on June 15, 2002, at the place set forth in paragraph 12 for sending notices. Such notice shall be deemed to have been delivered after personal delivery to Owner at the address to which notices are to be sent or within 24 hours after deposit in any branch of the United States Post Office in California, addressed as herein provided, registered or certified mail, return receipt requested and postage fully prepaid.

3. *Owner's right to effect an exchange.* Upon timely exercise of the option, Owner shall thereafter have until July 15, 2002, to exchange Parcel A of the Subject Property for other property of like kind, and to close the exchange. As soon as Owner exchanges Parcel A for other property, it will cause the new owner or owners to agree in writing to sell Parcel A to Optionee according to the following terms and provisions:

(a) If Parcel A is not exchanged by Owner in a consummated transaction within the time provided above, it shall be sold by Owner to Optionee as provided below.

(b) Optionee shall acquire Parcel A from Owner or from the person or persons then owning Parcel A, for the price and upon the terms set forth herein. Within five business days after Optionee has duly exercised the option, Owner shall enter into an escrow at the Western Title Company, Santa Ana, California, or cause the person or persons with whom Owner has entered into an exchange for Parcel A to enter therein, with Optionee, for the sale of Parcel A. Such escrow shall provide for the closing not later than on July 15, 2002. The value and purchase price of Parcel A shall be \$600,000. The purchase price of Parcel A shall be paid in cash at the close of escrow, and Optionee shall not be entitled to any credit for the \$50,000 already paid under the terms of paragraph 1.

(c) The parties agree to execute the escrow instructions as an accommodation for assisting the escrow holder in settling the escrow transaction. If no escrow instructions are executed, the terms of this agreement shall be deemed to be

instructions to such escrow holder.

(d) The following provisions shall govern the escrow:

(1) Parcel A shall be conveyed to Optionee free and clear of encumbrances, except any lien or liens for real property taxes and assessments not then delinquent, and any lien or charge suffered or created by the Optionee on Parcel A. The condition of title shall be subject to reservations, restrictions, easements, and rights-of-way of record at the date of execution of this agreement, but no others. Title shall also be subject to any future bonds and assessments placed of record after the date hereof.

(2) All real property taxes and assessments for the then current fiscal year shall be prorated to the close of the escrow.

(3) The seller and purchaser under such escrow shall pay the customary charges of the Western Title Company for its services and delivery of a standard coverage policy of title insurance. In particular, the seller shall pay for the standard policy of title insurance, the seller and purchaser shall each pay one-half of the escrow fee, the purchaser shall pay for the recordation of documents, and any unusual charges shall be paid by the party causing such expense to occur.

4. *Grant of second option.* If Optionee exercises the option set forth in paragraph 1, and acquires Parcel A of the Subject Property according to all of the applicable conditions, Optionee shall have the exclusive right and option to acquire Parcel B of the Subject Property upon the terms and conditions hereinafter set forth. The option to acquire Parcel B shall automatically terminate if Optionee fails either to perform any condition specified above within the time limitation provided or to exercise the option as provided below. In either event, Owner may retain the \$50,000 paid to it by Optionee under paragraph 1 as consideration for this option.

5. *Exercise of second option.* Optionee shall exercise the option as to Parcel B of the Subject Property by delivering to Owner, at the address provided in paragraph 12, a written notice that it intends to exercise the option as provided in paragraph 6. Such notice shall be deemed to have been delivered after personal delivery to Owner at the address to which notices are provided to be sent, or within 24 hours after deposit in any branch of the United States Post Office in California, properly addressed, registered or certified mail, return receipt requested, and postage fully prepaid.

6. *Time for exercise and price.* The written notice of exercise of the option to acquire Parcel B of the Subject Property shall be made in the manner described in the next preceding paragraph but shall only be effective if given during one of the periods of time set forth below. The value and purchase price of Parcel B shall be adjusted upward depending upon the date of exercise of the option. The applicable value and purchase price of Parcel B per gross acre is set forth opposite the respective periods of time for exercise of such option, as follows:

Period of Time	Value per Gross Acre
(a) July 16-31, 2002	\$20,600
(b) October 16-31, 2002	\$20,800
(c) January 16-31, 2003	\$21,000
(d) April 16-30, 2003	\$21,200
(e) July 16-31, 2003	\$21,400
(f) October 16-31, 2003	\$21,600

7. *Owner's right to effect exchange.* Upon timely exercise of the option, Owner shall have 90 days within which to exchange Parcel B of the Subject Property for other property of like kind, if such exchange is completed within 90 days after exercise of the option. As soon as Owner exchanges Parcel B for other property, it will cause the owner or owners to agree in writing to sell Parcel B to Optionee according to the following terms and provisions:

(a) If Parcel B is not exchanged by Owner in a consummated transaction within the time provided, it shall be sold by Owner to Optionee as provided below.

(b) Optionee shall acquire Parcel B from Owner or from the person or persons then owning Parcel B for the price and upon the terms set forth herein. Within 150 days after exercise of the option, Owner shall enter into an escrow at the Western Title Company at its then existing office in Orange County, or cause the person or persons with whom Owner has entered into an exchange for Parcel B to enter therein, with Optionee for the sale of all of Parcel B. Such escrow shall provide for the closing within 180 days after exercise of the option to acquire Parcel B. The purchase price shall be paid in cash at the close of escrow, except that Optionee shall be entitled to credit for the \$50,000 already paid as option money under paragraph 1.

(c) The following provisions shall govern the escrow:

(1) Parcel B shall be conveyed to Optionee free and clear of encumbrances, except any lien or liens for real property taxes and assessments not then delinquent, and any lien or charge suffered or created by Optionee on Parcel B. The condition of title shall be subject to reservations, restrictions, easements, and rights-of-way of record at the date of execution of this agreement, but no others. Title shall also be subject to any future bonds and assessments placed of record after the date hereof.

(2) All real property taxes and assessments for the then current fiscal year shall be prorated to the close of escrow.

(3) The seller and purchaser under such escrow shall pay the customary charges of the Western Title Company for its services and delivery of a standard coverage policy of title insurance. In particular, the seller shall pay for the standard policy of title insurance, the seller and purchaser shall each pay one-half of the escrow fee, the purchaser shall pay for the recordation of documents, and any unusual charges shall be paid by the party causing such expense to occur.

8. *Alternative method of exchange.* As an alternative to the manner of exchanging Parcels A and B of the Subject Property as set forth in paragraphs 3 and 7 above, Optionee shall cooperate fully with Owner and purchase any other land that Owner wishes to receive in exchange for Parcel A or B, or both. Optionee shall not be charged with any additional expense on account of the exchange transactions. The closing dates and other provisions of this agreement shall remain unchanged.

9. *License to optionee to enter property.* Owner hereby grants to Optionee a nonexclusive license to enter the Subject Property from time to time during the option period referred to in paragraph 1, for the sole and exclusive purpose of allowing Optionee to conduct soil, engineering, and other tests on such land. Optionee shall indemnify and hold Owner harmless from all damage caused by Optionee or its agents to the land, crops, and cattle grazing thereon. Optionee shall be responsible for any hazards created through its conduct on the Subject Property. After performing its tests and engineering work, Optionee shall restore the land to substantially the same condition that existed before its activities thereon. Optionee shall warn Owner before it goes onto the land so that Owner may post notices of nonresponsibility. Owner's failure to post such notices shall not be deemed a failure to mitigate any damages caused by Optionee's conduct on the land. Optionee shall indemnify and hold Owner harmless from all mechanics', laborers', and other liens arising out of its activity on the Subject Property. The license to go onto the Subject Property shall be only for the limited

purpose of allowing Optionee to perform soil, engineering, and other tests. The license shall automatically terminate after the option period referred to in paragraph 1 expires or the tests are completed, whichever occurs first. Thereafter, Optionee shall not have the right to possession of any portion of the Subject Property until it acquires fee title.

10. *Limitation on right of assignment.* Optionee shall not assign this agreement or any right or interest hereunder without Owner's prior written consent. No such prior approval shall be necessary, however, if Optionee assigns its entire rights hereunder to a corporation in which it owns at least 50 percent of the voting stock, or to a joint venture in which it owns at least a 50-percent interest in the profits. Optionee shall remain liable hereunder even if it makes a valid assignment.

11. *Remedies.* If either party brings an action against the other to enforce any term or provision of this agreement or in connection with the Subject Property, the prevailing party shall be awarded its reasonable costs and expenses, not limited to taxable costs, and reasonable attorneys' fees. Such award shall be in addition to any other available relief, including damages or injunction.

12. *Notices.* All notices under this agreement, whether to a party or the escrow holder, shall be in writing and delivered personally or mailed by certified or registered mail, postage prepaid, return receipt requested, addressed to the parties or the escrow holder at the respective addresses set forth below, or to any other address later designated by them:

Owner:

Mountain Bank & Trust Company, Trustee
under Trust 500
100 West First Street
Santa Ana, California

Optionee:

Smith Realty Company
100 Coast Highway
Santa Barbara, California

Escrow Holder:

Western Title Company
Santa Ana, California

Any notice sent by mail shall be deemed given on the day after it is deposited in the United States mail, properly addressed with postage fully prepaid, if mailed in the County of Orange, or on the second day after mailing if mailed elsewhere.

13. *Binding effect.* This agreement shall be binding upon and inure to the benefit of the parties hereto and their respective legal representatives, successors, and assigns.

14. *Entire agreement; modification.* This agreement constitutes the entire agreement between the parties. It is entered into after full investigation, neither party relying upon any statement or representation made by the other not embodied herein. This instrument may not be changed or terminated except by an agreement duly executed and signed by both parties.

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15. *Non-waiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

16. *Headings.* Headings in this agreement are for convenience and reference only and shall not be used to interpret or construe its provisions.

17. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of California.

In witness whereof this agreement has been executed at Santa Ana, California, by the parties as of the day and year first above written.

Mountain Bank and Trust

Company

Trustee under Trust 500

by _____

Vice President

by _____

Secretary

Owner

Smith Realty Company

by _____

President

by _____

Secretary

Optionee

B.11 Broker's agreement granting exclusive agency to sell real property for fixed time period--terms of sale include existing and purchase money mortgages

COMMENT

In the following form, an owner of real property grants a broker an exclusive agency to negotiate a sale of the property. This agreement does not preclude the owner from selling the property without the broker. Unless the owner is a dealer in real estate, selling commissions are an offset against selling price and are not separately deductible.

For further information, see Chapters 6, 8, and 13.

FORM

AGREEMENT made September 21, 2002, between Max Ross, 4 Larch Avenue, Scarsdale, New York, the Owner, and Michael Blum, 912 Third Avenue, New York, New York, the Broker.

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1. *Exclusive agency.* The Owner grants to the Broker the exclusive agency to sell the real property hereinafter described for a period of six months from the above date.

2. *Description of property.* The property covered by this agency is the parcel of land, with the buildings and improvements thereon in the County of Westchester, State of New York, generally known as 4 Larch Avenue, Scarsdale, New York, and more particularly described in the annexed Exhibit A subject to the encumbrances listed in Exhibit A and to any other encumbrances and to any zoning regulations, ordinances, encroachments, covenants, restrictions of record, and any other defects which a title search may reveal and to any state of facts an accurate survey may show.

3. *Terms of sale.* The purchase price for the property shall be not less than \$200,000, to be paid by the purchaser as follows: \$10,000 in cash on the signing of the contract; \$50,000 in cash or certified check upon the closing of title; \$60,000 by the purchaser taking the premises subject to a mortgage for that amount now a lien on the premises; and \$80,000 by the purchaser executing and delivering to the Owner a purchase-money mortgage for \$80,000 payable in 15 years with interest of 12 percent per annum payable semiannually.

4. *Commission.* The Broker shall be entitled to a commission of 7 percent, payable out of such purchase price when, as, and if title actually closes.

5. *Commission at higher sales price.* If the Broker sells the real property for more than the amount set forth in paragraph 3, and on the same terms and conditions, except that the balance of such purchase price over the mortgages referred to in paragraph 3 is payable in cash, the excess amount over \$200,000 shall be divided as follows: 75 percent to the Owner and 25 percent to the Broker.

6. *Authority of broker.* The Broker is authorized to place a "For Sale" sign on the premises and to take all necessary steps to bring about a sale.

7. *Duties of broker.* The Broker shall make diligent efforts to effect a sale of the property, and shall list and advertise it in such manner as he deems most likely to bring about a sale.

8. *Representations.* The Owner represents that he is now the owner in fee simple of the property, and shall convey it by a bargain and sale deed with full covenants if it is sold by the Broker for the price and on the terms and conditions above set forth.

In witness whereof the parties have executed this agreement the date above written.

Max Ross

Michael Blum

B.12 Sale and leaseback of commercial property

COMMENT

The nature of a "sale and leaseback" transaction is apparent from its title. Generally, a sale of property is made on condition that the purchaser lease it back to the former owner. The seller becomes the lessee of the property he has just sold. The new owner does not get physical possession of his property; his right is to receive rent under the lease to the former owner. Usually, the lease is made for a long term, and often with renewal options.

Tax advantages to seller-lessee:

The sale and leaseback arrangement may frequently offer tax and nontax advantages to both parties. The seller converts his equity in the property into the cash and other proceeds of the sale, while retaining physical use of the property. As tenant, he may deduct his rental payments, which are often greater than the deductions for cost recovery or depreciation and mortgage interest available to an owner. When a substantial portion of the value of property is allocable to the land, which is not depreciable, or is allocable to substantially depreciated assets, the deductions as a lessee are especially likely to be greater than those as an owner. The loss of the cost recovery or depreciation deduction may, in some circumstances, outweigh any advantage from the deductible leaseback rent payments. In that case, the sale and leaseback may not be appropriate.

Options to renew or purchase:

Because the seller-lessee wants to retain use and occupancy of the property, there may be an option to renew the lease in the leaseback, or even an option to buy back the property. The options to renew or purchase may subject the transaction to attack by the Service, on the basis that the parties are actually financing by mortgage loan, rather than completing a bona fide sale. Here, a careful examination of the case law, the Code, and regulations is required.

The renewal option in the leaseback assures the seller continued use of the property, even though title has been relinquished. The purchase option provisions in the leaseback agreement often establishes the option price. The price can be stated, or can be determined in the future by appraisal, or related to the remaining lease payments. The purchase option can be limited in time by permitting exercise only during the term of the lease, only during certain periods, or only upon expiration of the lease. These terms are usually negotiated between the parties based on business concerns, but with an eye toward the possible tax consequences of these factors.

Advantages to purchaser:

A major attraction to the buyer is that he often obtains a long-term tenant who has a special interest in remaining on the property. In many transactions the lease calls for a net rental, under which the tenant is obligated to pay all carrying charges, such as taxes, insurance, etc. This rental usually is designed to give the new owner sufficient money to pay the mortgage servicing charges (interest plus amortization) and a fair return on his investment. The entire rental, of course, is deductible by the tenant. The owner, on the other hand, has interest and cost recovery or depreciation deductions to set off against his rental income.

Taxation of the seller-lessee:

The seller-lessee exchanges deductions of mortgage interest and cost recovery or depreciation for the deduction of rent, and additional rent in the net leaseback. The seller-lessee can determine the time of sale, thus timing the realization of gain or loss. Gain may be timed to be realized on an appreciated asset in a year when net operating loss carryover or investment credits would expire otherwise unused. The gain would thus be sheltered by the net operating loss carryovers or investment credit carryover which would otherwise be lost.

Although normally gain realized would be capital gain, the property sold may be subject to investment credit or depreciation recapture. The recaptured amount would be taxed at ordinary income rates, and may offset any advantages from the sale and leaseback set up.

Taxation of purchaser-lessor:

Rent received by the purchaser-lessor is ordinary income. This is offset, to a certain extent, by the cost recovery or depreciation deduction. If accelerated cost recovery or depreciation is available, in the early years, the purchaser-lessor cannot only receive the rent tax-free, but shelter some other income as well. Interest on the purchaser's purchase money mortgage is also a deductible offset against rental income.

Tax recharacterization risks:

The tax and financial advantages of the sale and leaseback may be destroyed in the event of a successful Service attack on the substance of the transaction. This risk is increased when there is an obvious tax avoidance arrangement without a legitimate business purpose. The Service, however, has specific lines of attack on sales and leasebacks.

Recharacterization as mortgage loan:

A second line of attack by the Service on the sale and leaseback transaction is the recharacterization of the transaction as a mortgage loan. This approach is most likely to occur when the transaction looks like an alternative to conventional mortgage financing while the seller retains substantial control over the property. A purchase option in the leaseback for nominal consideration or for a price against which the rent is credited could cause the transaction to fail. If the Service prevails, the seller-lessor would not be entitled to deduct the entire rental payments, but only that portion which would have been interest on the intended mortgage. The seller, not the buyer-lessor, would be entitled to the cost recovery or depreciation deduction. The income to the lessor would not include all the rent payments, but only that portion credited to be interest on the hypothetical mortgage.

Economic substance test for tax classification:

The Supreme Court has held that where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties put into effect by the parties. Looking to the economic substance of the transactions, the court also found that the lessee's option to purchase, though fixed, was for a reasonable amount, and that the lessor bore the risk that the lessee would not exercise that option if the price was more than the fair market value of the property.

Sale and leaseback agreement:

This form illustrates an agreement for the sale and leaseback of property which the seller is under contract to purchase. In effect, the seller is arranging to finance his acquisition of a leasehold by the sale-leaseback technique. The seller is primarily interested in this commercial property for the various subleases. The rent is a fixed annual amount, plus an amount equal to the buyer-lessor's annual payments on the mortgage, plus a percentage of gross rentals from subtenants in excess of a fixed amount. If the rentals received from the subtenants exceed the fixed amount, the owner and the lessee will share the excess.

Information reporting of real estate transactions:

The attorney or title company responsible for closing title is required to report the real estate transaction

to the IRS. In addition, a statement must be provided to the customer before January 31 of the year following the closing. If an attorney or title company is not involved in the closing, the information reporting is the responsibility of the mortgage lender.

For further information, see Chapters 4, 18, and 19.

FORM

AGREEMENT made September 12, 2002, by and between Major Realty Corp., a New York corporation having an office at 100 East 42d Street, New York, New York ("Seller"), and Midwest Realty Investments Company, a partnership having its principal place of business at 1100 Main Street, Cleveland, Ohio ("Purchaser").

Recitals

Seller has entered into a contract to purchase a shopping center located in Broward County, Florida.

The parties desire that Seller, upon acquiring title to the shopping center, shall convey title to Purchaser and, that thereupon, Purchaser shall lease the premises back to Seller, all in accordance with the terms and conditions of this agreement.

Now, therefore, the parties agree as follows:

1. *Sale of premises.* Seller shall sell and convey, and Purchaser shall purchase, all that certain tract of land, together with the buildings and improvements erected thereon, lying and being in the County of Broward, State of Florida, commonly known as the Southern Shopping Plaza, and more particularly described in the annexed Exhibit A (the "Premises"). This sale shall include all of Seller's right, title, and interest in, to, and under all fixtures and articles of personal property attached or appurtenant to or used in connection with the Premises, excluding, however, any such fixtures or personal property belonging to tenants or subtenants.

2. *Purchase price.* The purchase price shall be \$1.45 million over and above an existing first mortgage covering the Premises held by the Central Life Insurance Company in the original principal amount of \$4.2 million and having an unpaid principal balance in the approximate amount of \$4.16 million, payable as follows:

(a) \$150,000 on the execution of this contract, by check subject to collection, payable to Wilson & Meredith, Esqs., as attorneys for Seller, to be held in escrow; and

(b) \$1.3 million in cash or certified check or checks on delivery of the deed.

3. *Liens and encumbrances and title policy.* The Premises are to be sold and conveyed subject to the following:

(a) The first mortgage held by the Central Life Insurance Company.

(b) All current zoning and building laws, regulations, and requirements relating to the Premises;

(c) Any state of facts as shown on an accurate survey of the Premises, if the same does not render title unmarketable.

(d) Rights of tenants under and subject to existing leases, and vacancies, rentals, and leases in existence at the time of closing of title.

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(e) Such state of facts as a personal inspection may disclose.

(f) Conditions, restrictions, and limitations of record none of which prohibit the use of the Premises for the operation of a shopping center or contain any reverter or forfeiture provisions.

Seller shall deliver to Purchaser at the closing, at Seller's expense, a title policy for \$5.61 million insuring Purchaser's interest as fee owner of the Premises, subject, however, to the matters herein set forth and the usual standard exceptions of the title company issuing such policy. Seller shall use its best efforts to have such policy provide that there are no restrictions of record which contain reversions or forfeitures.

4. *Representation by seller.* The Seller warrants and represents as follows:

(a) The first mortgage held by the Central Life Insurance Company is repayable in constant monthly payments of \$50,228 which include interest of 12 percent per annum, and is self-liquidating over a period of approximately 20 years.

(b) The attached Exhibit B is a true and correct list of tenants who have leased space in the Premises and the rentals provided for in their respective leases, all such leases having been exhibited to Purchaser and initialled by the parties. The tenants listed on Exhibit B are in possession and such leases are in full force and effect, except as otherwise noted thereon. Seller does not make any representations or covenants herein with respect to any vacancies which may occur between the date hereof and the closing date.

5. *Additional documents at closing.* At the closing Seller shall deliver to Purchaser:

(a) A certificate of occupancy issued by the applicable governmental authority (if any is issued under local regulations).

(b) A letter or receipt issued by the Central Life Insurance Company or its servicing agent certifying as to the amount of the unpaid principal and interest on the first mortgage, the date to which interest has been paid, and further certifying that the mortgage is in good standing and that the mortgagor is not in default. Such letter or receipt shall be deemed sufficient evidence of the reduction of the first mortgage.

(c) A letter from the present owner of the Premises stating that the first mortgage is in good standing and not in default and that all of the owner's obligations under the first mortgage have been performed.

6. *Outstanding assessments, taxes, etc.* In view of the leaseback provided in this agreement:

(a) If the Premises are affected by assessments at the time of Seller's delivery of the deed to Purchaser, Purchaser shall accept title subject to such assessments, and Purchaser shall not be entitled to any reduction of the cash to be paid at closing on account thereof. However, to the extent that Seller has received sufficient payment (or credit at closing) from the present owner of the Premises to discharge an assessment, Seller shall apply the amount in payment of such assessment.

(b) The existence of any violations or unpaid real estate taxes, utility charges, or like charges on the date of title closing shall not be deemed an objection to title.

(c) No closing adjustments shall be made between the parties at the closing.

7. *Seller's contract to obtain title.* It is understood that Seller is not the owner of the Premises, but Seller represents that it is the owner of a contract for the purchase of the Premises. It is further understood that all of the statements, conditions, representations, and agreements herein contained, in reference to the title to the Premises, the income, the

rents, leases, other agreements, rent rolls, and other matters and things are made by Seller based not upon its own knowledge but upon information received from others and as contained in the contract of sale executed by the present owner. Seller shall use its best efforts to obtain title to the Premises from the present owner and convey the same to the Purchaser at the closing so as to vest title to the Premises in Purchaser. However, if for any reason (other than Purchaser's default) title is not conveyed in accordance with the terms hereof, or if any matter represented herein appears to be inaccurate, Purchaser shall be entitled to the return of the monies deposited on the execution hereof. Upon such payment, this contract shall terminate, and there shall be no further obligation or liability between the parties. If the present owner of the Premises defaults under its contract with Seller, Seller shall pay Purchaser one half of all amounts received by Seller as liquidated damages by reason of the owner's default. Seller shall not be required to incur any expense or commence any litigation in order to clear title or compel performance of the sales contract with the present owner.

8. *Destruction of premises.* Seller represents that the following provision is set forth in its contract with the present owner of the Premises: "Between the date hereof and the date of closing hereunder, Seller assumes the full risk for any damage or destruction by fire or the elements to the premises, including the buildings, structures, and other improvements comprising the shopping center, and Seller shall bear the full cost of the work of restoration, rebuilding, repairing, and replacement before the closing date. Such risk of loss or damage assumed by Seller shall continue until the actual delivery of the deed in accordance with the terms of this agreement."

9. *Deed.* The deed shall be the usual bargain and sale deed with covenant against grantor's acts in proper statutory form for recording, and shall be duly executed and acknowledged so as to convey to Purchaser the fee simple of the Premises free of all encumbrances except as herein provided.

10. *Closing.* The closing shall be held at the office of Burger & Kahn, Esqs., Plaza Office Building, Palm Beach, Florida, at 10 a.m. on October 3, 2002, or at any other place in Florida or New York City that Seller designates by notice to Purchaser. However, Seller reserves the right to cause title to be closed earlier than October 3, 2002 by giving Purchaser at least 48 hours prior written notice, in which event Purchaser shall close title on the earlier date designated by Seller. Purchaser shall not adjourn closing of title without Seller's prior written consent. Seller reserves the right to grant an adjournment of closing of title in connection with its contract for the purchase of the Premises, and Purchaser agrees to a similar adjournment of closing of title hereunder in order to provide for simultaneous closings.

11. *Leaseback.* At the closing, and immediately after Purchaser receives a deed to the Premises from Seller, Purchaser, as landlord, shall enter into a net lease of the Premises with Seller, as tenant. The lease shall be in the form of that annexed as Exhibit C, and shall provide, inter alia, as follows:

(a) The initial term shall be for 21 years, and there shall be three 21-year renewal options.

(b) The fixed rent shall be \$159,500 plus the annual interest and amortization charges required to be paid in reduction of the first mortgage now held by the Central Life Insurance Company.

(c) The tenant shall pay the landlord 50 percent of gross rentals received by the tenant from sublessees in excess of \$620,000, as reduced by 50 percent of any increase in real and personal property taxes and assessments against the Premises after the first lease year.

The form of lease attached hereto shall be completed at the closing as follows: the date of the lease shall be the date of the closing of title; the commencement date of the initial term of the lease shall be the date of title closing; and the dates of the renewal terms shall be set forth to comply with the foregoing.

12. *Assignment and reassignment of leases.* At the closing, Seller shall assign to Purchaser all of its right, title, and interest in and to all of the existing leases (or subleases) affecting the Premises; and, in turn, Purchaser shall reassign

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such leases (or subleases) to Seller as lessee under the foregoing leaseback. All securities and deposits paid over by the present owner of the Premises to Seller at the closing of title shall be retained by Seller as lessee under the foregoing leaseback.

13. *Rental of space.* Purchaser consents to the renting of any space in the Premises which is now vacant, or which may become vacant between the date hereof and the date of title closing, and agrees to take title subject to such leases.

14. *Corporation as purchaser.* If Purchaser takes title in the name of a corporation, such corporation shall be qualified to do business in the State of Florida before the closing date.

15. *Escrow of deposit money.* The down payment check of \$150,000 delivered by Purchaser to Seller's attorneys on the execution hereof shall be deposited by the attorneys, and the proceeds therefrom shall be held in escrow upon the following conditions:

(a) If Purchaser fails or refuses to consummate this agreement in accordance with its terms, through no fault of Seller, Seller's attorneys shall deliver such proceeds to Seller, whereupon Seller's attorneys shall have performed their duties hereunder and will be relieved and discharged of any further obligations in connection therewith.

(b) If Seller defaults under this agreement, or is unable to convey title to Purchaser, Seller's attorneys shall return such proceeds to Purchaser, whereupon Seller's attorneys shall be relieved and discharged of any further obligations in connection therewith.

(c) If there is any dispute in respect of the above, Seller's attorneys may deposit the proceeds with any court of competent jurisdiction in New York City. In such event, they shall be relieved and discharged of any further obligations in connection therewith.

16. *Broker.* The parties agree that Parsons & Company of New York City brought about this sale and leaseback, and Seller agrees to pay a commission to Parsons & Company pursuant to separate agreement. Purchaser shall indemnify and hold Seller harmless from any claim made by any other broker in connection with this transaction. This agreement by Purchaser shall survive the closing of title.

17. *Notices.* All notices hereunder shall be in writing and delivered personally or mailed by certified or registered mail, postage prepaid, return receipt requested, addressed to the other party at its address set forth at the beginning of this agreement, or at any other address the party designates in writing.

18. *Entire agreement; modification.* This instrument constitutes the entire agreement between the parties with respect to the subject matter hereof. It may not be modified or terminated except by an agreement duly executed by both parties.

19. *Nonwaiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

20. *Headings.* Headings in this contract are for convenience and reference only and shall not be used to interpret or construe its provisions.

21. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of Florida.

22. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

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23. *Time of essence.* Time is of the essence of this agreement.

In witness whereof the parties have caused these presents to be executed on the day and year first above written.

Attest:

Major Realty Corp.

by _____

Secretary

President

Midwest Realty Investments Company

by _____

Partner

Receipt of the down payment made by the Purchaser is acknowledged by the undersigned to be held in escrow pursuant to the provisions of paragraph 15.

Wilson & Meredith, attorneys for Seller

by _____

John Wilson

B.13 Sale of land for shopping center--construction by developer--leaseback of store to seller

COMMENT

The seller in this form is a retailer who owns land suitable for a shopping center and is interested in operating a retail store in the center. He sells the land to a developer for cash and a purchase money mortgage. The developer is to construct a building to be occupied by the seller, in accordance with the seller's plans and specifications, and the building is to be leased back to the seller at the closing. The remainder of the shopping center is to be constructed by the developer, subject to the approval of the seller, and is to be leased to others. The developer agrees to obtain commitments from lessees of specified types of establishments.

For further information, see Chapters 4 and 18.

FORM

AGREEMENT made May 10, 2002, between Metropolitan Realty Co., Inc., a New York corporation of 100 East 42d Street, New York, New York ("Seller"), and Fillmore Shopping Centers, Inc., a New York corporation of 525 Fifth Avenue, New York, New York ("Developer").

Recitals

Seller acquired real estate for development and use as a one-stop regional shopping center; and

Developer, having been fully informed of Seller's intent and desires with respect to the development and use of such real estate, on its own initiative proposed that if Seller would sell such real estate to Developer, Developer would cause the same to be developed and used in the manner below and in the accompanying documents and would give Seller the assurances to do so.

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The parties, therefore, agree as follows:

Article I Sale of Center

Section 1.1. *Sale.* Seller shall sell and convey, and Developer shall purchase, that certain parcel of land situate, lying, and being in Rockland County, State of New York, described as follows:

(Insert description)

Section 1.2. *Purchase price.* The purchase price for the Center is \$800,000, payable as follows:

(a) Upon the execution and delivery of this agreement, a down payment of \$100,000 by check subject to collection (the "down payment"); and

(b) Upon the closing date, as defined below:

(1) by delivery to Seller of a check of Developer drawn to Seller's order upon a bank which is a member of the New York Clearing House and duly certified by such bank or official, or cashier's check of a New York City bank to Seller's order, for \$200,000; and

(2) by Developer duly executing, acknowledging, and delivering to Seller a purchase money note and mortgage for \$500,000 covering the Center in the form and substance annexed, completed as therein indicated.

Section 1.3. *Deed.* The deed conveying the Center to Developer shall be the usual bargain and sale deed with covenant against grantor's acts in proper short statutory form for recording; shall be duly executed and acknowledged so as to convey to Developer the fee simple to the Center, free of all encumbrances, except as herein stated; and shall also contain the covenant required by subdivision 5 of Section 13 of the Lien Law. All expenses in connection with the recording of the deed, including the recording charges, shall be paid on the closing date by Developer.

Section 1.4. *Purchase money mortgage.* The purchase money note and mortgage shall be drawn by Seller's attorneys at Seller's expense. Developer shall, on the closing date, pay the mortgage recording tax and recording fees.

Section 1.5. *Prorations.* All taxes, including town, village, and school taxes, and water charges for the Center, shall be apportioned as of the closing date. If the closing date occurs before the tax rate is fixed, the apportionment of taxes shall be based upon the tax rate for the next preceding year applied to the latest assessed valuation. If there is any water meter or meters on the Center, Seller shall furnish a reading to a date not more than 30 days before the closing date and the unfixed meter charge for the intervening time shall be apportioned on the basis of the last reading.

Section 1.6. *Condition of property.* Seller has not made and does not make any warranty or representations as to the quality or nature of the Center's ground or subsurface.

Section 1.7. *Right of entry.* From and after the date hereof and so long as Developer is not in default under any provision of this agreement, Developer may, from time to time, at its sole cost, expense and risk, enter upon all or any part of the Center for the purpose of performing Developer's obligations hereunder.

Section 1.8. *Title examination.* (a) Developer shall order an examination of title to, and survey of, the Center, and shall deliver a copy of the report and survey to Seller's attorneys, Sterne and Leeds, Esqs., 666 Fifth Avenue, New York, New York, no later than 20 days after the date hereof. If any defects, encumbrances, or encroachments appear upon such

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report or survey, other than those to which Developer has agreed to take subject to by the terms of this agreement, which render the title unmarketable, Developer shall send notice to Seller's attorneys within five days after the above-specified date. Developer shall take title subject to any defects, encumbrances, and encroachments set forth in such report or survey and not included in such notice. Within 20 days after receipt of such notice, Seller shall notify Developer either that it will cure the defects, encumbrances, and encroachments of which Developer notified Seller (other than those to which Developer has agreed to take subject), or that it elects to cancel this agreement. If Seller fails to notify Developer that it will cure such defects, encumbrances, and encroachments, this agreement shall be cancelled. In such event, neither party shall have any liability to the other hereunder; but Seller shall promptly thereafter refund to Developer the down payment and pay to Developer the cost of title examination, Developer's reasonable attorneys' fees, and the reasonable value of all work performed by architects and engineers, which Developer has paid or is obligated to pay, as provided in Article II of this agreement. The term "cost of title examination" is defined, for the purposes of this agreement, as the expense actually incurred by Developer for title examination, but in no event to exceed the charges fixed by the New York Board of Title Underwriters for title examination of the Center, without the issuance of a policy, plus the cost to Developer of any survey actually obtained.

(b) Developer shall also order a continuation of the examination of title and a survey of the Center, and deliver a copy of the report and survey to Seller's attorneys not less than ten or more than 20 days before the closing date.

(c) Seller shall be entitled to a 20-day adjournment of the closing date in order to eliminate the defects, encumbrances, and encroachments contained in the continuation report and survey.

Section 1.9. *Failure of title.* If Seller is unable to convey title to the Center to Developer in accordance with the terms of this agreement, Developer shall have only the following rights:

(a) to accept any title Seller is able to convey without any abatement of the purchase price or any other liability by Seller. However, if the title is encumbered by any lien dischargeable by the payment of money (except liens that Developer has agreed hereunder to take subject to), Seller shall either present a proper discharge to Developer at the closing and pay the cost of filing and recording such instruments, or deduct the amount thereof with costs of discharge from the purchase price; or

(b) to reject title.

Developer shall not have any other right or remedy. If Developer rejects title, neither party shall have any liability to the other hereunder, but Seller shall promptly refund the down payment to Developer and pay Developer for the cost of title examination and its reasonable attorneys' fees. If Developer rejects title because of any defect, encumbrance, or encroachment appearing on the report, continuation report, or surveys, which render title unmarketable, or if title is rejected under Section 1.14, Seller shall pay Developer, in addition to and at the time of the payments specified above, all related architects' and engineers' fees and other expenses which Developer has paid or is obligated to pay under Article II. If, however, the defects, encumbrances, or encroachments that render title unmarketable appear in the continuation report or survey but not in the original title report or survey, and such defects, encumbrances, or encroachments were in existence when the original title report was issued or the original survey was made and should have been disclosed therein, Seller shall not be required to pay Developer the architectural and engineering fees and expenses specified in this section.

Section 1.10. *Test of good title.* Seller shall give, and Developer shall accept, any title approved and insured by Home Guaranty Company, subject to any objection that Developer has agreed under this agreement to take subject to. If at the closing date the Center is subject to any liens that are the subject of litigation or negotiation or that have not been finally fixed (except those to which Developer is to take subject hereunder), such liens shall not be deemed an objection to title if Home Guaranty Company, upon delivery of the deed, issues or binds itself to issue a fee title policy which will insure Developer against the collection of such liens.

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Section 1.11. *Customs.* Except as otherwise provided in this agreement, "the customs in respect of title closings" adopted by the Real Estate Board of New York, Inc., as amended, shall apply to the apportionments and other matters mentioned in this Article I.

Section 1.12. *Fire and condemnation.* The parties waive the provisions of Section 5-1311 of the New York General Obligations Law. If, before the closing date, all or any part of the Center is taken by eminent domain, neither party shall have the right to cancel this agreement, and Seller, upon the closing of title and the receipt of the purchase price, shall assign, transfer, and set over to Developer all of Seller's right, title, and interest in and to any awards made for such taking.

Section 1.13. *Purchaser's lien.* The cost of title examination and the \$100,000 down payment by check subject to collection delivered by Developer simultaneously with the execution and delivery of this agreement shall, upon collection, become a lien upon the Center. Such lien shall not continue after default by Developer or payment to it of all the moneys provided for in Sections 1.8 or 1.9.

Section 1.14. *Zoning and other restrictions.* (a) Developer shall take title subject to existing zoning and building laws, ordinances, restrictions, and regulations imposed by any public authority ("zoning laws") affecting the Center. If, between the date hereof and the closing date, such zoning laws are so changed as to prevent the construction, operation, maintenance, and use of the Center as a one-stop regional shopping center as described in this agreement, Developer shall have only the right to accept title and thereby waive any objections to such change in zoning laws or to reject title, in which case its only rights and remedies shall be as provided in Section 1.9.

(b) If any governmental authority having jurisdiction over the Center has obtained, at the closing date, any rights in and to any streets, roads, or avenues in, upon, or across the Center which may be plotted or laid out on any map or plan issued and filed by such authority, or has imposed any restrictions against building upon the bed of such streets, roads, or avenues, and if such rights or restrictions would prevent the construction, operation, maintenance, and use of the Center as a one-stop regional shopping center as described in this agreement, Developer shall have only the right to accept title and thereby waive any objections to such rights and restrictions or to reject title, in which case Developer's only rights and remedies shall be as provided in Section 1.9.

Article II Development of Center

Section 2.1. *Outline plans.* Seller has previously prepared and delivered to Developer, and each has approved and initialed, outline plans and specifications for the construction of Seller's building. As used in this agreement, the term "Seller's building" means the Tenant's building--including building equipment--to be erected and installed as provided in Article II of the lease. The plans and specifications for Seller's building shall be so drawn and written that it will be capable of supporting and servicing four stories, including a basement.

Section 2.2. *Preliminary architectural and structural engineering plans.* No later than 30 days after the date hereof, Developer shall, at no expense to Seller, prepare and deliver to Seller preliminary architectural and structural engineering plans and specifications for Seller's building, including building equipment. Such plans and specifications and those referred to in Section 2.3 shall be consistent with and reasonably inferable from both Seller's outline plans and specifications referred to in Section 2.1 and provide for first-class workmanship and materials. The parties contemplate that Seller's building will be of the same quality of workmanship and material as is contained in, but may otherwise differ substantially from, Seller's Yonkers, New York, store. Such preliminary plans and specifications and all other plans and specifications and drawings shall be prepared by architects and engineers selected by Developer from time to time, as provided in this section. Developer shall select only architects or engineers approved by Seller from time to time to perform services with respect to the leased premises. Before selecting an architect or engineer to perform

services with respect to the remainder of the Center, excluding the premises, Developer shall deliver to Seller a list of one or more proposed architects or engineers. Within 20 days after receiving such list, Seller shall advise developer of any architect or engineer of which it disapproves, but Seller shall not unreasonably withhold its approval. After the 20-day period expires, Developer may select any architect or engineer named in the list to perform services with respect to the remainder of the Center, excluding the leased premises, except those specifically disapproved of by Seller. Developer shall pay all of the selected architects' and engineers' fees and expenses. Developer shall submit each unit or part of the preliminary architectural and structural engineering plans and specifications for Seller's building as soon as it completes the same. Developer shall complete and submit all of the preliminary plans and specifications to Seller on or before July 10, 2002. Seller shall have full right and authority to object to, and require changes, modifications, and corrections which it deems necessary or desirable in the plans and specifications, if such objections and requirements are made in writing within 30 days after receipt of the preliminary plans and specifications and are consistent with and reasonably inferable from Seller's outline plans and specifications referred to in Section 2.1. Developer shall, at no cost to Seller, revise the preliminary plans and specifications and diligently make all changes, modifications, and corrections required by Seller promptly after it receives Seller's written request therefor. Seller's failure to make such request within the specified 30-day period shall be deemed to constitute its approval. Three copies of all revised and corrected preliminary plans and specifications shall promptly be supplied to Seller without charge after they are completed.

Section 2.3. *Preliminary mechanical engineering plans.* Developer shall diligently prepare, at no cost to Seller, preliminary mechanical engineering plans and specifications for Seller's building, and shall submit each unit or part thereof to Seller as it is completed, but in any event shall complete and submit all such plans and specifications no later than August 10, 2002. Seller shall have the unconditional right to object to such plans and specifications and to require any change, modification, or correction it deems necessary or desirable, if the objections and requirements are made in writing within 30 days after the plans and specifications are received and are consistent with and reasonably inferable from Seller's outline plans and specifications referred to in Section 2.1. Promptly after receiving Seller's written request, Developer shall, at no cost to Seller, revise the preliminary plans and specifications and diligently make all required changes, modifications, and corrections. Seller's failure to make the request within the above 30-day period shall be deemed its approval of the preliminary plans and specifications. Copies of all revised and corrected preliminary plans and specifications shall promptly be supplied to Seller without charge.

Section 2.4 *Final plans.* No later than 30 days after (a) Seller approves Developer's preliminary plans and specifications originally submitted to Seller under Section 2.3, or (b) Developer makes all of the requested changes, modifications, and corrections and supplies the revised and corrected plans and specifications to Seller, as the case may be, Developer shall:

Commence to prepare and thereafter diligently prepare, without cost to Seller, and deliver to Seller detailed final architectural and engineering plans and specifications, including working drawings, for Seller's building. The final plans, specifications, and drawings shall be consistent with and reasonably inferable from the preliminary plans and specifications, as revised and corrected under Sections 2.2 and 2.3. Developer covenants that it will submit completed units or parts of the final plans, specifications, and working drawings for Seller's building as each unit or part is completed, and that it will complete all the plans, specifications, and drawings and deliver them to Seller within eight months after the applicable date provided in the first sentence of this section for Developer to commence their preparation. Seller shall have the unconditional right to object to the final plans, specifications, and drawings and to require any change, modification, or correction it deems necessary or desirable, if the objections and requirements are made in writing within 30 days after the plans, specifications, and drawings are received and are consistent with and reasonably inferable from the preliminary plans and specifications, as revised and corrected under Sections 2.2 and 2.3. Promptly after receiving Seller's written request, Developer shall, at no cost to Seller, revise the final plans, specifications, and drawings and diligently make all required changes, modifications, and corrections. Seller's failure to make the request within the above 30-day period shall be deemed to constitute its approval of the plans, specifications, and drawings. Copies of all revised and corrected final plans, specifications, and drawings shall promptly be supplied to Seller without charge.

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Section 2.5. *Costs in excess of items in seller's building.* If the plans, specifications, and drawings for Seller's building, under Sections 2.2, 2.3, and 2.4, include any items of equipment or material which are more or less expensive than items that serve the corresponding functions in Seller's Yonkers, New York store, Developer shall advise Seller of any such net increase, as follows:

(a) Whenever Seller requests, Developer shall promptly cause to be prepared and submitted to Seller a bona fide written estimate by the architects or engineers responsible for the preparation of such plans, specifications, and working drawings of any increase or decrease in architects' and engineers' fees and in such construction costs that would result from any such request. Such estimate shall itemize separately the estimated cost of any item of material Seller so requested Developer to include.

(b) Any approval by Seller of the submitted estimate shall be in writing and returned to Developer within 15 days after the estimate is received. If Seller approves the estimate, it shall reimburse Developer under the attached lease for any aggregate net increase in architects' and engineers' fees and in construction costs shown on all the approved estimates promptly after a statement therefor is received following completion of the work involved. Alternately, Seller may revise the submitted estimate by deducting from any stated increase in such fees and costs the difference between the estimated cost of any item of material included therein and the lower written bid for the identical item from a reliable supplier, if Seller submits the bid to Developer within 15 days after Seller receives the estimate. Any approval by Seller of the revised estimate shall be in writing and returned to Developer within 15 days after it is received. If Seller approves the revised estimate, it shall reimburse Developer under the attached lease for any aggregate net increase in architects' and engineers' fees and in construction costs shown on all the approved estimates, as so revised, promptly after a statement therefor is received following completion of the work involved. If Seller does not approve of the estimate, whether or not revised, and return it to Developer within the above 15-day period, Seller shall be deemed to have withdrawn the request, but it shall reimburse Developer for reasonable architects' and engineers' fees for preparing the estimate.

Section 2.6. *Preliminary plans for other buildings.* No later than 30 days after the date hereof, Developer shall commence to prepare and thereafter diligently prepare, at no cost to Seller, and deliver to Seller, preliminary architectural plans and outline specifications, including isometric drawings and elevations, for the construction of at least 200,000, but not more than 400,000, square feet of building floor area of the buildings, other than Seller's building, and the other improvements. Such plans, specifications, drawings, and elevations shall provide for good quality workmanship and materials, that all vehicular and pedestrian traffic ways be hard-surfaced, and that all parking areas be finished with a permanent surface at least equal in quality to blacktop. Developer covenants to complete and submit to Seller without charge copies of such plans, specifications, drawings, and elevations no later than 90 days after the date hereof. If Seller, within 30 days after receiving such plans, specifications, drawings, or elevations, gives written notice to Developer that any of them do not comply with this section, Developer shall, promptly after receipt of such notice, and at no cost to Seller, diligently make any change, modification, or correction to make them so comply. Seller's failure to give Developer notice within the above 30-day period shall be deemed to constitute Seller's approval of the plans, specifications, drawings, and elevations. Copies of the revised and corrected plans, etc., shall be promptly supplied to Seller without charge after their completion.

Section 2.7. *Plans for service areas.* Developer covenants to prepare, without cost to Seller, and deliver to Seller no later than 60 days before the closing date, preliminary architectural plans for screened service courts for all buildings other than Seller's building, unless before the delivery date the parties agree on a substitute arrangement to replace such courts.

Section 2.8. *Other leases.* Developer guarantees that on or before June 30, 2002, tenants other than Seller will have entered into commitments to lease stores aggregating at least 200,000 square feet of floor area in the Center. Such tenants will be obliged to open for business on or before the date that Seller opens for business in its building, or May

10, 2004, whichever is later. Developer shall deliver a true copy of each lease commitment to Seller on or before June 30, 2003. Each commitment shall include a commitment for lease of at least: (a) 5,000 square feet of floor area to a drugstore for an initial term of at least ten years; (b) 15,000 square feet of floor area to a supermarket for an initial term of at least 15 years; (c) 20,000 square feet of floor area to one or more variety of stores for initial terms of at least 20 years each; and (d) 40,000 square feet to apparel stores for initial terms of at least 15 years each. Developer shall deliver to Seller a true copy of each lease or commitment to lease space in the Center within ten days after its execution.

Article III Closing

Section 3.1. *Place of closing.* All matters to be performed under this agreement on the closing date shall be done at the office of Sterne and Leeds, Esqs., 666 Fifth Avenue, New York, New York, at 11 a.m. on the closing date.

Section 3.2. *Date of closing.* The closing date shall be September 11, 2002. However, Developer may accelerate the closing date if (1) it is not in default hereunder, (2) all matters to be performed hereunder before the closing date, except those required of Seller, have been performed, and (3) Developer gives 20-days' prior written notice to Seller of the earlier closing date. The closing date may be extended as provided in Section 1.8 or 3.3.

Section 3.3 *Default by developer.* Seller may cancel this agreement and retain the down payment if Developer defaults under any provision hereof and shall fail to cure the same within 20 days after Seller's written notice specifying the nature of the default. Seller's cancellation shall not prejudice any of its other rights or remedies hereunder, in any other instrument, or at law.

Section 3.4 *Completion bond.* On the closing date, Developer shall deliver a bond to Seller in which the general contractor to be employed by Developer to construct Seller's building and Developer shall be the Principals, Seller shall be the Obligee, and any surety company shall be the Surety. The bond shall be for \$700,000, unless the amount is changed as provided below, and shall guarantee the construction and completion of Seller's building, fully paid for. If either party believes that the cost of such construction and completion will be more or less than \$700,000, it may request that the amount be changed by giving the other party written notice between 60 and 90 days before the closing date. If the parties cannot agree upon a mutually satisfactory amount within ten days after notice is given, either party may refer the dispute to the architect selected to perform services for the leased premises, as provided in Section 2.2, not later than 45 days before the closing date. The architect shall, not later than 15 days before the closing date, advise the parties of the amount required by a responsible contractor to construct and complete Seller's building, and the bond shall be in that amount.

Section 3.5. *Authority of seller.* On the closing date, Seller shall deliver to Developer: (1) certified resolutions of Seller's Board of Directors authorizing the execution of this agreement and performance of its obligations, and (2) an opinion of Sterne & Leeds, Esqs., Seller's attorneys, to the effect that the execution and delivery of this agreement and of the deed and lease have been duly authorized by Seller, have been duly executed and delivered on behalf of Seller by a duly authorized officer or officers, and are legal, valid, and enforceable under their terms.

Section 3.6. *Authority of developer.* On the closing date, Developer shall deliver to Seller: (1) certified resolutions of Developer's Board of Directors authorizing the execution of this agreement and performance of its obligations, (2) an opinion of James Cooper, Esq., Developer's attorney, to the effect that the execution and delivery of this agreement and of the purchase money mortgage, purchase money note, the bond, and the lease have been duly authorized by Developer, have been duly executed and delivered on behalf of Developer by a duly authorized officer or officers, and that all the above documents are legal, valid, and enforceable in accordance with their terms, and (3) a certificate, executed by Developer's chief executive officer, to the effect that all leases or written commitments to lease any part of the Center entered into by or on behalf of Developer conform with this agreement and the accompanying documents.

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Section 3.7. *Documents.* On the closing date, provided that all matters required to be performed hereunder by both parties prior thereto have been duly performed:

(a) Seller shall deliver the required deed to Developer;

(b) Concurrently, Seller and Developer shall duly execute, acknowledge, and deliver, as Tenant and Landlord, respectively, the lease in the attached form (the "lease").

On the closing date, before the parties execute such lease:

(a) Both parties shall approve, date, and initial the final plans, specifications, and drawings, as revised and corrected under Section 2.4, and the preliminary plans, specifications, drawings, and elevations, as revised and corrected under Section 2.6.

(b) The lease in form attached shall be completed as indicated therein.

Article IV Miscellaneous

Section 4.1. *Notices.* Unless otherwise expressly provided herein, all notices hereunder shall, be in writing and be deemed to have been given when mailed by registered or certified mail, postage prepaid, to the other party at the address stated below, or at the last changed address given by the other party:

If to Developer, at:

Fillmore Shopping Centers, Inc.
525 Fifth Avenue
New York, New York 10017

If to Seller, at:

Metropolitan Realty Co., Inc.
100 East 42nd Street
New York, N.Y. 10017

Either party, however, may at any time change its address for notification purposes by mailing a notice to the other party, as provided above, stating the change and setting forth the new address.

Section 4.2. *Assignment; binding effect.* All references herein to Developer shall be deemed to mean Fillmore Shopping Centers, Inc. If, however, Developer assigns all of its right, title, and interest under this agreement to any person, firm, or corporation, Developer shall be deemed to mean that person, firm, or corporation. If this agreement is assigned, the assignee shall expressly assume, in writing, all of Developer's obligations hereunder, and a duplicate original of the assignment and assumption shall be delivered to Seller no later than five days before the closing date. The duplicate original shall state the assignee's business address and, if the assignee is a corporation, the state of its incorporation. Except as otherwise expressly provided herein, this agreement shall be binding upon and inure to the benefit of both parties and their respective legal representatives, successors, and assigns.

Section 4.3. *Relationship between parties.* The relationship between the parties is solely that of Vendor and Purchaser. Nothing contained herein shall be construed to make the parties partners or joint venturers, or to render either party liable for the other party's debts or obligations. The provisions of Sections 1.6, 4.3, and 4.5 and of Article II shall survive the delivery of the deed and lease.

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Section 4.4. *Nonwaiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

Section 4.5. *Broker.* The parties agree that Rossman Realty Associates, 600 Third Avenue, New York, New York, brought about this agreement as broker. Developer shall pay all commissions or brokerage with respect to this agreement and its negotiation, including the attached lease and extensions or renewals thereof and all additions to Seller's building.

Section 4.6. *Headings.* Headings in this contract are for convenience and reference only and shall not be used to interpret or construe its provisions.

Section 4.7. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New York.

Section 4.8. *Entire agreement; modification.* This instrument constitutes the entire agreement between the parties. It may not be changed or terminated except by an agreement duly executed by the parties.

Section 4.9 *Short forms for recording.* For recordation purposes, Developer shall execute and deliver a short form of this agreement, in the form requested by Seller, in order to record its provisions. Each party shall execute, in recordable form, any certificate reasonably requested by the other party concerning the parties' rights and obligations hereunder.

Section 4.10. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original and all of which together shall constitute one and the same instrument.

Section 4.11. *Time of essence.* Time is of the essence of this agreement.

In witness whereof the parties have duly executed this agreement as of the day and year first above mentioned.

Attest:

Metropolitan Realty Co., Inc.

by _____

Secretary

President

Attest:

Fillmore Shopping Centers,

Inc.

Secretary

by _____

President

B.14 Sale and leaseback of single-purpose property improved by seller to his own specifications

COMMENT

This form illustrates the use of the sale-leaseback technique as a method of releasing working capital for a business organization. Here, the owner is planning to construct an office and research building to its own specifications for use in its own business. The owner has arranged to sell the property for cash upon the completion of the improvements, and simultaneously to take back a long-term lease from the new owner.

Tax aspects on termination:

If the lease is cancelled before the end of its term, the unamortized portion of the cost of the lessee's improvements is deductible in the year of cancellation. The lessor is not entitled to depreciation upon a building or other improvements constructed by the lessee. The value of improvements made by the lessee

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does not constitute income to the lessor either during the lease term or when the lessor acquires the improvements upon the termination of the lease.

For further information, see Chapters 4 and 18.

FORM

AGREEMENT made January 2, 2002, between Jason Products, Inc., a New York corporation, having its principal office at 100 White Plains Road, White Plains, New York ("Seller"), and Realty Holding Corp., a New York corporation, having its principal office at 600 Fifth Avenue, New York, New York ("Purchaser").

1. *Sale.* Seller agrees to sell and convey, and Purchaser agrees to purchase, the premises situated on Central Avenue, in the City of White Plains, County of Westchester, State of New York, together with the buildings and improvements to be completed and constructed by the Seller, such premises being more particularly described in the annexed Schedule A initialed by the parties (the "Premises").

2. *Liens and encumbrances.* The premises are being sold subject to the encumbrances, liens, and exceptions to title enumerated in Schedule A.

3. *Purchase price.* The purchase price is \$600,000, payable as follows:

\$60,000 on the signing of this agreement, receipt of which, by check, is acknowledged, subject to collection; and

\$540,000 either by check drawn by the grantee named in the deed, on a bank or trust company which is a member of the New York Clearing House, to the direct order of Seller as payee, and duly certified by such bank or trust company, or by an official check of such a bank or trust company to the direct order of Seller, to be delivered against receipt of the deed.

4. *Satisfaction of liens at closing.* If, at closing of title, the premises are affected by any lien which Seller is required hereunder to discharge or satisfy, Seller shall not be required to discharge or satisfy the lien of record if proper instruments of satisfaction or discharge are delivered to Purchaser at the closing and proper allowance is made to Purchaser for recording charges.

5. *Construction of improvement by Seller.* Seller shall, at its expense, complete and construct a two-story and basement office and research building on the premises in accordance with the plans and specifications of Jones & Harrison, Architects, which have been initialed by the parties. Such construction shall include all improvements shown on the plans and specifications, and the installation of all fixtures and articles of personal property shown thereon. Seller shall perform the construction and installation with diligence and continuity until completion. All construction and installations, and the buildings and improvements when completed, shall comply with all federal, state, and local laws and regulations, as well as the orders, rules, and regulations of the New York Board of Fire Underwriters or any other body exercising similar functions. All construction and installation shall be under the supervision of Jones & Harrison, Architects. Construction and installation shall not be deemed completed until the following are delivered to Purchaser:

(a) a certificate of completion by Jones & Harrison, Architects, certifying that the work has been completed in accordance with such plans and specifications, and with all applicable laws, ordinances, orders, rules, regulations, and requirements, and

(b) a Certificate of Occupancy issued by the governmental authorities having jurisdiction over the premises, a certificate of the New York Board of Fire Underwriters, and any other certificate required or customarily issued by any other

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governmental authority or agency having jurisdiction over the premises.

If the construction and installation is not completed on July 10, 2002, Purchaser may either:

(a) Cancel this agreement by giving written notice to Seller. If Purchaser cancels, Seller shall immediately refund to Purchaser the amount paid on account of the purchase price, without interest, and pay Purchaser's net cost of examining the title. This agreement shall then terminate, and neither party shall have any further claim against the other by reason thereof; or

(b) Extend Seller's time for completing the construction and installation, by giving it written notice of the extension. If the construction and installation is not completed at the end of the extended time, Purchaser may either cancel as provided in subdivision (a) or further extend as provided in this subdivision (b).

Seller warrants and represents that the building and improvements on the premises, when completed, their sale to Purchaser, and Seller's use thereof as tenant under the lease will not violate any applicable zoning restrictions or ordinances.

6. *Personalty, fixtures, and equipment.* No part of the personal property, fixtures, machinery, or equipment used or procured for use in connection with the operation of Seller's business, whether now or later placed on the premises, is included in this sale, regardless of whether such property, etc., can be removed without material damages to the freehold. It is expressly understood and agreed that all the above property, including movable partitions, shall be and remain Seller's property. However, all fixtures and articles of personal property, machinery, and equipment used or procured for use in connection with the operation of the building, now or hereafter placed on the premises, and the heating, lighting, ventilating, plumbing, and any air conditioning systems are represented to be owned by Seller free from all liens and encumbrances and are included in this sale as a part of the realty.

7. *Leaseback.* Upon closing of title, Seller, as tenant, and Purchaser, or the person or corporation taking title to the premises, as landlord, shall enter into a lease of the premises in the form and containing the same provisions as those set forth in the annexed Schedule B, initialed by the parties, and a short form memorandum of such lease for recording in the form set forth in the annexed Schedule C, initialed by the parties.

8. *Street rights.* This sale includes all of Seller's right, title, and interest in and to any land lying in the bed of any street, road, or avenue opened or proposed, in front of or adjoining the premises, and in and to any award made or to be made in lieu thereof. Seller will execute and deliver to Purchaser on closing of the title, or thereafter, on demand, all proper instruments for the conveyance of such title and the assignment and collection of any such award. The proceeds of any such award shall, however, be dealt with by Purchaser pursuant to the terms of the lease in the same manner and to the same extent as though Purchaser were now the owner, and Seller the tenant from Purchaser, of the premises under the lease.

9. *Deed.* Seller shall, upon receipt of the amounts specified in paragraph 3, make, execute, and deliver a good and sufficient deed to convey to Purchaser, or Purchaser's assigns, the fee of the premises, free from all encumbrances, except as herein stated. Such deed shall be a bargain and sale deed in statutory short form for record, and, except as hereinafter stated, shall contain no covenants or warranties, and shall be duly executed and acknowledged by Seller, at Seller's expense. Such deed shall contain the covenant required by subdivision 5 of Section 13 of the Lien Law.

10. *Closing.* The closing of title shall take place and the deed shall be delivered and the price paid on the 24th day of July, 1987 at 11 a.m. at the office of the Seller's attorneys, Messrs. Smith & Ryan, 100 Wall Street, in the Borough of Manhattan, City of New York. Purchaser may have the title closing advanced to an earlier date if it notifies Seller's attorneys at least five days before such date.

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11. *Objections to title.* Purchaser shall deliver to Seller's attorneys, at least five days before title closing, a statement of all defects, encumbrances, and objections to title, except those to which by the terms of this agreement the premises are to be conveyed subject or which may be expressly waived herein. Seller shall pay all taxes or assessments that are assessed, levied, confirmed, imposed, or become a lien upon the premises or that are due and payable at or before title closing, and shall cure or remove all encumbrances or objections to title arising from Seller's own acts. Seller, however, shall not be under any duty or obligation to cure or remove, or incur any expense to cure or remove, any other defects, encumbrances, or objections to title.

12. *Seller's inability to convey good title.* If Seller is unable to convey a good and marketable title under this agreement, its sole liability shall be to refund to Purchaser the amount paid on account of the purchase price, without interest, and to pay Purchaser's net cost of examining the title. Upon the Seller's making the refund and payment, this agreement shall terminate, neither party shall have any claim against the other, and any lien of Purchaser against the premises shall wholly cease. Seller shall not be required to bring any action or proceeding, or otherwise to incur any expense or take any steps, to render the title to the premises marketable, except as provided in paragraph 11. Purchaser may, however, accept any title that Seller is able to convey, without reduction of the purchase price or any credit or allowance against the same, and without any other liability of Seller. Purchaser's acceptance of a deed shall be deemed full performance and discharge of all Seller's agreements and obligations hereunder, except those specifically stated herein to survive delivery of the deed. All of Seller's obligations as tenant under the lease shall survive delivery of the deed.

13. *Lien for deposit and title expense.* All sums paid on account of this agreement and the reasonable cost of title examination are made a lien against the premises. The lien, however, shall not continue after Purchaser's default hereunder or after any termination of this agreement as provided herein.

14. *Brokers.* The parties agree that Messrs. Gordon & Roth, of 400 Lexington Avenue, New York, New York, are the brokers who brought about this sale. Seller shall pay the brokerage commission, but only upon the conditions and in the amount, with which Purchaser is fully familiar, agreed upon between Seller and Messrs. Gordon and Roth.

15. *Notices.* All notices under this agreement shall, unless otherwise expressly provided herein, be in writing and be deemed to have been given when mailed by registered or certified mail, postage prepaid, to the other party at the address set forth above, or at the last changed address given by the other party.

16. *Departmental violations.* Seller shall, at or before title closing, comply with all applicable state, local, or municipal laws affecting the premises at the closing date, including zoning ordinances, health codes, multiple dwelling laws, building codes, fire ordinances, and the like. This provision shall survive delivery of the deed. Seller shall furnish Purchaser, at its request, with an authorization to make the necessary searches for the above violations.

17. *Unpaid assessments for improvements.* If, upon delivery of the deed, all or part of the premises are or have been affected by any one or more assessments which are or may become payable in annual installments, of which the first installment is then a lien or charge, or has been paid, for the purposes of this agreement all the unpaid installments of any such assessment, including those that are to become due and payable after the delivery of the deed, shall, if required by the mortgagee from whom Purchaser or its assigns borrows part of the purchase price, be deemed to be due and payable and to be liens upon the premises affected thereby. Seller shall pay and discharge such assessments at or before delivery of the deed. The Westchester County Sewer System taxes shall be excluded from the provisions of this paragraph, and the installments of such taxes not due and payable upon delivery of the deed shall not be assumed by Seller as tenant under the lease.

18. *Taxes, assessments, and insurance.* The parties shall not apportion any taxes, assessments, or insurance premiums. At or before title closing, Seller shall pay and discharge all taxes, assessments, water charges, and sewer rents that are assessed, levied, confirmed, imposed, or become liens upon the premises or that become due and payable on or before the closing date. In addition, Seller, as tenant under the lease, shall pay all taxes and assessments, water charges, and

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sewer rents that become liens on or after the closing date. At title closing, Seller shall have in force and deliver to Purchaser all insurance policies required under such lease, and shall cause such policies to be bound for the benefit of the landlord and tenant and the holder of any mortgage upon the premises, as their respective interests appear, in the manner required by the provisions of such lease.

19. *Survival of certain provisions.* The provisions of paragraphs 5, 8, 16, 17, and 18 shall survive delivery of the deed.

20. *Entire agreement; modification.* This instrument constitutes the entire agreement between the parties. It may not be changed or terminated except by an agreement duly executed by the parties.

21. *Nonwaiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

22. *Headings.* Headings in this contract are for convenience and reference only and shall not be used to interpret or construe its provisions.

23. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of New York.

24. *Counterparts.* This agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

25. *Time of essence.* Time is of the essence of this agreement.

In witness whereof the parties have caused these presents to be executed in their names and on their behalfs by their respective officers the day and year first above written.

Corporate Seal

Jason Products, Inc.

Attest:

by _____

President

Secretary

Corporate Seal

Realty Holding Corp.

Attest:

by _____

President

Secretary

(Acknowledgments)

B.15 Escrow agreement--funded by part of mortgage proceeds--completion of building

COMMENT

A lender is usually not required to disburse the mortgage proceeds until the terms and conditions of its mortgage commitment are satisfied. These conditions usually include such matters as title, insurable first lien, fire insurance, survey, and premises that are approved for occupancy. Occasionally, a loan will be made prior to complete satisfaction of the conditions of the commitment letter if the lender determines that the loan will otherwise comply with its lending restrictions and the unsatisfied matters are reasonably certain of being cleared within a short time. As a protective measure, the lender may withhold a part of the mortgage proceeds, in escrow, until the unsatisfied matters are resolved. Such matters might

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include the obtaining of an administrative certification, clearing a relatively minor title defect or removal of an undesirable exception to the title insurance.

Here the purpose of the escrow is the completion of a building to the point where the local authorities will issue various certifications. The escrow provides the lender with funds which it considers to be adequate to complete the building if the builder fails to do so by a specified date.

For further information, see Chapters 6, 17, and 19.

FORM**ESCROW RECEIPT**

Dated:	2/24/02	Re:	Mortgage No. 99999
Amount of Escrow:	\$9,000	Premises:	
Depositor of Escrow:	New England River Homes, Inc.	571 Waterbury-Stamford Road	Georgetown, Connecticut

In connection with the above premises, Hartford National Bank and Trust Company ("Hartford") acknowledges receipt of the above identified escrow deposit, to be held in escrow until completion of the escrow purposes.

If the escrow purposes are not completed on or before the completion date to Hartford's sole and exclusive satisfaction, Hartford, without notice to anyone, may cause the escrow purposes to be completed and fulfilled, and may deduct from the escrow deposit the full costs, disbursements, and expenses deemed necessary by Hartford and actually incurred in the furtherment of the escrow purposes, regardless of whether the escrow purposes are in fact completed.

The costs, disbursements, and expenses shall include, work, labor, materials, general and subcontractor charges, official permit, license, filing and recording fees, legal fees, and fees of architects and other professionals and specialists.

The escrow sum shall not bear interest. Any balance remaining shall be returned to the depositor of the above escrow.

Hartford shall have no liability in completing any escrow purposes beyond the amount of the escrow deposit.

If the escrow purposes are completed on or before the completion date to Hartford's sole and exclusive satisfaction, the escrow shall be returned to the depositor of the escrow.

The escrow sum is not assignable by the depositor of the escrow.

Depositor of Escrow:	New England River Homes, Inc.
Completion Date:	May 24, 2002
Escrow Purposes:	

Issuance of and exhibition to Hartford of a Certificate of Occupancy providing for a one-family dwelling; also Connecticut Electrical Inspection Certificate and Fire Underwriter's Certificate. Upon issuance of Certificate of

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Occupancy, \$9,000 will be released to the escrow depositor.

Hartford Bank and Trust

Company

by _____

The above terms accepted by:

New England River Homes, Inc. by

B.16 Occupancy agreement--occupancy by purchaser prior to settlement--owner's form

COMMENT

An occupancy agreement is useful when the right of possession is transferred at a time before or after settlement. If the buyer wishes to occupy the building before settlement, possession would be given prior to closing by the seller. If, on the other hand, the seller wishes to remain in possession for a limited time after the transfer of title, the buyer, as the new owner, would let the seller retain possession for the limited time. The terms of the agreement depend upon the negotiating strength of each party. Matters to be negotiated include the occupancy fee, risk of loss, liability insurance, settlement adjustments, and surrender of possession if necessary.

Occupancy fee:

Generally the owner will require a fee from the party to occupy the property. Although the occupancy fee can be any amount agreed to by the parties, some practitioners believe it should have some relationship to the owner's expenses. These expenses include the monthly amortization due on the owner's mortgage, the proportionate amount of real estate and other taxes, and other charges incurred by the owner by reason of title to the property. The owner may add a premium to this amount and establish the occupancy fee. If the party taking possession does not assume the utility charges for gas, electric, water, etc., these should be included in the occupancy fee. However, since the occupying party has control over the extent of use of utility services, it is often provided that the occupant assume such charges.

Risk of loss:

The risk of loss to the premises is usually assumed by the party in possession. The party in possession maintains the most control over the premises, so the occupier is better able to protect against loss. If the buyer is to take possession prior to settlement, then the risk of loss should, by agreement, shift to the buyer upon occupancy. If the seller is to remain in possession after closing, the risk of loss should remain with the seller until possession is surrendered.

Liability and insurance:

Both the party in possession and the owner have insurable interests in the property and liability risks. Each should maintain insurance for their own protection. Usually an owner will have insurance from the date of ownership to the date of transfer. However, the party in occupancy may overlook this risk. The owner may wish to have a fund to recover against in the event the occupant is liable to the owner. Therefore the agreement should provide that the party in occupancy maintain satisfactory insurance

coverage.

Settlement adjustments:

Customarily, expenses incurred in occupying property are borne by the party in possession. Therefore, settlement adjustment associated with possession should correspond to the time when possession changes hands, rather than the date title changes hands. Such items would include fuel, utilities, real estate, water or other taxes, and maintenance expenses. Personal obligations of the parties, however, would be adjusted as of settlement, and would include such items as insurance, mortgage payments, and mortgage insurance, if any. (Part or all of these personal expenses can be recovered, however, in the occupancy fee.)

Surrender of possession:

If all does not go as planned, the owner will want some assurance that possession will be surrendered or returned. This can be handled by a number of different methods. One method may require liquidated damages in a prescribed monthly amount. Another approach would prescribe an increased monthly occupancy fee, which could be secured by an adequate cash deposit. Another approach, used separately or in conjunction with the other methods, would be an express submission to the court having jurisdiction over summary eviction proceedings.

Inspection of the property:

In some locations it is customary for the purchaser to conduct an inspection of the property prior to closing. This may be specifically allowed in the contract, or may be part of the practice in the locality. In order to avoid a situation where the seller is held responsible for damages to the property between the time the buyer takes possession and the settlement date, the pre-closing inspection should be moved up to a time just prior to the purchaser's taking possession. Any objections can be raised and resolved before possession or closing. Any unsatisfactory conditions not objected to by purchaser, or occurring during purchaser's occupancy, would be the purchaser's responsibility.

For further information, see Chapters 1, 4, and 9.

FORM**USE AND OCCUPANCY AGREEMENT**

AGREEMENT made September 23, 2002, by and between John P. La Costa and Mildred O. La Costa, husband and wife, residing at 449 Windsor Street, Round Valley, Pennsylvania ("Seller"), and Charles W. Long and Alice B. Long, husband and wife, residing at 213 Craig Drive, Chattanooga, Tennessee ("Buyer").

Recitals

By a certain contract of sale between the parties, dated August 11, 2002, Seller agreed to sell and Buyer agreed to purchase the premises known as 449 Windsor Street, Round Valley, Monongahela County, Pennsylvania ("the premises").

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Buyer is desirous of taking possession of the premises before the anticipated closing of title on October 31, 2002, and Seller is willing to allow such possession of the premises subject to certain conditions:

Now, therefore, the parties agree as follows:

1. *Possession; fee.* Seller will on September 27, 2002, at 4:00 p.m., deliver to Buyer the full possession of the premises as if the conveyance thereof had been executed, and Buyer shall pay Seller an occupancy fee of \$1,000 per month commencing with this agreement.

2. *Disclaimer.* Buyer acknowledges and agrees that the use and occupation of the premises contemplated by this agreement is on an AS IS basis. SELLER HAS NOT INSPECTED THE PREMISES TO DETERMINE ITS PRESENT CONDITION. SELLER MAKES NO WARRANTIES OR REPRESENTATIONS, EXPRESS OR IMPLIED, ABOUT THE PREMISES EXCEPT AS SPECIFICALLY SET FORTH IN THE CONTRACT OF SALE. SELLER HAS ENTERED INTO THIS AGREEMENT IN RELIANCE UPON THESE LIMITATIONS OF SELLER'S LIABILITIES AND WOULD NOT HAVE ENTERED INTO THIS AGREEMENT WITHOUT SUCH LIMITATIONS.

3. *Liability.* Buyer assumes all risks of and responsibility and liability for all losses, damages, and personal injuries incurred by Buyer or any other persons during Buyer's use and occupancy of the premises, regardless of whether they are caused by Buyer's use and occupancy thereof. Buyer shall indemnify and hold Seller harmless from all claims, actions, suits, proceedings, costs, expenses, damages, and liabilities, including attorneys' fees, arising out of, connected with, or resulting, directly or indirectly, from or during Buyer's use and occupancy of the premises. Buyer shall defend, at his expense, all suits brought against Seller, either alone or in conjunction with others, upon any such liabilities of claims, and shall promptly satisfy, pay, and discharge all judgments and fines recovered against Seller in all such actions.

4. *Adjustments.* All adjustments for taxes, water charges, and utility charges shall be determined as of September 27, 2002, and Buyer shall thereupon be solely liable for their payment.

5. *Insurance.* Buyer shall secure hazard and liability insurance covering the premises to protect against any loss or damage occurring, or liability incurred, during Buyer's use and occupancy of same. Prior to delivery of possession, Buyer shall provide satisfactory evidence of such insurance to Seller's attorney. Such evidence shall include a copy of the insurance policy issued and a premium paid receipt.

6. *Surrender of possession.* If the closing of title does not take place by October 31, 2002, through no fault of Seller, Buyer shall pay \$1,300 per month to Seller commencing on November 1, 2002. In no event, however, shall Buyer's use and occupancy of the premises at any time be considered a tenancy in any form. Buyer shall vacate the premises immediately following Seller's demand in the event of a breach by Buyer of any term or conditions of this agreement. Buyer further agrees that, failing such voluntary vacation, Buyer may be dispossessed on three days' notice by summary proceedings.

7. *Maintenance and compliance.* During Buyer's use and occupancy of the premises, Buyer shall keep the premises in good condition and repair at his expense and shall comply with all governmental ordinances and regulations concerning the premises.

8. *Deposit.* Prior to delivery of possession, Buyer shall deposit \$3,000 with Seller's attorney to be held in escrow. This sum may be applied to: (a) the \$1,000 per month occupancy fee agreed to by and between the parties; (b) the repair of any damages to the premises incurred after the date of delivery of possession; (c) the payment of any taxes, water charges, or utility charges incurred after that date; or (d) the payment of any other amounts which are Buyer's responsibility under the terms and conditions of this agreement, following Buyer's failure to pay for any of the above items upon demand. Any balance remaining shall be repaid to Buyer at title closing.

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9. *Assignability.* Neither this agreement, nor any right or obligation hereunder, is assignable by Buyer.

10. *Contract of sale.* Neither this agreement, nor Buyer's taking of possession of the premises, shall be deemed a waiver of the contract of sale, but shall be considered as being conditional upon, and without prejudice to, the due performance of the contract of sale in all respects.

11. *Inspection of premises.* Buyer acknowledges that he has conducted an inspection of the premises prior to taking occupancy thereof, and waives all rights to such an inspection prior to settlement, which may arise by custom or contract. Buyer shall accept the premises in the condition found upon their taking occupancy, and acknowledges that any personal property included in the sale is properly located in the premises and is in good working order.

12. *Entire agreement; modification.* This instrument constitutes the entire agreement between the parties in connection with Buyer's use and occupancy of the premises. No modification of this agreement shall be effective unless in writing and signed by both parties.

13. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of Pennsylvania.

14. *Notices.* All notices hereunder shall be sent by registered or certified mail, postage prepaid, return receipt requested, addressed to the other party at its address set forth at the beginning hereof. Either party, however, may designate a different address by serving written notice of change of address on the other party, in the manner provided above.

15. *Binding effect.* This agreement shall be binding upon and inure to the benefit of the parties hereto and their respective legal representatives, successors, and assigns.

16. *Headings.* Headings in this agreement are for convenience and reference only and are not deemed to be a part thereof.

17. *Non-waiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

18. *Counterparts.* This agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

19. *Time of essence.* Time is of the essence of this agreement.

In witness whereof the parties have set their hands and seals the day and year first above written.

Witness:

_____	_____
_____	_____
_____	_____
_____	_____

B.17 Occupancy agreement--occupancy by seller subsequent to closing--letter agreement

COMMENT

This form reflects the buyer's agreement to permit the seller to remain in occupancy after settlement. The seller is usually required to surrender possession of the property, along with title, at closing. This agreement not only permits the seller to remain in possession for the specified time, but also deals with closing adjustments, utilities, failure to surrender possession, buyers' right of inspection, indemnification and insurance.

Closing adjustments:

Settlement adjustments are made as of the date the seller is to vacate the property. The seller will enjoy the benefits of possession until such date, and should bear the expenses related to possession. Such adjustments would include real estate taxes, utilities, and fuel.

Possession deposit:

At closing, the seller, under the agreement, deposits a sum of money with the buyer's attorney to secure the surrender of possession by the seller. The deposit also secures the payment of the monthly occupancy charge, as well as expenses incurred to obtain possession from the seller. A specified \$100 per diem liquidated damages provision is also secured by the deposit. The seller will be obligated to pay the buyer an additional \$100 per day for each day beyond the date the seller is supposed to vacate the property. This is in addition to the other accruing charges and expenses.

Right of inspection:

The purchaser's right to inspect the property just prior to closing will not give the buyer an opportunity to object to any defects or unsatisfactory conditions in the premises after the seller vacates. Therefore, this agreement provides for the inspection to take place after the property is vacated by the seller. All representations and warranties contained in the contract are extended past settlement, so that, upon inspection, the buyer has the same rights as he had prior to closing. This provision should prevent non-title representations being deemed waived or merged with delivery of the deed, by expressly providing that the parties intend such representations and warranties to survive settlement and delivery of the deed.

Indemnification and insurance:

By reason of ownership of the property, the buyer may be subject to liability and law suits. This agreement provides that the seller will indemnify the buyer for any liability incurred by reason of the seller's continued occupancy. To back up this indemnity, the seller is obligated to continue his insurance on the property.

For further information, see Chapters 1, 4, and 9.

FORMS

(1) Letter agreement form

May 16, 2002

Mr. and Mrs. Mark C. Witkowski
c/o Dolan, Levine and Camprice
Attorneys at Law
1030 First Street
Bridgeport, Connecticut

Re: 195 Centerville Road
Hamden, New Haven County Connecticut

Dear Mr. and Mrs. Witkowski:

As sellers of the above premises pursuant to our contract dated May 1, 2002, we are not entitled to remain in possession of the premises after closing. However, at our request, you agreed to our continued possession.

1. *Adjustments.* We agree at the closing, all adjustments will be as of June 30, 1992. During the time of extended possession, we will pay all the expenses of running the premises, including fuel oil, water, electricity, gas, and repairs.

2. *Relationship.* The relationship between us in this transaction is that of licensee and licensor, and not that of landlord and tenant.

3. *Surrender of possession.* If we do not surrender possession to you for any reason by July 1, 2002, we agree upon three days' written notice from you or your attorney, to vacate the premises and deliver it to you in broom clean and good condition. In addition, we shall make full payment of the amount then due at the monthly rate of \$1,112, as apportioned from June 30, 2002 to such date. Furthermore, if we refuse to remove ourselves and possessions on the date set forth in such notice, we shall reimburse you for all reasonable costs incurred in recovering possession of the property, including reasonable attorney's fees and an additional \$100 per day for each day we continue in possession after the date of such revocation of license. You are authorized to deduct such sums from the \$4,000 deposited at closing with your attorney before returning the balance to us.

4. *Inspection.* We acknowledge that you have the right to inspect the house after our vacation therefrom. We agree that your closing of title, in reliance upon this letter agreement, shall not constitute an acceptance of the house in its present state and condition. Any representations, covenants, promises, or obligations made by us as set forth in such contract shall survive the closing of title and delivery and acceptance of the deed. Further, we agree that all of the personal property set forth in the contract as included in the sale, shall be present in the house upon surrender of our license.

5. *Occupancy.* While we are in possession of the house, after the closing of title, we shall take good care of the premises, make all necessary and reasonable repairs, and be responsible for any damage.

6. *Indemnification.* We further agree to indemnify you and hold you harmless from all damages caused by our occupancy of the house, and the money deposited at closing with your attorney shall be held by him also as a fund out of which you shall be reimbursed for such damages, after the assessment of same. We agree to continue our insurance on the premises until we turn over possession to you.

Very truly yours,

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Roger V. Rustic

Jane C. Rustic Agreed and Accepted:

Mark C. Witkowski

Barbara J. Witkowski

(2) Contract form

THIS AGREEMENT, made this 1st day of August, 2002 between Roger V. Rustic and Jane C. Rustic, husband and wife ("Sellers"), and Mark C. Witkowski and Barbara J. Witkowski, husband and wife ("Purchasers"), each of whom is a party to the following agreement and to that certain contract to sell and purchase premises located at 12 Elm Street, Hempstead, Nassau County, New York dated June 2, 2002.

Recitals

The closing of title has been negotiated and took place on August 27, 2002, in accordance with the terms of the sale contract.

Sellers are unable to vacate the premises on the date of closing of title and desire to continue to reside within the premises until September 15, 2002.

Purchasers are willing to grant Sellers continued occupancy until the September 15, 2002, and not longer.

It is understood and agreed that:

1. Purchasers and Sellers have made their adjustments as of September 1, 2002. If Sellers remove from occupancy by such date, no additional charges shall be made or payable by them except as set forth below. If, however, Sellers remain beyond September 1, 2002, they shall pay a charge of \$77 for each day until removal, or such amount shall be deducted from any deposit or escrow held herein and given to Purchasers.
2. Sellers will deposit in the trust account of Purchasers' attorney the sum of \$4,000 as a good faith deposit to insure the performance of this agreement. The deposit will be returned to Sellers when they vacate the premises.
3. Sellers shall be responsible for the cost of any repairs, maintenance, or damage with respect to the premises resulting from their occupancy during the above period of time.
4. Sellers shall be responsible for all public and private utility charges, inclusive of oil, gas, electricity and water, for the period during their occupancy.
5. Sellers shall suffer all risk of loss or damage to their property stored or located on the premises, and shall hold Purchasers harmless from all claims or demands arising from their occupancy of the premises.
6. Sellers agree that if they fail to vacate the premises on or before September 15, 2002, a penalty of \$200 per day shall be charged against them until they vacate the premises.

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7. It is expressly understood and agreed that no landlord-tenant relationship is implied or created by this agreement, except that this agreement may be enforced in the landlord-tenant court or in any other court of the state and Seller may be put out of the premises by Purchaser's physical act if Purchaser so desires, without any further liability to Purchaser on and after September 15, 2002.

8. Seller waives any defense it may have with respect to any matter contained in this agreement.

In witness whereof the parties have duly executed this agreement, the day and year first above written.

Roger V. Rustic, Seller

Mark C. Witkowski, Purchaser

Jane C. Rustic, Seller

Barbara
J.
Witkowski,
Purchaser

B.18 Commercial building note and mortgage--building equipment included as collateral--parties' rights regarding rent defined--no recourse against borrower--New York

COMMENT

This is a note secured by a mortgage on a commercial building which the seller of the building accepts from the purchaser as part of the purchase price.

Building equipment and fixtures as collateral:

As additional collateral for the payment of this note and mortgage, the mortgage covers "any and all articles of personal property attached to or used in any way in connection with the operation or renting of the premises." In the event of default, the mortgagee may take possession of the building or request the court to appoint a receiver to collect rents and operate the building. The right to possession of not only the building itself, but also the fixtures, equipment and furnishings necessary or desirable for the continued operation of the building and the collection of rent, can have significant economic effects. A substantial factor in the valuation of a commercial building is the amount of rent generated. Upon possession, the mortgagee is concerned not only with receiving sufficient cash flow to pay operating expenses but also maintaining rent-paying tenants in the building. The fixtures, equipment and furnishings for the operation of the building are therefore important security for the loan. Although fixtures, permanently attached to the building, are generally covered by the mortgage on the real estate, it may be advisable to take additional steps, under Article 9 of the Uniform Commercial Code, to perfect a security interest in personal property used in the operation of the building. Some practitioners take the additional step of perfecting a UCC security interest in fixtures as well.

Rent provisions:

Specific and detailed provisions dealing with rent are included in this mortgage. The building owner is prohibited from accepting rent prepayments from tenants (paragraph 28), and rents are assigned to the

mortgagee effective on default (paragraph 18). Upon default, the owner of the building is also required to pay rent, if it is an occupant in the building (paragraph 19).

No recourse:

The mortgagee agrees not to sue on the note, but to resort solely to the security of the mortgage to recover any money due on the note. If, after foreclosure, there is a deficiency, the mortgagee may not seek a judgment against the mortgagor (note and paragraph 27 of the mortgage).

For further information, see Chapters 12 and 19.

FORM

(1) Nonrecourse note

\$3,150,000 New York, July 28, 2002

FOR VALUE RECEIVED, Central Offices, Inc., a New York corporation, having its principal place of business at 250 East 57th Street, New York, New York ("Maker"), promises to pay to 236 West 32nd Street Corporation of 926 Fifth Avenue, New York, New York ("Payee"), or order, at 926 Fifth Avenue, New York, New York, or at any other place designated in writing by the holder of this note, the principal sum of \$3,150,000, as follows: \$126,000 on November 1, 2002, and a like amount of \$126,000 on the first days of February, May, August, and November in each year thereafter, to be applied first to interest at the rate of 10 percent per annum computed from the date hereof, and the balance in reduction of the principal of this note, until August 1, 2012, when the entire unpaid principal balance of together with accrued interest on this note shall become due and payable. The Maker of this note may prepay it in whole at any time after August 1, 2010, upon giving 30 days' prior written notice to the holder, without penalty or premium.

1. *Default.* The principal sum secured by this note shall become due at the holder's option on the happening of any default or event by which, under the terms of the mortgage securing this note, the principal sum may or shall become due and payable. All of the covenants, conditions, and agreements contained in the mortgage are made part of this instrument.

2. *No recourse.* This is a nonrecourse note and, anything herein to the contrary notwithstanding, Payee agrees for itself, its representatives, successors, endorsees, and assigns that (a) neither Maker nor its representatives, successors or assigns shall be personally liable on this note, it being intended that Maker's obligation to pay the principal of this note with interest thereon is included for the sole purpose of establishing the existence of the indebtedness represented hereby, and (b) in the event of default, Payee (and any such representative, successor, endorsee, or assign) shall look for payment solely to the security of the property which is the subject of the mortgage and will not make any claim or institute any action or proceeding against Maker (or any representative, successor or assign of Maker) for payment of this note (or for any deficiency remaining after application of the property which is the subject of the mortgage). Nothing contained herein, however, shall be construed to release or impair the indebtedness evidenced by this note, or of the lien upon the property mortgaged to secure it, or preclude the application of said mortgaged property to the payment hereof in accordance with the terms of the mortgage.

3. *Waiver.* Presentment for payment, notice of dishonor, protest, and notice of protest are waived.

4. *Mortgage.* This note is secured by a mortgage made by Maker to Payee of even date herewith, on property situate at 236 West 32nd Street, in the Borough of Manhattan, City and State of New York.

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5. *Amendment.* This note may not be changed or terminated orally.

Central Offices, Inc.

by _____

Conrad Johnson, President

(2) Commercial building mortgage

THIS MORTGAGE made July 28, 2002, between Central Offices, Inc., a New York corporation, having its office and principal place of business at 250 East 57th Street, Borough of Manhattan, City and State of New York, the mortgagor, and 236 West 32nd Street Corporation, a New York corporation, having its office and principal place of business at 926 Fifth Avenue, Borough of Manhattan, City and State of New York, the mortgagee.

Witnesseth, that to secure payment of an indebtedness in the sum of \$3,150,000, lawful money of the United States, to be paid with interest thereon, according to a certain note or obligation bearing even date herewith, the mortgagor hereby mortgages to the mortgagee

All that certain plot, piece or parcel of land, situate, lying and being in the Borough of Manhattan, City, County and State of New York, bounded and described as follows:

[Insert Description of Property]

This mortgage and the accompanying note have been executed and delivered by authority of the mortgagor's Board of Directors.

Together with any and all articles of personal property attached to or used in any way in connection with the operation or renting of the premises, including all partitions, elevators, engines, motors, dynamos, boilers, furnaces, fuel oil, coal; heating, refrigerating, air-conditioning, plumbing, gas and electric light equipment; vacuum cleaning system, sprinkler system or other fire preventing or extinguishing equipment and materials; stoves, ranges, refrigerators, ice boxes, awnings, screens, window shades; furniture and furnishings for the common halls and lobbies; hotel, theatre, meeting hall, club and lodge furnishings and equipment; also all other articles constituting a part of, or used in connection with the operation of, the plant of the mortgaged premises, to all of which the mortgagor represents that the mortgagor has title free from any prior liens or encumbrances, and all buildings, structures, improvements, fixtures and articles of personal property at any time hereafter constructed, affixed to or placed upon said premises or used in connection with the operation thereof. This provision shall apply to any personalty or fixtures, now or hereafter in the premises, even though any fixture or article of personal property may not form a part of the realty as a matter of law, or may not be essential to the support of the realty. It is intended that such fixtures and articles of personal property shall become a part of the mortgaged realty and be covered by the lien of the mortgage. If any security agreement is executed simultaneously with the execution hereof, the security agreement shall be deemed to be given by the mortgagor and accepted by the mortgagee as additional security and shall be in confirmation of the foregoing. The execution or delivery of such other security agreement shall not render the security interest or mortgage herein contained ineffective or without force, regardless of whether any financing statement or mortgage is filed or refiled, the security interest herein being, notwithstanding the execution and delivery of such security agreement, fully effective and operative. If any of the personal property or fixtures are placed in the premises by the mortgagor or any successor in interest subject to any conditional bill of sale, or subject to a security interest, the lien of this mortgage shall be deemed to include the

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equity and interest of the mortgagor or any such successor in interest in any of such personal property. In the event of any default hereunder, all the right, title and interest of the mortgagor or of any such successor in interest in and to any and all personal property is assigned to the mortgagee, together with any benefits of any deposits or payments theretofore made thereon by the mortgagor or any such successor in interest. The mortgagor grants to the mortgagee a security interest in all fixtures and personal property to the extent provided herein.

Together also with all awards made by any Municipal, County, State, Federal or other governmental authority to the present and all subsequent owners of the premises, including awards for any changes of grade of streets affecting the premises. All such awards are assigned to the mortgagee, and its legal representatives, successors and assigns. The mortgagee, for itself and its legal representatives, successors and assigns (at its or their option) is authorized, directed, and empowered to collect and receive the proceeds of all such awards from the authorities making the same and to give proper receipts and acquittances therefor, and to apply the proceeds toward the payment of the amount owing on account of this mortgage and its accompanying note, even though the amount owing on account of the mortgage and note is not then due and payable. The mortgagor, for itself and its legal representatives, successors, and assigns, agrees to and with the mortgagee and its legal representatives, successors, and assigns, upon demand by the holder, to make, execute, and deliver all assignments and other instruments sufficient for the purpose of assigning the awards to the holder of this mortgage, free, clear, and discharged of all encumbrances of any kind or nature.

And the mortgagor covenants with the mortgagee as follows:

1. *Payment of debt.* The mortgagor will pay the indebtedness as above provided.

2. *Insurance on real property.* The mortgagor will keep the buildings on the premises insured against loss by fire and all other hazards and casualties against which the mortgagee, from time to time, deems it advisable to be insured for its behalf. The mortgagor will assign and deliver to the mortgagee fully prepaid, unassigned, unpledged, and unencumbered policies of insurance required by the mortgagee. The unexpired premiums on such policies shall at all times likewise be unassigned, unpledged, and unencumbered, except that in the event of any default hereunder, any unearned premium on any policy of insurance for fire or any other insurance required by the mortgagee, is assigned to the mortgagee. The mortgagor will reimburse the mortgagee for any premiums paid for insurance by the mortgagee on the mortgagor's default in so insuring the buildings or in so assigning and delivering said policies. The provisions of subdivision 4 of Section 254 of the Real Property Law applying to insurance against loss by fire shall apply, so far as possible, to any other insurance required by the mortgagee hereunder.

3. *Insurance on personal property.* The mortgagor will insure and keep insured all of the articles of personal property, referred to above, against loss by fire or any other casualty or hazard against which the mortgagee from time to time deems it advisable to be insured, for the mortgagee's benefit. This provision shall be construed in the same manner as the foregoing provision for the keeping of the buildings on the premises insured against loss by fire and any other casualty or hazard.

4. *Maintenance of building.* The mortgagor will maintain the buildings on the premises in good repair. If all or any portion thereof is rented or adopted for renting, the mortgagor will maintain same in good rentable condition at all times, whether or not occupied.

5. *Structural changes.* No structural changes shall be made to the building on the premises, and no building on the premises shall be removed or demolished, without the mortgagees' prior written consent.

6. *Payment defaults.* The entire principal sum, and the interest thereon, shall become due, at the mortgagee's option, after default in any of the following: in the payment of any installment of principal when due, or of interest for ten days; in the payment of any taxes, including corporate franchise taxes payable by any corporate owner of the premises, water rates, or assessments for 30 days; either in assigning or delivering the policies insuring the buildings against loss by fire,

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or any other hazard or casualty referred to in paragraph 2 hereof, or in reimbursing the mortgagee for premiums paid on such insurance; or upon request, in furnishing a statement setting forth the amount due on the mortgage and whether any offsets or defenses exist against the mortgage debt.

7. *Receiver.* The holder of this mortgage shall be entitled to the appointment of a receiver in any action to foreclose the same.

8. *Taxes.* The mortgagor shall pay all taxes, including corporate franchise taxes, assessments, and water rates, and, on demand, shall submit receipted bills therefor to the mortgagee. If the mortgagor fails to pay such taxes and assessments, the mortgagee may do so. If any duplication of payment results from the mortgagor's failure to submit receipted bills, mortgagor shall bear the costs of procuring a refund of duplicate payments.

9. *Debt statement.* The mortgagor, within six days upon request in person or within 15 days upon request by mail, will furnish a written statement, duly acknowledged, setting forth the amount due on this mortgage and whether any offsets or defenses exist against the mortgage debt.

10. *Notice.* All notices and demands or requests under this mortgage shall be served either in person or by registered or certified mail, postage prepaid, return receipt requested, addressed to the other party at its address set forth at the beginning hereof. Either party, however, may designate a different address by serving written notice of change of address on the other party, in the same manner.

11. *Warranty of title.* The mortgagor warrants the title to the premises.

12. *One parcel.* In case of a sale, the premises, or so much thereof as may be affected by this mortgage, may be sold in one parcel.

13. *Defaults.* The principal shall become due, at the mortgagee's option, upon the occurrence of any of the following events of default: (a) after default for 30 days, after notice and demand, in the payment of any installment of any present or future assessment for local improvement, which is, or may become, payable in installments, and which has affected, now affects, or may hereafter affect the premises, even if the installments are not due and payable when the notice and demand is made; (b) immediately after any structural change is made, or upon the actual or threatened demolition or removal of any present or future building on the premises, without the mortgagee's prior written consent. In such event, interest on the indebtedness secured by this mortgage shall be 12 percent per annum from the date that the unauthorized structural change, demolition, or removal commenced, but only if such interest rate is then less than 12 percent per annum; (c) upon any default in keeping the building and contents on the premises insured against loss by fire or any other casualty or hazard, as required by paragraphs 2 and 3; or (d) if the buildings on the premises are not maintained in reasonably good repair or good rentable condition.

14. *Real estate and mortgage taxes.* If, after the date of this mortgage, the State of New York enacts any law that deducts the lien on land from the value of the land for tax purposes, or changes in any way the laws of taxation of mortgages, or debts secured thereby, for State or local purposes, or the manner of collecting such taxes, so as to affect such mortgage, the holder of the mortgage and of the debt secured thereby may, by giving 30 days' written notice, require the owner of the land to pay the mortgage debt. If such notice is given, the debt shall become due, payable, and collectible when the 30-day period expires.

15. *Mortgage foreclosure moratorium laws.* If this mortgage is now or hereafter protected or affected by moratorium laws, or by any other statutes preventing the mortgagee from foreclosing for nonpayment of the principal at the expiration date hereof, the mortgagor shall continue to pay amortization to the mortgagee (if the mortgagee so elects, and only so long as such laws or statutes protect the mortgagee from foreclosure for nonpayment of the balance of the principal debt), at the same rate existing during the last year of this mortgage, on its maturity date, and, thereafter, on

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the same days of the months provided for herein. If, however, the laws of New York State require, in connection with mortgages so protected or affected, that installment payments to the mortgagee amortizing such debt be greater, in aggregate per annum, than the aggregate per annum of the payments that would be due if based on such last year's payments, the mortgagee may elect, as soon as permitted after the debt matures, that the installments payable, after the installment required by this paragraph to be paid on the maturity date hereof, shall be at the rate and as provided for in such laws. If the mortgagor defaults in paying any such amortization installment on its due date, the mortgagee may foreclose solely by reason of such default.

16. *Litigation expenses.* If any action or proceeding is commenced (except an action to foreclose this mortgage, or to collect the debt secured thereby) and to which the holder of this mortgage is made a party, or in which it becomes necessary to defend or uphold the lien there of, all sums paid by the holder for the expense of any litigation to prosecute or defend the rights and lien created by this mortgage (including reasonable counsel fees), shall be paid by the mortgagor, together with interest thereon at 12 percent per annum. Any such sum, and the interest thereon, shall be a lien on the premises before any right or title to, interest in, or claim upon the premises attaches or accrues, subsequent to the lien of this mortgage, and shall be deemed to be secured by this mortgage and by the note secured thereby. In any action or proceeding to foreclose this mortgage, or recover or collect the debt secured thereby, the provisions of law respecting the recovery of costs, disbursements, and allowances shall not be affected by this covenant.

17. *Violations.* If the premises, as they exist or are used, or because of changes in their physical condition or use, are or may become in violation of any New York State statute, or any other applicable local or municipal law, including zoning ordinances, labor laws, multiple dwelling laws, building codes, fire ordinances, and the like, the mortgagor shall take immediate steps to alter the premises to comply with such laws. In any such event, (a) the alteration or repair shall proceed with all due diligence and be completed within a reasonable time, and (b) there shall be submitted to the mortgagee, upon completion (i) receipted bills evidencing the payment of the cost of such work, and (ii) satisfactory proof that no liens or encumbrances have been, or will be, filed on account thereof. If the alterations or repairs require filing and approval of plans or specifications by a governmental department, the plans and specifications must first be approved by the mortgagee. The mortgagor, on completion, shall procure and exhibit to the mortgagee a Certificate of Occupancy issued by such governmental department, and a Notice of Dismissal of all violations. If the alterations do not require filing and approval of plans, the mortgagor shall produce, on completion, a Notice of Dismissal of all violations. For the purpose of this mortgage, any attempted compliance with the above by the partial, or total, vacating of the premises, shall not be considered compliance with the requirements hereof. On any occasion, when the premises are deemed to be in violation of any law, order, decree, code, violation or requirement, it shall be deemed so to be on the assumption that the premises are, or will be, fully occupied. The repairs and alterations to be made, in order to comply with the foregoing, shall include all unoccupied portions of the premises with like effect as though they were fully occupied.

18. *Assignment of rents.* In the event of any default hereunder, by the mortgagor or any subsequent owner of the premises, the rents and profits of the mortgaged premises are assigned to the holder of the mortgage as further security for the payment of the indebtedness. Immediately upon the occurrence of any default or breach, the mortgagee may immediately, with the irrevocable consent of the mortgagor, or any subsequent owner or person then in possession, given and evidenced by the execution of this mortgage, enter upon and take possession of the premises, including any portion occupied by the mortgagor or any subsequent owner. At the option of the mortgagee, such entry and taking of possession shall be accomplished either by actual physical entry and taking of possession or by written notice given personally or by mail addressed to the owner at his address as it then appears on the mortgagee's records. Such entry and taking of possession may be so accomplished irrespective of the pendency of any action of foreclosure by the mortgagee or any junior lienor. Simultaneously with such actual physical entry and taking of possession or the giving of written notice, the rents, issues, profits and all other amounts accrued, and accruing, to the owner by reason of the ownership of the premises, including deposits held as security under leases, thereupon shall be deemed to be assigned as security to the mortgagee, together with the leases and all other documents evidencing such rents, issues, profits and other amounts, including deposits held as security under leases. For the purpose of giving immediate effect to such

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assignment, no other or further instrument of assignment or other document shall be necessary or requisite. The mortgagee may then let all or any part of the premises, collect and receive all the rents, issues, profits, and other amounts past due, due, or to become due to the mortgagor or any subsequent owner of the premises by reason of such ownership, and apply the same after payment of all necessary charges and expenses in connection with the operation of the premises, including any managing agent's commission, at the mortgagee's option, on account of the interest, amortization, taxes, water charges and assessments, insurance premiums, and any advance made by the mortgagee for the account of the mortgagor, or on account of the debt hereby secured.

19. *Rent upon possession.* In the event of entry, of taking of possession by the mortgagee pursuant to the above provisions, or of the appointment of a receiver of rents or profits in any action brought by the mortgagee under this mortgage, the mortgagor or any subsequent owner, if in possession of any portion of the mortgaged premises, shall be obligated to pay to the mortgagee or to the receiver of rents, a reasonable rental monthly in advance for the portion of the premises so occupied. If a receiver is appointed by reason of such default or breach, the amount of rent payable shall be determined upon an application to be made by the receiver to the court for a determination of the reasonable rental value payable by the mortgagor, or any subsequent owner. In the event of a default in the payment of any advance monthly rent, to be determined as above stated, the mortgagor, or any subsequent owner, may be dispossessed by the usual summary proceedings in the same manner that any defaulting tenant may likewise be dispossessed.

20. *Assignment.* The mortgagor shall not assign, pledge, or otherwise alienate any rents, issues, or profits from the premises without the mortgagee's prior written consent and any such attempted assignment, pledge, or alienation shall be subject and subordinate to the rights of the mortgagee.

21. *Proportionate income payments.* If, at any time, the income of the property is any criterion of the amount of interest, or amortization, payable by the owner, either by operation of any law, or otherwise, the portion of the mortgaged premises occupied by the owner shall be treated as income producing and the reasonable rental value thereof shall be treated as additional income from the mortgaged premises.

22. *Books and records.* If by law, or the provisions hereof, the amount of income from the premises is any basis for a determination of the amounts payable to the mortgagee, the mortgagor shall make its books, records and vouchers of income and disbursements available for inspection by the mortgagee at any time, upon the mortgagee giving mortgagor five days' prior written notice.

23. *Accounting.* The mortgagor, or any subsequent owner of the premises, upon demand, shall furnish to the mortgagee or any subsequent holder of this mortgage, a full and complete statement of all income and expenses incurred in the operation and maintenance of the premises.

24. *Trust funds.* In compliance with Section 13 of the Lien Law, the mortgagor shall receive the advances secured by this mortgage, and hold the right to receive such advances, as a trust fund to be applied first for the purpose of paying the cost of the improvement, and the mortgagor shall apply the advances first to the payment of the cost of the improvement before using any part of them for any other purpose.

25. *Acceleration.* Upon the breach of any covenant hereof, at the option of the mortgagee, or any subsequent holder of this mortgage, the entire principal sum secured hereby shall become due and payable, and the mortgagee, or any subsequent holder hereof, may foreclose this mortgage.

26. *Sundays and holidays.* If the date for payment of all or any part of the principal sum secured by the note to which this mortgage is collateral falls on a Sunday or any public holiday other than a half holiday, it is understood and agreed that interest thereon at the rate provided for therein shall be paid to the actual date of payment of such principal sum.

27. *No recourse.* The mortgagee shall not exercise its right to institute any action at law against the mortgagor for the

payment of any sum of money which is or may be payable under the note secured hereby, other than the right to foreclose, which is specifically reserved; nor shall it seek against the mortgagor any judgment for a deficiency in any action to foreclose this mortgage, provided, however, that nothing shall be, or be deemed to be, a release or impairment of the indebtedness, or of the lien thereof upon the Premises, or preclude the holder of the note secured by the mortgagee from foreclosing the mortgage in case of any default, or from enforcing any and all rights under and by virtue of the mortgage.

28. *Rent prepayment.* The mortgagor shall not accept the prepayment of rent under any leases for a period of more than one month.

29. *Purchase money.* This is a Purchase Money Mortgage given to secure a portion of the purchase price of the mortgaged premises conveyed this day from the mortgagee, as seller, to the mortgagor, as purchaser.

30. *Late payment penalty.* If default is made in the payment of the indebtedness when due, pursuant to the terms hereof, the mortgagee shall be entitled to receive interest on the entire unpaid principal sum at the legal rate of interest at the time of such default, at 12 percent, or at the highest rate of interest set forth herein or in the obligation secured by the mortgage, whichever is the greater, to be computed from the due date and until the actual receipt and collection of the entire indebtedness. This charge shall be added to and be deemed secured by the mortgage. The within clause, however, shall not be construed as an agreement or privilege to extend the mortgage, nor as a waiver of any other right or remedy accruing to the mortgagee by reason of any such default.

31. *Collection fees.* If the mortgage is referred to attorneys for collection or foreclosure, the mortgagor shall pay all sums, including reasonable attorney's fees, incurred by the mortgagee, together with all statutory costs, disbursements and allowances, with or without the institution of an action or proceeding. All such sums with interest thereon at the rate set forth herein shall be deemed to be secured by the mortgage and collectible out of the mortgaged premises.

32. *Late charge.* If any payment provided for herein is made more than 15 days after the due date thereof, a "late charge" of four cents for each \$1 of such payment shall become immediately due to the mortgagee as liquidated damages for failure to make prompt payment. Such charge shall be payable not later than the due date of the next payment, and shall be secured by such mortgage.

33. *Condemnation.* In the event of condemnation, the mortgagee shall not be limited to the interest paid on the award by the condemning authority but shall be entitled to receive out of the award interest on the entire unpaid principal sum at the rate herein provided. The mortgagor assigns to the mortgagee so much of the balance of the award payable by the condemning authority as is required to pay such total interest.

34. *Ownership change fee.* For recording on its records a change of ownership of the mortgaged property, the mortgagee shall be entitled to receive a fee of \$50, except that in no event shall this fee be payable if it would render the loan usurious under the laws of the jurisdiction where the property is situated.

35. *Prepayment.* The mortgagor may prepay this mortgage in whole without penalty or premium after eight years from the date hereof, by giving the holder of the mortgage 30 days' prior written notice.

36. *Rent roll statement.* The mortgagor shall furnish to the mortgagee, within 15 days after the mailing by the mortgagee of a written request therefor, a detailed certified statement in writing, duly sworn, showing all income derived from the operation of the premises, and all disbursements made in connection therewith, and containing a list of the names of all tenants of the premises and all occupants other than those claiming possession through such tenants, the portion or portions of the premises occupied by each such tenant and occupant, the rent and other charges payable under the terms of their leases or other agreements, and the periods covered by such leases or other agreements. Such statement shall cover the period of time specified in the request.

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37. *Corporate authority.* The execution and delivery of this mortgage has been duly authorized by the mortgagor's Board of Directors, and the mortgagor's certificate of incorporation does not require any vote or consent of the shareholders to authorize the making of this mortgage.

38. *Insurance proceeds.* If the buildings on the mortgaged premises are damaged by fire or other insured casualty, the mortgagee shall deliver to the owner of the premises the loss proceeds, if any, received from the insurance companies by appropriate progress payments if the work or repair and rehabilitation progresses to full restoration to the reasonable satisfaction of the mortgagee. Any excess of moneys over the cost of restoration of the damaged buildings is to be applied toward reduction of the mortgage principal or returned to the owner at the mortgagee's discretion. No moneys shall be delivered to the owner if the mortgage is in arrears or under foreclosure, and any loss under the fire insurance policies, as stated in the loss payable clause, shall be payable to the mortgagee.

39. *Undisclosed principals.* The covenants to pay the indebtedness contained herein shall be binding only upon the mortgagor, and not upon any disclosed or undisclosed principal or any other person or corporation.

40. *Entire agreement; modification.* This instrument constitutes the entire agreement between the parties. No modification or discharge of this mortgage shall be effective unless it is in writing and signed by the party, or by its duly authorized agent, against whom enforcement of the change or discharge is sought.

41. *Binding effect.* This instrument shall be binding upon and inure to the benefit of both parties and their respective heirs, legal representatives, successors, and assigns.

42. *Governing law.* This mortgage shall be construed in accordance with and governed by the laws of the State of New York.

43. *Headings.* Headings in this instrument are for convenience and reference only and are not deemed to be a part thereof.

44. *Non-waiver.* No delay or failure by either party to exercise any right under this mortgage, and no partial or single exercise of such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

45. *Counterparts.* This instrument may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

In witness whereof this mortgage has been duly executed by the mortgagor.

[Corporate Seal]

Central Offices, Inc.

Attest:

by _____

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Barbara Smith, Secretary

(Acknowledgment)

B.19 Wraparound mortgage--loan evidenced by promissory note and secured by second mortgage

COMMENT

A wraparound mortgage is a form of second mortgage and is subordinate to an existing first mortgage or other prior mortgages, on the real property involved. The first mortgage remains outstanding and unsatisfied but the face of a wraparound mortgage restates the actual indebtedness by adding in the unpaid balance of the first mortgage to raise the total. The wraparound contains a special provision for payment of the debt service on the first mortgage. The loan is otherwise evidenced and secured by the usual form of promissory note and a second or junior mortgage. The annual debt service is figured on the over-stated face amount so the wraparound mortgage interest rate is always greater than the interest rate on the first mortgage alone.

Prior mortgage payments:

The wraparound lender agrees, when he receives his interest payments on the wraparound mortgage, to deduct and remit directly to the first mortgagee the required debt service on the first mortgage. If the wraparound lender does not receive the debt service on the wraparound mortgage, he has no obligation to remit the payments on the first mortgage. Failure to pay debt service on a wraparound mortgage constitutes a default under that mortgage. In addition, the borrower expressly agrees not to make any further payments to the first mortgagee on account of the first mortgage.

Borrower's obligations:

The wraparound mortgage usually contains covenants by the borrower identical with those in the first mortgage, including escrow of taxes and insurance premiums which, on receipt by the wraparound lender, will be remitted to the first mortgagee. The first mortgage must not contain covenants personal to the borrower and which cannot be cured or complied with by the wraparound mortgagee. The wraparound borrower agrees to comply with all nonmoney covenants in the first mortgage and a default in the first mortgage is deemed a default in the wraparound mortgage.

The borrower also has the following obligations:

(1) Notification to the first mortgagee that payments of debt service, as well as any prepayment or payment after acceleration, are to be received from the wraparound mortgagee, in his behalf;

(2) Authorization of acceptance of such payments by the first mortgagee or prior mortgagees;

(3) Direction of due delivery to the wraparound lender of all notices by the lender under the mortgage.

Economic advantages:

A hybrid mortgage of this type permits a lender to advance funds to a borrower in excess of an existing first mortgage, or to enable the borrower to obtain terms different from those of the existing first mortgage, without requiring the discharge of the existing mortgage. Usually, the wraparound mortgagee advances the difference between the amount due on the existing mortgage and the amount of the wraparound mortgage to the mortgagor. However, the wraparound mortgagee may instead give the borrower terms that are considerably different from those of the existing mortgage. In either case, the wraparound mortgagee takes over the obligations in connection with the existing mortgage. The borrower need no longer deal with the original mortgagee.

For further information, see Chapters 7, 12, and 13.

FORM

This Mortgage Agreement, made this June 29, 2002, between John Gigante & Sons, Inc., a New York corporation, having its office at 370 Fifth Avenue, New York, New York ("Mortgagor"), and Panadyne Corporation, a New York corporation, having its office at 37 Park Avenue, New York, New York ("Mortgagee").

Recitals

Mortgagor is the owner of the fee simple title to the real estate and the buildings and improvements thereon, situated and being in the County of Westchester, State of New York (collectively, the "Mortgaged Premises"), more particularly described in Exhibit A attached to this agreement.

The consideration for this mortgage is \$680,166.03, representing cash advanced by Panadyne Corporation, and \$1,769,833.97 representing the assumption, by Panadyne Corporation of the interest and principal payments under the First Mortgage (the "Wraparound Mortgage").

The Mortgaged Premises are subject to, and the Wraparound Mortgage is subordinate to, a certain mortgage note and mortgage securing such note (collectively, the "First Mortgage"). The note by its terms matures on January 1, 2016. The mortgage and the mortgage note, both of which are dated August 3, 1994, were originally made between Morris Management Corporation, as mortgagor, and Merchants Bank of New York Trust Company, as mortgagee. The mortgage was recorded in the Clerk's Office of the County of Westchester on August 5, 1994, in Liber 6862 of Mortgages on Page 6. The mortgage and mortgage note were subsequently assigned by Merchants Bank of New York Trust Company to Massachusetts General Life Insurance Company by assignment dated June 24, 1995 and recorded in the Clerk's Office of the County of Westchester on January 5, 1985, in Liber 6994 on Page 44. The mortgage constitutes a first mortgage lien upon the Mortgaged Premises described in Exhibit A attached hereto, the principal balance of which is \$1,769,833.97 as of the date of this agreement, the Mortgagor on the date hereof having made the principal payment coming due on July 1, 2002.

Now, therefore, the parties agree as follows:

1. *Wraparound mortgage.* The principal amount due to the mortgagee by the mortgagor is \$2.45 million. This sum represents \$680,166.03, the amount advanced by the mortgagor to the mortgagee upon the execution of this agreement, plus \$1,769,833.97, representing the mortgagee's assumption of the interest and principal payments under the First Mortgage.

2. *Interest.* The interest rate payable on the principal sum of the Wraparound Mortgage shall be 10 percent per annum. Such interest shall commence to accrue on June 29, 2002.

3. *Payments.* The principal sum of the Wraparound Mortgage, together with interest thereon at 10 percent per annum, shall be payable as follows: Constant equal monthly payments of \$34,166.66 each shall be paid on the 15th of each calendar month, starting on July 15, 2002, and ending on January 15, 2015, at which date the entire unpaid principal balance of the Wraparound Mortgage, together with accrued interest, shall be due and payable. Each constant monthly payment when received shall be applied first in payment of interest on the unpaid balance, and the balance in reduction of the unpaid principal sum.

4. *Payments on first mortgage.* (a) *Payment.* Mortgagee shall pay to the holder of the First Mortgage, the \$1,769,833.97 unpaid principal balance of the First Mortgage, together with all interest thereon accruing thereunder from and after June 29, 2002, as and when required by the terms of the First Mortgage, that is, by paying the constant monthly installments of principal of \$14,333.33 before the expiration of the applicable grace periods provided for such payments as contained in the First Mortgage.

(b) *Other obligations.* With the sole exception of the payments of principal, and of the interest due thereon after June 29, 2002, Mortgagee does not assume any of Mortgagor's obligations under the First Mortgage. Mortgagee's obligation to make the above payments of principal and interest under the First Mortgage shall be solely for the benefit of Mortgagor hereunder or any subsequent owner of the Mortgaged Premises, and shall not inure to the benefit of, or be enforceable by, any third person or party, and specifically not the holder of the First Mortgage.

5. *Prepayments of first mortgage.* Mortgagee shall not make any prepayments of principal or of interest under the First Mortgage, without Mortgagor's prior written consent. Mortgagee, however, may prepay all or any part of the First Mortgage if Mortgagor commits a default under either the First Mortgage or the Wraparound Mortgage, or in any other instance in which this agreement grants Mortgagee the express or implied right to make prepayments of the First Mortgage. Such implied right shall arise whenever a prepayment right is necessary or appropriate for Mortgagee to have the benefit of some other right granted to it under the Wraparound Mortgage (for example, Refinancing mentioned in paragraph 35).

6. *Modification of first mortgage.* Mortgagor shall not exercise any right or privilege of prepayment (in whole or in part) of principal or interest under the First Mortgage, and shall not enter into any agreement with the holder of the First Mortgage modifying or amending any of its provisions, including the provisions dealing with payment of principal or interest, without Mortgagee's prior written consent.

7. *Obligations of mortgagor--first mortgage.* (a) *Performance.* Mortgagor shall comply with all of the terms, covenants, and conditions of the First Mortgage, other than with respect to the payment of the monthly constant payments of principal and interest due under the First Mortgage.

(b) *Default.* If Mortgagor shall fail to comply with any term, provision, or condition of the First Mortgage within five days before the expiration of any applicable grace period provided for in the First Mortgage, and Mortgagor's noncompliance results in a default thereunder (other than with respect to payment of the constant monthly payments), such failure shall automatically constitute a default under the Wraparound Mortgage. Such deemed default shall, in turn, entitle Mortgagee to exercise any or all of the same rights and remedies given to it in the Wraparound Mortgage in the event of a default in the payment of principal or interest thereunder.

8. *Principal reductions.* If the unpaid principal balance of the First Mortgage is reduced either by application by the holder of the First Mortgage of insurance proceeds or of condemnation proceeds in reduction of the principal balance, or by prepayments made by Mortgagor with Mortgagee's prior written consent, so that in either event Mortgagee's

obligation under the Wraparound Mortgage to pay the holder the unpaid principal balance of the First Mortgage is similarly reduced, Mortgagee agrees that Mortgagor's obligation to pay the principal indebtedness to Mortgagee under the Wraparound Mortgage, shall be likewise reduced by an equivalent amount, which shall be deducted from the payment Mortgagor is to make to Mortgagee under the Wraparound Mortgage at maturity. Such deduction, however, shall not operate to reduce Mortgagor's obligation to make the constant monthly payments (of principal and interest) due and payable under the Wraparound Mortgage.

9. *Grace period.* If Mortgagee defaults in making any required constant payment (of principal interest) under the First Mortgage, at least five days before the expiration of the applicable grace period therefor, Mortgagor may advance the necessary funds to cure such default. All funds so advanced by Mortgagor, together with interest thereon at the rate of 10 percent per annum, shall be credited against the next installment(s) of the interest and principal due under the Wraparound Mortgage.

10. *Title searches and defects.* Each month hereafter, Mortgagor shall furnish or cause to be furnished, at its expense, a continuation title search issued by The Urban Title Guaranty Company (the "Title Company"), showing the status of the title records in the Office of the County Clerk of Westchester County, respecting any liens or encumbrances which are filed against the Mortgaged Premises except the lien of the First Mortgage, the Wraparound Mortgage, and any other liens or encumbrances which were recorded at the date of this agreement. If a Title Company search discloses the entry of any liens or encumbrances, other than liens upon personal property created by occupancy tenants, Mortgagor shall cause the liens or encumbrances to be forthwith discharged of record by bonding or otherwise. If Mortgagor fails to do so within ten days after receiving written notice from Mortgagee, such failure shall constitute a default under the Wraparound Mortgage and entitle the Mortgagee to accelerate the maturity date thereof immediately, and Mortgagee may advance funds necessary to effect a discharge of such liens or encumbrances. All funds so advanced, together with interest thereon at the rate of 12 percent per annum (or lesser percentage, not exceeding the maximum rate legally collectible if 12 percent exceeds the maximum legal rate), shall be payable by Mortgagor to Mortgagee on demand, and shall be recoverable by Mortgagee in addition to all principal and interest then due on the Wraparound Mortgage, and shall be treated as part of the principal debt thereon for which the Wraparound Mortgage shall stand as security.

11. *Casualty and condemnation.* Notwithstanding any contrary provision above: (a) *Casualty.* In case of casualty to any portion of the Mortgaged Premises resulting in damage or destruction, all insurance moneys paid to Mortgagee, less any actual costs, fees and expenses incurred in connection with the adjustment of the loss, and provided no default exists under the terms of the Wraparound Mortgage, shall be made available to Mortgagor from time to time towards the cost of restoring the Mortgaged Premises, as the work of restoration progresses. Such payments shall be made on the certification of an independent, reputable licensed architect of the Mortgagor or of the then owner of the Mortgaged Premises, showing the amounts actually expended or incurred in connection with such restoration. This provision shall be further conditioned on proof satisfactory to Mortgagee being submitted to Mortgagee in writing before the request for release of any proceeds, that the cost of such restoration will not exceed the net amount of the insurance proceeds actually collected. If it is determined that the cost of restoration will exceed the net amount of such proceeds, Mortgagor shall deposit with Mortgagee sufficient funds (or security therefor reasonably acceptable to Mortgagee) which, when added to the net insurance proceeds collected, shall be adequate to pay for the complete restoration. If the amount of the net insurance proceeds received by Mortgagee from the insurance carrier, plus any additional funds paid by Mortgagor, exceeds the actual amount necessary to effect such restoration, then after the completion of such restoration, any balance remaining in Mortgagee's hands shall be applied by Mortgagee to the payment of principal due under the Wraparound Mortgage at maturity. However, no such principal payments shall operate to reduce Mortgagor's obligation to make the constant monthly payments (of principal and interest) due and payable under the Wraparound Mortgage. The provisions of this subparagraph (a) are subject to the rights of the holder of the First Mortgage. Prior to release of funds under this subparagraph (a) or subparagraph (b), Mortgagor shall submit proof satisfactory to Mortgagee that there are no claims for mechanics liens.

(b) *Eminent domain.* In the event of any partial taking of the Mortgaged Premises in condemnation or by right of

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eminent domain, Mortgagee shall, if Mortgagor is not in default in performing any covenant or agreement contained herein, make the net award paid to Mortgagee, less all expenses incurred in effecting collection thereof, available from time to time as work progresses to Mortgagor or the then owner of the Mortgaged Premises for the purpose of restoring the improvements thereon to a complete architectural unit. Such award shall be made available to Mortgagor or the then owner of the Mortgaged Premises in the same manner and under the same conditions as required in the case of fire insurance proceeds under subparagraph (a) of this paragraph. The preceding provision shall apply only if Mortgagor or the then owner of the premises proceeds, with reasonable diligence, to so restore the improvements. The provisions of this subparagraph (b) are subject to the rights of the holder of the First Mortgage.

12. *Reimbursement.* If Mortgagor defaults in performing any covenant or condition hereof, Mortgagee may perform such covenant or condition. In such case, the expense thereof, together with interest at 12 percent per annum (or lesser percentage, not exceeding the maximum rate legally collectible, if 12 percent exceeds the maximum legal rate) from the date the expense is incurred until the date Mortgagor reimburses Mortgagee, shall immediately be due and payable from Mortgagor to Mortgagee, and be secured by the Wraparound Mortgage.

13. *Financial and operating reports.* Mortgagor shall furnish Mortgagee, within 30 days after Mortgagee mails a written request (but not more than once in any year), a detailed statement, signed by Mortgagor (or by one of its duly authorized officers if it is a corporation, or by a general partner if it is a partnership), covering the period specified in such request. The statement shall show all income derived from the operation of the Mortgaged Premises and all disbursements made in connection therewith, and a rent roll listing all tenants (which may be by apartment or office numbers instead of names) of the Mortgaged Premises, the rent and other charges payable under the terms of their leases or other agreements, and the expiration dates of their leases. The Mortgagee and its authorized representatives shall have the right to enter and inspect the Mortgaged Premises at all reasonable times.

14. *Covenants run with land.* The covenants contained in this agreement shall run with the land and bind Mortgagor, its successors and assigns, and all subsequent owners, encumbrancers, tenants, and subtenants of Mortgaged Premises, and shall inure to the benefit of the Mortgagee, its personal representatives, successors, and assigns, and all subsequent holders of the Wraparound Mortgage.

15. *Attorneys' fees; defenses waived.* Mortgagor shall pay Mortgagee its reasonable attorneys' fees if (a) any mortgage secured by the Wraparound Mortgage is placed in the hands of an attorney for collection, either after maturity or upon Mortgagor's default; (b) legal proceedings are instituted for the recovery of all or part of such note, or for interest thereon; or (c) such note is placed in the hands of an attorney to protect the rights of the holder or to enforce any agreement contained in the Wraparound Mortgage. Mortgagor waives any defense, setoff, or counterclaim (except those resulting from Mortgagee's failure to make the constant monthly payments under the First Mortgage, as provided in paragraph 4(a)) in any action or proceeding to enforce payment or any other provision of the Wraparound Mortgage.

16. *Condemnation; application of proceeds.* If all or part of the Mortgaged Premises are taken in condemnation by any governmental authority, the Wraparound Mortgage and the notes secured by it, after vesting of title in such condemnation and until paid, shall nevertheless continue to bear interest at the rate of 10 percent per annum (or lesser percentage not exceeding the maximum rate legally collectible if 10 percent exceeds the maximum legal rate). If the rate of interest on the condemnation award is less than the 10 percent rate, Mortgagor covenants to pay to Mortgagee the difference between the 10 percent interest and the interest paid by the government or condemning authority, computed upon the unpaid principal from the date to which interest on the Wraparound Mortgage has been paid to the date of payment of the award to the Mortgagee. Mortgagor assigns to Mortgagee so much of the award in such condemnation as is required to pay the difference in interest. The foregoing assignment of the award is in addition to, and not in derogation or limitation of, the rights in and claim to any condemnation award for the taking of the whole or part of the Mortgaged Premises which, by virtue of the Wraparound Mortgage or by operation of law, Mortgagee may have for the principal and interest under the Wraparound Mortgage unpaid and accrued on the date of the vesting of title in such condemnation.

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17. *Leases.* Mortgagor shall not cancel, abridge, or otherwise modify existing or future tenancies, sub-tenancies, leases, or sub-leases of the Mortgaged Premises, or accept prepayment of installments of rent without Mortgagee's prior written consent, which it shall not unreasonably withhold or delay. However, Mortgagor may cancel any lease, without Mortgagee's consent, if simultaneously therewith Mortgagor enters into a new lease with a replacement tenant, and (a) the new tenant has a net worth equal to or greater than the net worth of the tenant under the cancelled lease; (b) the annual rental payable under the new lease is not less than the annual rental payable under the cancelled lease; and (c) the new lease is for a term not less than the term remaining of the cancelled lease.

18. *Notices and payments.* Mortgagor shall promptly send to Mortgagee copies of all notices received by it from the holder of the First Mortgage. Mortgagee shall send to Mortgagor, at the time the Mortgagee makes each monthly constant payment to the holder of the First Mortgage, an advice that each such payment has been made. (A copy of Mortgagee's transmittal letter, if any, will suffice).

19. *Continuing obligations.* Mortgagor's obligations under the Wraparound Mortgage, and the mortgage notes which it is given to secure, shall continue until the entire debt is paid, notwithstanding any action or actions of partial foreclosure which are brought to recover any amount or amounts for installments of principal, interest, taxes, assessments, water rates, vault taxes or fire insurance premiums, or other payments due and payable under the provisions of the Wraparound Mortgage.

20. *Mortgage tax.* If it is determined by any competent governmental authority that United States or New York State mortgage taxes are due on any mortgage note secured by the Wraparound Mortgage, Mortgagor shall pay such taxes, together with any accrued penalty.

21. *Waiver.* No delay or omission by Mortgagee to exercise any right, power, or remedy accruing under the Wraparound Mortgage shall be construed to be a waiver of any default or acquiescence. A waiver in one or more instances to exercise any right, power, or remedy shall apply only to the particular instance or instances, and at the particular time or times only. No such waiver shall be deemed a continuing waiver, but every term, covenant, provision, or condition establishing such right, power, or remedy shall survive and continue to remain in full force and effect.

22. *UCC documents.* At Mortgagor's request, the Mortgagor shall execute and deliver Uniform Commercial Code Financing Statements, in duplicate, covering the fixtures, chattels, and articles of personal property subject to the lien of the Wraparound Mortgage.

23. *Municipal requirements.* Mortgagor shall promptly pay and discharge all license fees or similar charges, with penalties and interest, which are imposed by the municipality in which the Mortgaged Premises are situated, for the use of vaults, chutes, areas and other space beyond the lot line and under or abutting the public sidewalks in front of or adjoining the Mortgaged Premises. Mortgagor shall promptly cure any violation of law and comply with any order of the municipality in which the Mortgaged Premises are situated respecting the repair, replacement, or condition of the sidewalk or curb in front of or adjoining the Mortgaged Premises. If Mortgagor defaults in any of the above, Mortgagee may pay any or all of the license fees or similar charges with penalties and interest, and the municipality's charges for such repair or replacement. In such event, Mortgagor shall, on demand, repay Mortgagee for all amounts expended, with interest thereon at 12 percent per annum (or lesser percentage, not exceeding the maximum rate legally collectible, if 12 percent exceeds the maximum legal rate) from the date the expenses are incurred until the date Mortgagor reimburses Mortgagee. Such amounts shall thereupon be liens on the Mortgaged Premises and secured by the Second Mortgage.

24. *Further instruments.* The Wraparound Mortgage is a security agreement which covers, and the Mortgaged Premises includes, both real and personal property and all other of Mortgagor's rights and interests, whether tangible or intangible in nature, in the Mortgaged Premises. Mortgagor shall, at Mortgagee's request deliver to Mortgagee all further

instruments required by Mortgagee in order to further secure and perfect the lien of the Wraparound Mortgage.

25. *Severability.* If any term, covenant, or condition of the Wraparound Mortgage is held to be invalid, illegal, or unenforceable in any respect, the Wraparound Mortgage shall be construed without such provision.

26. *Governing law; cumulative rights.* The terms of the Wraparound Mortgage shall be construed under the laws of the State of New York. The rights of Mortgagee shall be separate, distinct, and cumulative, and none shall be given effect to the exclusion of the others. No act of Mortgagee shall be construed as an election to proceed under any one provision herein to the exclusion of any other provision.

27. *Prepayment penalty.* Mortgagor may prepay in full the unpaid balance of the indebtedness under the Wraparound Mortgage at any time by giving Mortgagee at least 90 days prior written notice, by paying the principal and interest due plus a prepayment fee as follows: During the first loan year, 3 percent of the then principal amount; thereafter the prepayment fee will reduce by one half of 1 percent each loan year until the prepayment fee is reduced to 1 percent, the 1 percent to prevail during the remaining term of the loan. A "loan year" shall be any one year beginning on the date of this agreement or any anniversary hereof. If Mortgagor prepays the entire unpaid principal balance of the indebtedness under the Wraparound Mortgage, such amount shall include all prepayment charges due under the First Mortgage. In addition, if Mortgagee makes all prepayment of the First Mortgage, either in whole or in part, and pays to the holder of the First Mortgage a prepayment fee, the amount of the prepayment fee shall be added to and become part of the principal of the Wraparound Mortgage, and shall bear interest of 10 percent per annum (or lesser percentage not exceeding the maximum rate collectible, if 10 percent exceeds the maximum legal rate).

28. *Subsequent liens.* No further mortgage may be placed by Mortgagor against all or any part of the Mortgaged Premises unless such mortgage contains express language satisfactory to Mortgagee subordinating the mortgage to the lien of the Wraparound Mortgage and to all the provisions thereof, including the full principal indebtedness of the Wraparound Mortgage as such indebtedness may be reduced by the application of a portion of the constant monthly payments thereunder in amortization of the principal indebtedness and all past and future advances made or to be made by Mortgagee. The placing, by Mortgagor, or by any subsequent fee owner of all or any portion of the Mortgaged Premises, of any such mortgage not containing the subordination provisions herein required shall make such mortgage null and void and of no force and effect, and such act shall be a default under the Wraparound Mortgage, entitling Mortgagee to the same rights and remedies given it in the Wraparound Mortgage for nonpayment of interest or principal.

29. *Subrogation.* Mortgagor agrees that Mortgagee is subrogated to all of the rights, remedies, and liens held by the holders of the First Mortgage to the extent of all amounts paid out or advanced by Mortgagee which are used directly or indirectly to reduce, pay-off, discharge, or satisfy in whole or in part any part of the indebtedness secured by the First Mortgage, or to cure any default thereunder.

30. *First mortgage.* Mortgagor shall, immediately at Mortgagee's request from time to time, notify and confirm to the holder of the First Mortgage, by signed notice sent by registered or certified mail, return receipt requested, with a counterpart delivered to Mortgagee, that: (i) Mortgagor has entered into the Wraparound Mortgage, describing the essence of the Wraparound Mortgage so that the holder of the First Mortgage will understand the same as it affects said holder, (ii) payment of the constant monthly payments under the First Mortgage as well as deposits for taxes, assessments, and similar charges which are mentioned in the First Mortgage, as well as any prepayment under the First Mortgage, or payment after acceleration of the First Mortgage, shall be made by the holder of Wraparound Mortgage upon receipt of the same from Mortgagor, (iii) authorizing and directing the holder of the First Mortgage to accept the aforesaid payments, as well as the payment or performance of any other obligation contained in the First Mortgage to be performed by Mortgagor's thereunder, with same effect as if paid or performed by Mortgagor itself, (iv) directing the holder of the First Mortgage to send and deliver to the holder of the Wraparound Mortgage counterpart copies of all demands, notices and communications of defaults, payments due, or otherwise, required to be given or actually given to

Mortgagor, and (v) requesting the holder of the First Mortgage to enter into an agreement with the holder of the Wraparound Mortgage whereby the holder of the Wraparound Mortgage is given notice of and opportunity to cure any default by Mortgagor under the First Mortgage.

31. *First mortgage due dates.* Notwithstanding any contrary provision in the Wraparound Mortgage, all payments required to be made by Mortgagor, whether to Mortgagee or to any other person, by the provisions of the First Mortgage (except the constant payments of principal and interest under the First Mortgage, which Mortgagee has agreed to pay) shall be due and payable at least 15 days before such payments are required to be made by the provisions of the First Mortgage, except if a period of time more than 15 days is required expressly by the Wraparound Mortgage, the longer period shall be effective.

The whole of the principal sum and interest on the Wraparound Mortgage shall become due at Mortgagee's option after default in the payment of any installment of principal or of interest for five days. The preceding sentence shall supersede any contrary provision contained elsewhere in the Wraparound Mortgage.

32. *Purchase-money mortgage.* The Wraparound Mortgage constitutes a purchase-money mortgage given to secure a portion of the purchase price paid by Mortgagor in acquiring the fee title to the Mortgaged Premises.

33. *Representations of mortgagor.* Mortgagor covenants, represents, and warrants that on the date of the agreement it is not default under the First Mortgage, and there are no outstanding claims of indebtedness for labor or materials furnished in connection with the construction, improvements, alteration or repair of any building or other improvements on the Mortgaged Premises.

34. *Assignment of first mortgage.* If Mortgagee pays or satisfies the First Mortgage at any time, it may obtain from the holder thereof, instead of satisfaction piece, an assignment to it of the First Mortgage.

35. *Refinancing.* The First Mortgage or the Wraparound Mortgage, or both, may, at Mortgagee's option, be extended, replaced, increased, modified, or consolidated ("Refinancing"), including a consolidation with the Wraparound Mortgage. Any mortgage so extended, replaced, increased, modified or consolidated, is referred to as "New Mortgage(s)."

The conditions of the Refinancing are as follows:

- (1) All proceeds, if any, in excess of the then unpaid principal amount of the First Mortgage and/or the Wraparound Mortgage being refinanced shall be the property of Mortgagee and shall not be deemed to reduce the principal amount of the Wraparound Mortgage plus interest and other charges secured by the Wraparound Mortgage. Notwithstanding any Refinancing, nothing shall be deemed to reduce, abridge, or postpone Mortgagor's obligation to make the regular payments of principal or interest or other payments required by the Wraparound Mortgage;
- (2) The aggregate annual charges payable for interest and amortization on the New Mortgage(s) shall not at any time exceed the annual charges then payable for interest and amortization under the Wraparound Mortgage;
- (3) The maturity date of any New Mortgage(s) shall not be later than the maturity date of the Wraparound Mortgage;
- (4) If the proceeds of any New Mortgage(s) are insufficient to pay the unpaid principal amount then due to the holder of the mortgage being refinanced, the deficiency shall be paid by Mortgagee;
- (5) Mortgagee shall pay all expenses necessary to consummate the closing of the New Mortgage(s);
- (6) The aggregate unpaid principal amount of the New Mortgage(s) shall not at any time exceed the unpaid principal

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amount of the Wraparound Mortgage plus interest and other charges secured by the Wraparound Mortgage;

(7) In Refinancing, the forms customarily utilized by the holder of the New Mortgage for similar properties shall be used, and if the holder of the New Mortgage has no forms which are customarily used for such property, the customary forms of an institutional lender who makes loans on similar properties shall be used;

(8) The New Mortgage(s) may provide for a prepayment penalty not to exceed 3 percent of the amount being prepaid;

(9) Mortgagee shall request the holder of the New Mortgage(s) to utilize provisions equivalent to those contained herein for insurance and condemnation proceeds.

(10) The New Mortgage(s) shall not prohibit the sale of the Mortgaged Premises.

(11) The New Mortgage(s) shall not be cross-collateralized with any other mortgage or loan, and shall cover only the Mortgaged Premises. The maturity date of the Wraparound Mortgage for the purpose of this paragraph shall be deemed to be the maturity date when, pursuant to the terms of the Wraparound Mortgage, the unpaid principal amount thereof is stated therein to become due and payable.

Mortgagor shall execute all documents that are necessary to effectuate such Refinancing, provided such documents provide for an exculpation of Mortgagor from personal liability. Upon Mortgagor's failure to execute such documents within ten days of Mortgagee's written request, the unpaid principal balance due on the Wraparound Mortgage and interest, shall become due, at Mortgagee's option in the same manner as Mortgagor's failure to pay interest or principal under the Wraparound Mortgage. Any additional mortgage placed by Mortgagor on the Mortgaged Premises or any part thereof shall be expressly subordinate to Mortgagee's right of Refinancing.

36. *Default in note.* Any default under the terms of any notes secured by the Wraparound Mortgage shall be deemed a default under the Wraparound Mortgage, and each of the terms, covenants, and conditions of such notes are incorporated in and made a part of this agreement.

37. *Ground leases.* No owner of the Mortgaged Premises shall enter into a ground or master lease covering all or a material part thereof unless: (a) a true copy is delivered to Mortgagee, by registered or certified mail not more than ten days after the execution thereof; and (b) such ground or master lease provides (i) that it is subject and subordinate to the Wraparound Mortgage and all advances, past or future, which are made thereunder and the Refinancing, and (ii) that all occupancy subleases shall provide that in case of termination of the ground or master lease, the sublessee will attorn to and recognize the lessor under such ground or master lease or the owner of the demised premises as sublessee's landlord unless such sublease has terminated in any dispossession or foreclosure proceedings.

38. *No usury.* Notwithstanding any contrary provision herein, Mortgagee shall not at any time charge, and Mortgagor shall not be required to pay, interest which exceeds the maximum rate of interest applicable to this agreement that is permissible under the laws of the State of New York.

If any interpretation of the provisions of this agreement would require Mortgagor to pay interest or other fees or sums the payment of which would, in the opinion of Mortgagee or its counsel, constitute a violation of the above-stated intention of the parties, Mortgagee shall advise Mortgagor in writing as to what reduced amount of interest or other charges or fees shall be paid. Thereupon, this agreement shall be deemed to be interpreted and intended to read as set forth herein as the true intention of the parties.

39. *Entire agreement; modification.* This instrument constitutes the entire agreement between the parties. It may not be modified, amended, or terminated unless such modification, amendment, or termination is in writing and signed by both parties.

40. *Binding effect.* This agreement shall be binding upon and inure to the benefit of both parties and their respective legal representatives, successors, and assigns.

41. *Notices.* All notices under this agreement shall be sent by registered or certified mail, postage prepaid, return receipt requested, addressed to the other party at its address set forth at the beginning hereof. Either party, however, may designate a different address by serving written notice of change of address on the other party, in like manner.

42. *Headings.* Headings in this agreement are for convenience and reference only and are not deemed to be a part hereof.

43. *Non-waiver.* No delay or failure by either party to exercise any right hereunder, and no partial or single exercise of such right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

44. *Counterparts.* This agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

In witness whereof the parties have duly executed this instrument as of the date first above written.

Panadyne Corporation

by _____

John Gigante & Sons, Inc.

by _____

(Acknowledgments)

B.20 Variable interest rate mortgage note--annual adjustment--adjustment limitations

COMMENT

Variable rate mechanism:

This variable rate note provides for a periodic review of interest rates once a year, with the possibility of a modest change either up or down, as indicated by the cost of money at the time of each review. The interest rate changes are legally regulated and are based on a prescribed standard or "index" which reflects the cost of money.

(1) No adjustment may be made more often than each semiannual period thereafter, and six months must elapse between any changes.

(2) No adjustment can be made unless the latest index, compared with the loan's base index, has a cumulative increase or decrease of 0.1 percent or more.

(3) No adjustment up or down may exceed 0.25 percent per annum in any semiannual period and shall not result in an interest rate more than a specified percentage greater than the initial interest

rate.

Mortgagor protection:

There is "downside" protection for the borrower as evidenced by the following aspects:

(1) Decrease. The note provides for mandatory decreases of rate when applicable, and there is no percentage limitation on decreases.

(2) Constant payment. On single family (one to four unit property) loans, under certain circumstances, regulations permit the term of the loan to be extended, not to exceed 40 years, to keep the monthly payment constant in the event of interest rate increases.

(3) Prepayment. Within 90 days from the date of a notice of increase of rate, the borrower has the right to pay all, or part of the loan, without a prepayment charge.

(4) Notice. A notice must be mailed to the mortgagor at least 30 days before any change. The change is effective with the payment due in the second month following the notice.

For further information, see Chapter 12.

FORMS

(1) Variable rate promissory note

Promissory Note NOTICE TO BORROWER: THIS DOCUMENT CONTAINS PROVISIONS FOR A VARIABLE INTEREST RATE

Loan No. 210802-47

\$44,000 Ventura, California May 7, 2002

1. *Promise to pay.* For value received, I promise to pay to State Savings and Loan Association, a corporation, or order, at its offices in the City of Ventura, State of California, or at any other offices that the holder of this note may from time to time designate, the principal sum of \$44,000, with interest from the date hereof on the unpaid principal balance at the initial rate of 15 percent per annum (the "Initial Interest Rate"), principal and interest payable in monthly installments of \$558.77 each, beginning on June 1, 2002 and continuing on the first day of each and every month thereafter until May 1, 2032, when the principal and interest shall have been paid in full.

Each payment shall be credited first on interest then due and the remainder on principal; and interest thereupon ceases upon the principal so credited.

2. *Variable rate; standard.* I agree that the Initial Interest Rate shall be increased and decreased from time to time in accordance with increases and decreases in the prime rate of State Savings and Loan Associations (the "Standard"), or any other Standard that may be approved by the California Savings and Loan Commissioner. Subject to the following provisions, the increases and decreases shall be effected in such manner as to maintain the same margin above or below

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the Initial Interest Rate as the last published Standard is above or below the last published Standard on the date of this Note:

- (a) *Maximum for term.* Any change in the interest rate shall not exceed 1 percent per annum in any annual period, and shall not result in an interest rate more than 4.75 percentage points greater than the Initial Interest Rate.
- (b) *Maximum per year.* No increase or decrease in the interest rate in any annual period shall be less than 1/10 of 1 percent per annum, except for increases or decreases not previously invoked in full by reason of the 1 percent per annum maximum limitation set forth above.
- (c) *Annual changes.* No change in the rate of interest shall be made during the first annual period; after the first annual period there shall be only one change in any one annual period and at least 12 months shall elapse between each change. As used in this Note, "annual period" means each of the successive periods of 12 calendar months commencing with the first day of the calendar month in which this Note is dated.
- (d) *Effective date of change.* Each change in the interest rate shall become effective commencing on the date the monthly installment becomes due during the second month following the first publication of the Standard in each annual period, provided, however, that the first change in interest rate (if there has then been a sufficient change in the Standard) shall become effective with the first loan installment falling due more than 30 days after the first publication of the Standard following expiration of the first annual period of the loan.
- (e) *Decreases.* Decreases in the interest rate shall be mandatory and increases shall be optional with the holder. The fact, however, that the holder may not have invoked a permissible increase, in whole or in part, shall not be deemed a waiver of the holder's right to invoke such increase at any time thereafter within the limits herein provided.
- (f) *Monthly installments, term.* When there is a change in the interest rate, at the option of the holder of this Note, (1) the amount of each monthly installment may be decreased or increased to an amount which, when paid in equal monthly installments rounded to the next highest dollar amount, would result in full payment of the then unpaid principal balance together with interest thereon at the changed rate by the end of the amortization period in effect just prior to such change, or (2) with the consent of the undersigned, such amortization period may be reduced or extended, or (3) a combination of (1) or (2) may be made. Notwithstanding the foregoing, if the purpose of the loan evidenced by this Note is to finance the purchase or construction of real property containing four or fewer residential units, then upon any increase in the interest rate, at the option of the undersigned the amortization period of this Note may be extended for the additional period required to amortize this Note without increasing the then existing monthly installment, but not to exceed a maximum amortization period of 40 years from the due date of the first installment; provided that when there is a subsequent reduction in the interest rate, at the option of the holder such amortization period may be reduced to the degree that it was extended pursuant to the provisions of this sentence.
- (g) *Notices.* Notices of any change in interest rate or amount of the monthly installment shall be deemed given by the holder when deposited in the United States mail, postage prepaid, addressed to the current owner of the property described in the Deed of Trust securing this Note and any other person personally liable on this Note, as those persons' names and addresses appear on the holder's records at the time of giving notice.

3. The last published standard on the date of this Note is April 30, 2002.

(2) *Variable rate disclosure form*

[Click here to view image.](#)

B.21 Condominium mortgage note and mortgage--assignable to institutional lender

COMMENT

These forms may be used if the sponsor of a condominium project is unwilling or unable to sell the units for cash. In such case the sponsor may decide to accept the purchaser's agreement to pay the unpaid balance of the purchase price over a period of time, evidenced by the purchaser's promissory note, and a mortgage on the unit sold to the purchaser as security for payment.

These forms have two distinguishing features. First, the promissory note is acquired by an institutional lender, the purchaser agrees to pay additional amounts into a sinking fund which is used to discharge taxes and other amounts assessed against the condominium unit. Second, the forms presuppose that the unit is sold on a furnished basis and, accordingly, the furnishings within the unit are also covered under the mortgage. Since the furnishings constitute personal property, a security agreement and filed financing statements that comply with Article 9 of the UCC. are required. The "further assurance" clause contained in paragraph 22 of the mortgage only provides for situations which may arise subsequent to initial compliance with the UCC. For example, a financing statement will generally expire after five years and accordingly the security interest in the furnishings will not be perfected at that time unless another financing statement is obtained and filed.

Condominium owners may deduct mortgage interest and real estate taxes paid with respect to the unit to the same extent as other homeowners.

These forms may be adapted for use by any owner of a condominium unit who desires to sell to a subsequent purchaser on the purchaser's credit.

For further information, see Chapters 6, 12, and 16.

FORMS

(1) Mortgage note

New York, N.Y.
November 3, 2002

1. *Promise to pay.* For value received, I, Henry Phillips, promise to pay to West House Condominium Corporation, or order, at 700 Central Park South, New York, New York, or at any other place designated in writing by the holder of this note, the principal sum of \$200,000, with interest thereon to be computed from the date hereof at the rate of 10 percent per annum, in constant monthly installments of \$1,755.16 each, commencing on the first day of the calendar month after the date hereof and on the first day of each succeeding calendar month until September 1, 2017, when the entire unpaid balance of principal, together with accrued interest, shall become due and payable. Each constant monthly installment shall be applied first to the payment of interest accrued on the unpaid principal, and the balance on account of the principal sum.

2. *Total amount due.* The principal sum evidenced by this note and all accrued and unpaid interest shall become due at the option of the holder on the happening of any default or event by which, under the terms of the mortgage securing this note, such principal sum and interest may or shall become due and payable. All of the covenants, conditions, and agreements contained in the mortgage are made part of this instrument.

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3. *Extensions.* If time is extended for the payment of the principal sum because the due date falls on a Sunday or a public holiday, the extended time shall be included in the computation of interest.

4. *Prepayment right.* The principal sum may be prepaid in its entirety, or in part, on the first day of any calendar month without penalty. If partial prepayment of principal is made, the amount of each regular monthly installment of principal and interest thereafter shall not be reduced, and any such partial prepayments shall be applied to the regular monthly payments in the inverse order of their maturity.

5. *Tax escrow payments.* If the holder at any time is a bank, trust company, savings and loan association, insurance company, union, pension, welfare, or retirement fund or other institutional lender (the "Institutional Lender"), the maker agrees to deposit with the holder, at the holder's election, as and when each payment of a monthly installment becomes due during the period of 12 calendar months commencing on the first monthly installment payment date after the Institutional Lender becomes the holder and during each period of 12 calendar months thereafter, one twelfth of the amount, as estimated from time to time by the Institutional Lender, of the taxes, and assessments if any, becoming due with respect to the premises during the respective periods of 12 calendar months. It is intended that not later than one month before the respective due dates for such taxes, or assessments if any, sufficient amounts shall be deposited with the holder to pay the same. Such amounts shall be held by the Institutional Lender without interest, and applied to the payment of the items in respect of which such amounts were deposited, or, at the option of the Institutional Lender, to the payment of the items in any order of priority determined by such holder, on or before the respective dates on which the same or any of them would become delinquent. If one month before the due date of any of the aforesaid items, the amount then on deposit is insufficient for the payment of the item in full, the maker, within ten days after demand, shall deposit the amount of the deficiency with such holder. Nothing contained in this paragraph shall be deemed to affect any right or remedy of the holder under any provision of the mortgage or of any statute or rule of law to pay any such tax or assessment and to add the amount so paid, together with interest at the legal rate, to the indebtedness owing hereon which shall thereupon be secured by the lien of the mortgage.

6. *Joint and several liability.* If the maker consists of two or more parties, such parties shall be jointly and severally liable on all obligations of this note.

7. *Waiver of presentment.* Presentment for payment, notice of dishonor, protest, and notice of protest are waived.

8. *Security of note.* This note is secured by a mortgage made by the maker to the payee of even date herewith on the premises, including furnishings, designated as Unit No. 17W in the Declaration establishing a Plan for Condominium Ownership of the property known as and by the street number 700 Central Park South, Borough of Manhattan, City of New York.

In the Presence of

Mark Davis

Henry Phillips

[Acknowledgment]

(2) *Mortgage*

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THIS MORTGAGE, made November 3, 2002, between Henry Phillips, residing at 980 Riverside Drive, New York, New York (Mortgagor), and West House Condominium Corporation, having an office at 700 Central Park South, New York, New York (Mortgagee).

Recitals

To secure the payment of an indebtedness in the sum of \$200,000, lawful money of the United States, to be paid with interest thereon according to a certain note or obligation bearing even date herewith (the "note"), Mortgagor does mortgage to Mortgagee the unit known as Unit No. 17W in the property known as the West House Condominium located at 700 Central Park South, Borough of Manhattan, City, County and State of New York, such unit being designated and described as Unit No. 17W in the Declaration establishing a plan for condominium ownership of such property under Article 9-B (the "Condominium Act"), of the Real Property Law of the State of New York dated July 27, 1990, and recorded in the office of the City Register in the County of New York on September 27, 1990, in Reel 1975, page 1201 and also designated as Tax Lot 874 in Block 7518 of the Borough of Manhattan on the Tax Map of the Real Property Assessment Department of the City of New York and on the Floor Plans of the building, certified by Hans Hartmann, Architect, on June 15, 1989, and filed in the office of the City Register in the County of New York on September 27, 1990, as Condominium Plan No. 5018.

Together with the appurtenances and all the estate and rights of Mortgagor, including the appurtenant common interest, in and to the above-described unit conveyed or intended to be conveyed to Mortgagor by deed bearing even date herewith delivered and intended to be recorded simultaneously herewith. This mortgage is a purchase money mortgage.

Together also with all fixtures and equipment used or useful in connection with the above-described unit and now or hereafter attached to or installed therein.

Together also with all furnishings included within the above-described unit and now or hereafter attached to or installed therein, including furniture, rugs, carpeting, lighting fixtures, electrical appliances, cabinets, shelving, wall covering, pictures, decorative objects, draperies, window shades or blinds, and all other like furnishings used or useful within the unit.

Together also with the rents, issues, and profits of the above-described unit, including Mortgagor's right, title, and interest in the common profits.

Together also with all right, title, and interest hereafter acquired by Mortgagor in and to the property and in and to the net proceeds of sale thereof pursuant to provision of law or otherwise, not including, however, any other unit or any appurtenant common interest thereto hereafter acquired by Mortgagor or by the Board of Managers or their designee on Mortgagor's behalf.

The above-described unit is referred to in this mortgage as the Unit. The Unit together with the appurtenances and all the estate and rights of Mortgagor therein and all fixtures, furnishings, and equipment used or useful in connection with the Unit and now or hereafter attached to or installed therein, such rents, issues, and profits and such right, title, and interest of Mortgagor hereafter acquired in the property, and the net proceeds of sale pursuant to any provision of law are sometimes collectively referred to in this mortgage as the Mortgaged Premises.

Together with all awards heretofore and hereafter made for taking by eminent domain the whole or any part of the Mortgaged Premises or any easement, including any awards for changes of grade of streets, such awards being assigned to Mortgagee, which is authorized, subject to the provisions of Article VIII of the Condominium Bylaws, to collect and

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receive the proceeds of such awards and to give proper receipts and acquittances therefor, and to apply the same toward the payment of the mortgage debt, even if the amount owing thereon is not then due and payable.

The property in which the Unit is situated is bounded and described as follows:

All that certain plot, piece, or parcel of land, with the building and improvements thereon erected, situate, lying, and being in the Borough of Manhattan, City, County and State of New York, bounded and described as follows:

Beginning at a point on the southerly side of Central Park South, distance 200 feet easterly from the corner formed by the intersection of the easterly side of Apex Avenue with the southerly side of Central Park South; running thence southerly and parallel with Apex Avenue, 10 feet to the northerly side of 58th Street; thence easterly, along the northerly side of 58th Street, 270 feet 8 inches; thence northerly and again parallel with Apex Avenue, 310 feet to the southerly side of Central Park South; thence westerly along the southerly side of Central Park South, 270 feet 8 inches to the point or place of Beginning.

Together with an undivided 1.02 percent interest in the Common Elements of the Property, hereinafter called the Common Elements;

For the purposes of this mortgage, unless the context otherwise requires, the terms used herein shall have the meanings set forth in the Condominium Act.

Mortgagor covenants with Mortgagee as follows:

1. *Promise to pay.* Mortgagor will pay the indebtedness provided as in this mortgage and the note.
2. *Use of deposit.* If Mortgagee exercises any right under this mortgage to declare the principal sum and interest due, it may, at any time thereafter, apply the whole or any part of the amount then on deposit pursuant to the note on account of any accrued interest, and/or on account of the principal sum and/or any costs and expenses (including reasonable attorneys' fees) paid or incurred by Mortgagee in connection with the exercise of any remedies hereunder. If this mortgage is assigned, the assignor shall transfer to the assignee the amount then on deposit with the assignor pursuant to the note, and upon each such assignment and transfer the assignor shall be under no further obligation to Mortgagor with respect to such amount.
3. *Late charges.* To cover the additional expense incurred by Mortgagee in handling delinquent payments, Mortgagor will pay on demand a "late charge" not exceeding 5 cents for each dollar of principal, interest and other sum required to be paid or deposited pursuant to the note or this mortgage if any such payment or deposit is received more than 15 days after its due date. Such late charge shall be payable on each event of delinquency, and payment or tender thereof shall not preclude the exercise by Mortgagee of any remedies herein provided upon Mortgagor's default.
4. *Warranty of title.* Mortgagor warrants the title to the Mortgaged Premises.
5. *Payment of taxes.* To the extent provision has not otherwise been made for the payment under the note, Mortgagor will pay all taxes and assessments affecting the Mortgaged Premises and in default thereof, Mortgagee may pay the same.
6. *Alterations.* No structural alteration or improvement shall be made to the Mortgaged Premises without Mortgagee's prior written consent.
7. *Estoppel certificate, tax receipts.* Mortgagor, within five days upon request in person or within ten days upon request by mail, will furnish a written statement duly acknowledged of the amount due on this mortgage and whether any

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offsets or defenses exist against the mortgage debt and that after a similar request Mortgagor will exhibit receipts showing payment of all taxes and assessments affecting the Mortgaged Premises, unless paid by Mortgagee pursuant to the note.

8. *Appointment of receiver.* The holder of this mortgage, in any action to foreclose it, shall be entitled to the appointment of a receiver.

9. *Foreclosure sale.* In case of a foreclosure sale the Mortgaged Premises may be sold in one parcel.

10. *Defense of rights or lien.* If any action or proceeding is commenced to which Mortgagee is made a party, or in which it becomes necessary to defend or uphold the lien of this mortgage, all sums paid by Mortgagee for the expense of any litigation to prosecute or defend the rights and lien created by this Mortgage (including reasonable counsel fees), shall be paid by Mortgagor within 15 days after written demand, together with interest thereon at the legal rate. Any such sum and the interest thereon shall be a lien on the Mortgaged Premises, prior to any right, or title to, interest in or claim upon the Mortgaged Premises attaching or accruing subsequent to the lien of this mortgage, and shall be deemed to be secured by this mortgage. In any action or proceeding to foreclose this mortgage, or to recover or collect the debt secured hereby, the provisions of law respecting the recovery of costs, disbursements and allowances shall prevail unaffected by this covenant.

11. *Advance rent.* Mortgagor will not, without Mortgagee's written consent, receive or collect rent from any tenant of the Mortgaged Premises for a period of more than two months in advance.

12. *Use of advances.* Mortgagor will, in compliance with Section 13 of the Lien Law, receive the advances secured hereby and will hold the right to receive such advances as a trust fund to be applied first for the purpose of paying the cost of the Mortgaged Premises before using any part of the same for any other purpose.

13. *Rental payments in event of default.* In the event of any default under this mortgage Mortgagor will pay monthly in advance to Mortgagee, or to any receiver appointed to collect the rents, issues, and profits of the Mortgaged Premises the fair and reasonable rental value for the use and occupancy of the Mortgaged Premises if the same are in Mortgagor's possession. Upon default in any such payment Mortgagor will vacate and surrender the possession of the Mortgaged Premises to Mortgagee or to such receiver, and in default thereof may be evicted by any appropriate legal proceeding.

14. *Joint and several liability.* If Mortgagor consists of more than one party, such mortgagors shall be jointly and severally liable under all of Mortgagor's obligations, covenants, and agreements contained herein.

15. *Payment of common charges.* Mortgagor will pay all assessments for common charges, service charges, and expenses made against the Mortgaged Premises as and when they become due and payable.

16. *Condition of premises.* Mortgagor shall keep the Mortgaged Premises (other than the Common Elements) in reasonably good repair, working order and condition, and shall make all repairs, renewals, and replacements that Mortgagee deems reasonably necessary.

17. *Compliance with rules.* Mortgagor shall observe, perform and keep all of the terms, provisions, covenants, and conditions required by it to be kept, observed and performed under the Declaration, Bylaws, and Rules and Regulations, as the same shall exist from time to time.

18. *Default.* At Mortgagee's option, the entire principal amount and interest accrued thereon, as evidenced by the mortgage and the note secured thereby, shall immediately become due and payable if one or more of the following "Events of Default" shall occur and be continuing:

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- (a) Default is made in the payment of any installment of interest, or of principal and interest, or in the making of any deposit under the note when all or any part thereof becomes due and payable, and such default continues for 15 days;
- (b) Default is made in the payment of any tax or assessment when the same becomes due and payable, and the default continues for 30 days, unless provision for payment thereof has been made pursuant to the note;
- (c) Default is made in the performance of any covenant in paragraph 3, 4, 6, 7, 10, 11, 12, 13, or 20 of this mortgage within the time provided, or in the performance of the covenant in paragraph 15, and the default continues for 30 days;
- (d) Default is made in the performance of any covenant in paragraph 16 or 17, and the default continues for 30 days after written notice is given to Mortgagor, which specifies the nature of such default and requires the same to be remedied;
- (e) Mortgagor sells or otherwise conveys the Mortgaged Premises without having simultaneously paid the note in full plus all interest accrued thereon to the date of the sale or conveyance;
- (f) Withdrawal of the property from the Condominium Act is authorized as provided in Section 339-t of the act, or 75 percent or more of the building is destroyed or substantially damaged and 75 percent or more of the Unit owners do not duly and promptly resolve to proceed with repair or restoration;
- (g) Any provision of the Condominium Act, or its application, in any circumstances is held invalid, and such invalidity affects the lien of this mortgage or Mortgagee's rights;
- (h) Mortgagor assigns the rents, issues, or profits (including the common profits) of all or part of the Mortgaged Premises without Mortgagee's prior written consent;
- (i) Any fixtures, furniture, or equipment constituting a part of the Mortgaged Premises are removed from such premises unless, before or concurrently with such removal, the fixtures, furniture, or equipment are promptly replaced by other fixtures or equipment not necessarily of the same character but of a value at least equal to the removed items, which shall immediately become subject to the lien of this mortgage;
- (j) Any law is passed that deducts from the value of the property for tax purposes any lien thereon, or that changes in any way the taxation of mortgages or debts secured thereby for state or local purposes so as to affect this mortgage; or
- (k) A petition in bankruptcy is filed by or against Mortgagor, or Mortgagor makes an assignment for the benefit of creditors or receives the benefit of any insolvency or reorganization act.

19. *Waiver of provisions.* Any failure by Mortgagee to insist upon the strict performance by Mortgagor of any term or provision hereof shall not be deemed to be a waiver of that or any other term or provision. Notwithstanding such failure, Mortgagee may thereafter insist upon strict performance by Mortgagor of any or all of the terms and provisions of this mortgage. All clauses and covenants in this agreement that are similar to those construed under Section 254 of the Real Property Law shall also be construed under that section. The additional clauses and covenants herein shall afford rights that are supplemental to, and not exclusive of, the rights conferred by the clauses and covenants construed by Section 254. Such additional clauses and covenants shall not impair, modify, alter, or defeat such rights even though they relate to the same subject matter or provide for different or additional rights in the same or similar contingencies as clauses and covenants construed by Section 254. Mortgagee's rights hereunder shall be separate, distinctive, and cumulative, and none of them shall be exclusive of any other. Moreover, no act of Mortgagee shall be construed as an election to proceed under any one provision hereof to the exclusion of any other provision.

20. *Eminent domain.* Notwithstanding any contrary provisions of existing or future law, Mortgagor shall continue to pay

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interest on the entire principal sum secured as such principal is reduced from time to time at the rate specified in the note, until any award or payment made by any public or quasi-public authority or corporation for taking by eminent domain of the entire or part of the Mortgaged Premises, or any easement therein, has actually been received by Mortgagee. Any reduction in the principal sum resulting from the application by Mortgagee of such award or payment shall be deemed to take effect only on the date of such receipt.

21. *Inspection of premises.* Mortgagee and all persons authorized by it may enter and inspect the Mortgaged Premises at all reasonable times.

22. *Further assurances.* Promptly upon request, Mortgagor shall execute and deliver to Mortgagee all additional instruments or assurances that are reasonably necessary or desirable to further secure the lien of this mortgage, including the execution and delivery of one or more financing statements on Form UCC-1 under the Uniform Commercial Code.

23. *Definitions.* Wherever used in this mortgage, unless the text clearly indicates a contrary intent or otherwise specifically provided herein, the word "Mortgagor" shall be construed to mean the "Mortgagor and/or any subsequent owner or owners of the Mortgaged Premises," and the word "Mortgagee" shall be construed to mean "Mortgagee or any subsequent holder or holders of the mortgage." Other terms used herein shall be defined as follows: "Declaration" means the instrument recorded, as provided above, in the office of the City Register in New York County submitting the property to the provisions of the Condominium Act; "Bylaws" means the instrument required by Section 339-u of the Condominium Act providing for the operation of the property, a true copy of which is annexed to the Declaration; and "Rules and Regulations" mean the instrument referred to in clause (i) of Section 339-v of the Condominium Act, relating to restrictions and requirements respecting the use and maintenance of the Unit and the common elements of the property.

This mortgage cannot be changed or terminated orally.

In witness whereof this mortgage has been duly executed by Mortgagor.

_____ (L.S.)
Henry Phillips

(Acknowledgment)

B.22 Cooperative apartment loan security agreement

COMMENT

This is a form for an agreement giving a creditor a security interest in the shares of stock and proprietary lease allocated to a cooperative apartment, as a part of the financing of the debtor's purchase of the apartment. Although similar to the financing of a purchase of real property, the financing of the purchase of a cooperative apartment must be structured differently because the purchaser is buying an interest in the cooperative corporation and a lease, rather than an interest in real property. Unlike a mortgage, a security interest in shares of stock of a cooperative corporation, or in a proprietary lease from such a corporation, is subject to the provisions of UCC Article 9. This form provides for the execution and filing of a financing statement as provided by the Uniform Commercial Code for secured transactions.

Truth in Lending:

A cooperative apartment loan security agreement must comply with the requirements of the Truth in Lending Act. The Federal Reserve Board has issued model disclosure forms and clauses which are

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published in an appendix to Regulation Z. A creditor is not required to use the model disclosure forms; however, they are a useful guide in drafting such forms.

For further information, see Chapters 9, 12, and 16.

FORM**Loan Security Agreement**

THIS AGREEMENT made _____, 20 _____, between _____, residing at _____ Street, City of _____, State of _____ ("Debtor"), and _____ Bank Corp., a corporation incorporated under the laws of the State of _____, having its principal office at _____ Avenue, City of _____, State of _____ ("Secured Party").

WHEREAS:

A. Debtor has executed, or is about to execute, a Purchase Agreement for the purchase of _____ shares of capital stock of _____ Cooperative Apartment Corp. ("Corporation") allocated to Apartment No. _____ in premises known as _____ Road, City of _____, State of _____, and the acquisition of the accompanying proprietary lease at the purchase price of \$ _____.

B. Pursuant to the Purchase Agreement, Debtor has made or is about to make the down payment of \$ _____, leaving the remainder of the purchase price in the amount of \$ _____ to be furnished by the Secured Party, for the account of and as a loan to the Debtor.

C. Debtor desires to borrow from the Secured Party, and the Secured Party is willing to lend to Debtor the remainder of the purchase price, namely \$ _____, all upon the terms and conditions set forth below.

NOW THEREFORE, in consideration of their mutual promises, it is hereby covenanted and agreed as follows:

1. The Debtor hereby agrees to borrow from the Secured Party the sum of \$ _____, and, provided that Debtor makes the payment required to be made by Debtor pursuant to the Purchase Agreement, Secured Party shall lend Debtor the sum of \$ _____. The sum borrowed by Debtor from Secured Party shall be paid to the Corporation/Seller on behalf of and for the account of the Debtor.

2. Simultaneously herewith, Debtor shall execute the following documents: (a) a promissory note in form annexed hereto, (b) a stock power in form annexed hereto, (c) an assignment of proprietary lease in form annexed hereto, and (d) a pledge of the shares in the cooperative corporation. Debtor agrees that provided that the Secured Party makes the loan provided for herein and advances to the Corporation/Seller on behalf of and for the account of Debtor the sum borrowed, then when the certificate of shares being purchased by Debtor and the proprietary lease are issued, such certificate and proprietary lease shall be delivered to Secured Party, and Debtor hereby authorizes the Corporation to deliver the certificate and lease to Secured Party. The certificate and lease are herein sometimes collectively referred to as "collateral" or "security."

3. Debtor hereby grants to Secured Party, as collateral security for the payment of the note, a continuing security interest in and to all of Debtor's right, title and interest in and to the shares of the Corporation to be evidenced by the certificate

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issued to Debtor and the proprietary lease entered into between Debtor and the Corporation for Apartment No. _____, together with the proceeds thereof. Upon repayment in full of the entire balance of the indebtedness hereby secured, together with accrued interest, the documents referred to in paragraph 2 above held by Secured Party, or its assignee or designee, shall forthwith be returned to Debtor, the security interest created herein shall cease and terminate, and this agreement shall be deemed terminated without further liability on the part of any party to the other. Debtor shall execute a Financing Statement and hereby authorized the Secured Party to file it.

4. In case any one or more of the following events ("Events of Default") shall occur, then, at the option of Secured Party, the note shall immediately become due and payable, together with accrued interest, without presentation, demand, protest or notice of any kind, all of which are hereby expressly waived:

- a. Nonpayment continued for thirty (30) days after the due date of any payment of interest and/or principal, or
- b. A default in the payment of maintenance charges and/or any other charges or payments required to be made pursuant to terms of the proprietary lease, which default is not cured within the time and in the manner provided for in the proprietary lease, or
- c. A default in performance of and/or a breach of any of the terms, covenants and conditions of the proprietary lease on the part of Debtor to be performed which is not cured within the time and in the manner provided for in the proprietary lease, or
- d. A termination and/or cancellation of the proprietary lease by the Corporation, or
- e. In the event Debtor shall become insolvent, or shall file a petition in bankruptcy, or take advantage of the Bankruptcy Act and/or any other law for the relief of debtors, or shall make an assignment for the benefit of creditors, or if a receiver, trustee or liquidator, whether temporary or permanent, shall be appointed for the property of Debtor, or if an involuntary proceeding under any bankruptcy law or insolvency act shall be instituted against Debtor and such proceedings and/or appointments shall not be dismissed or vacated within thirty (30) days after such institution or appointment, or if Debtor admits in writing Debtor's inability to pay his or her debts as they become due, or if Debtor becomes insolvent howsoever otherwise evidenced, or
- f. In the event Debtor shall transfer, sell, assign or grant a further security interest in the shares and/or proprietary lease without Debtor having paid Secured Party the entire remaining balance of Debtor's indebtedness, with interest, in or before the date of Debtor's transfer, sale, assignment or granting of a further security interest, or
- g. In the event Debtor sublets, or offers to sublet, or assigns, or offers to assign the proprietary lease for Apartment No. _____ without the prior written consent of Secured Party, which consent will not be unreasonably withheld if the Corporation's Board of Directors shall consent thereto.

Without limiting any of the terms and provisions contained in the Note, it is agreed that a default by Debtor in the performance of any of the terms or provisions on Debtor's part to be performed under the proprietary lease for Apartment No. _____, or the giving of any notice of surrender, cancellation or expiration of the proprietary lease (which notice the obligor represents shall not be given), shall constitute a default under the Note and entitle the holder of the Note, at its option, to exercise any and all of the rights under the Note and this Agreement.

5. In the event of the occurrence of any one or more of the Events of Default, and if the Secured Party elects to accelerate the Note, then written notice of such election and acceleration (which notice shall specify the amount of principal and accrued interest due) shall be given by Secured Party to the Debtor by registered or certified mail, return receipt requested; and, if Debtor shall fail to pay such principal and accrued interest within five (5) days of receipt (it being understood that if Debtor shall refuse to accept delivery of such notice, the date of refusal shall be deemed to be

the date of receipt), of such notice, then Secured Party in addition to any and all rights which it might have pursuant to the Uniform Commercial Code, may, but shall not be obligated to, sell, assign and deliver the security at public or private sale, for cash, upon credit or for future delivery with or without advertisement of the time, place, or terms of sale except that if the sale be a private sale, five (5) days' notice in writing from Secured Party of the time and place of sale and the terms of sale shall be given to Debtor. In case of any sale on credit or for future delivery, the security sold shall be retained by Secured Party until the sale price is paid, but Secured Party shall incur no liability if the purchaser fails to take up and pay for the security sold. In case of any such failure, the security may be again sold. At any sale, Secured Party, if Secured Party is an individual or individuals, may purchase the security sold, free from all right of redemption of the Debtor which is hereby waived and released. In case of any sale, Secured Party may first deduct all expenses of collections, sale and delivery of the security sold and any expenses incidental thereto, including, but not limited to, reasonable attorneys' fees, brokerage commissions and transfer taxes, and may then apply the residue to any liability of the undersigned under the Note, and shall return the surplus, if any, to Debtor. Any sale conducted upon the foregoing terms shall be deemed commercially reasonable. Debtor agrees that the Secured Party shall have the right to continue to retain the security until such time that Secured Party in its reasonable judgment believes that an advantageous price can be secured for the security, and Secured Party shall not be liable to Debtor for any loss in the value of the security by reason of any such retention of the security by Secured Party. If Secured Party shall not commence to dispose of the security within ninety (90) days after the right to dispose of the security shall have accrued, then Debtor shall have the right, at any time thereafter, and prior to the time that Secured Party shall commence to dispose of the security, to request of Secured Party that it dispose of the security, or Debtor himself or herself, at Debtor's own cost and expense, shall have the right to dispose of the security; provided however, that in the case of the former, Secured Party shall not be obligated to dispose of the security unless the net proceeds to be received therefrom shall be sufficient to satisfy in full the then obligations of Debtor to Secured Party, and that in the case of the latter, any disposition of the security by Debtor must be upon terms and conditions consented to by Secured Party. Secured Party shall be obligated to give consent to such terms and conditions if the net proceeds to be received from such disposition shall be sufficient to satisfy in full the then obligations of Debtor to Secured Party. Secured Party shall not be liable to Debtor for any agents' or brokers' fees in the event Debtor disposes of the security. Secured Party shall have the right to retain the security in partial discharge of Debtor's obligations to Secured Party. If Secured Party elects to retain the security, notice thereof by registered or certified mail, return receipt requested shall be given to Debtor, and if Debtor objects in writing within thirty (30) days after receipt of notification (it being understood that if Debtor shall refuse to accept delivery of the notice, the date of refusal shall be deemed to be the date of receipt) then and in such event Secured Party shall commence to dispose of the security in the manner hereinbefore set forth. In connection with any sale or disposition of the security, Secured Party shall have the absolute right to complete the incomplete stock power and assignment for the purpose of transferring the shares and proprietary lease.

6. Debtor agrees that until the Note together with accrued interest is paid in full, Debtor will not avail himself or herself of his or her rights under the proprietary lease to cancel and terminate the proprietary lease. A breach hereof shall be deemed an Event of Default entitling Secured Party to the rights provided for in paragraphs 5 and 6 hereof.

7. Debtor agrees that Debtor will not, and may not, assert against Secured Party or against the collateral security any claim, demand, offset or counterclaim arising out of the Purchase Agreement; and Debtor agrees that Debtor's sole remedies as a subscriber to the shares, as a shareholder and as a proprietary lessee are those afforded to all subscribers, shareholders and proprietary lessees in the Purchase Agreement and the proprietary lease. In an action on the Note or Security Agreement, Debtor will not interpose any defense or counterclaim which does not arise from this Loan Transaction.

8. Debtor agrees that the Corporation, its officers, agents, servants, employees and/or attorneys shall have no responsibility to Debtor hereunder other than to deliver the collateral security to Secured Party, or to return the collateral security to Debtor, all in accordance with the provisions of this Agreement.

9. Secured Party may, at its option, make any payments for Debtor's account, or do any acts required to be done in order

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to prevent a default in or breach of the proprietary lease, but Secured Party under no circumstances shall be obligated to do so. In the event Secured Party makes any of such payments or does any of such acts, the payments and the costs of such acts, together with interest thereon shall be added to the indebtedness hereby secured and the principal amount of the note shall be deemed increased accordingly; and the provisions thereof relating to no personal liability on the part of Debtor shall apply with equal force and effect to any such payments and/or costs.

10. In the event of a default as aforesaid, Debtor shall immediately remove himself or herself from the premises and give possession thereof to Secured Party. In the event that proceedings to evict Debtor become necessary, the cost of removal shall be borne by Debtor and the cost of the same may be added to the total indebtedness, evidenced by Debtor's Note.

11. The term "Secured Party" as used in this Agreement, includes the Secured Party named herein, its successors, assigns, heirs, executors, administrators and legal representatives.

12. The pronouns used herein shall be male, female or neuter and in the singular or plural, whichever the sense requires.

13. The term "Debtor" shall be read "Debtors" if more than one person is the Debtor, and in such event, the obligation of the Debtor shall be joint and several.

14. The Debtor shall not assign this Agreement without the prior written consent of Secured Party. Secured Party shall have the right to assign this Loan-Security Agreement and the collateral held as security hereunder and all of its right, title and interest hereunder and in said collateral without Debtor's consent.

15. Except as prohibited by statute, the respective parties hereto shall and they hereby do waive trial by jury in an action, proceeding or counterclaim brought by any of the parties hereto against the other on any matter whatsoever arising out of or in any way connected with this Agreement, the collateral security and/or the relationship created thereby and with respect to any matter for which a jury trial cannot be waived, the parties hereto agree not to assert any such claim as a counterclaim in nor move to consolidated same with any action or proceeding in which a jury trial is waived.

16. Secured Party agrees that until there has been an Event of Default and Secured Party has elected to accelerate the indebtedness, Debtor shall have the exclusive right to vote the shares as a shareholder at any meeting of shareholders of the Corporation, shall be entitled to receive and retain dividends, if any, from the Corporation, shall be exclusively entitled to the benefits of income tax deductions available to all shareholders of the Corporation, shall have the right to occupy the apartment as proprietary lessee and shall have all other rights and privileges of a shareholder and proprietary lessee. Debtor agrees that Debtor shall have the exclusive responsibility to the Corporation for payment of all maintenance charges and other charges to become due under the proprietary lease, shall be exclusively responsible for the performance of all of the terms, covenants and conditions of the proprietary lease on the part of the lessee to be performed and that Secured Party shall have no responsibility whatsoever under the proprietary lease and shall under no circumstances be deemed the lessee of the apartment for any purpose. Secured Party shall be entitled to receive distributions of capital, if any, from the Corporation, to be applied in reduction of the indebtedness in inverse order.

17. This Agreement contains the full understanding of the parties and may not be amended, altered, discharged or terminated, except by another instrument in writing signed by the party sought to be charged therewith, or by his, her or its duly authorized agent.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals this _____ day of _____, 20 ____.

Debtor

 _____ Bank Corp.

By: _____

B.23 Plain language note and mortgage--residential mortgage loan

COMMENT

The note, and the mortgage following this note, are drafted to comply with New York's "plain language" law. This law is a reflection of the increasing number of state laws enacted to protect consumers from deceptive trade practices.

"Consumer transactions":

Consumer transactions are purchases or leases by individuals of goods, equipment, or real estate for their personal, family, or household use. This typically includes automobile sales or leases, apartment leases, appliance, or furniture installment sales as well as purchase money loans on the purchase of a personal residence secured by a mortgage. One area of abuse, which consumer protection laws are aimed at correcting, is the use of complicated or incomprehensible language incomprehensible to consumers. In some situations, the consumer contract language is in direct contradiction to the oral representations of the seller, lessor, or creditor, or not a true expression of the agreement which the consumer believes was made.

Consumer protection laws:

Some states have enacted all or parts of the Uniform Deceptive Trade Practices Act (UDTPA), including Georgia, Nebraska, New Mexico, and Hawaii. Other jurisdictions have enacted their own version of consumer protection laws. The various consumer protection laws and UDTPA prohibit persons selling, leasing, or lending to individuals in consumer transactions from using unfair or deceitful practices. Enforcement of the act may be solely in the hands of the state's highest law enforcement official, such as an attorney general, or consumers themselves may be allowed to bring a direct individual or class action. In addition to recovery of damages, consumers may be entitled to also recover attorney's fees and penalties. The Texas Deceptive Trade Practice-Consumer Protection Act goes so far as to permit the consumer to enjoin deceptive practices and obtain, in specified circumstances, treble damages. These statutory remedies are usually in addition to any remedies at common law or in equity which the individual may otherwise have.

Legal document language:

Some courts have interpreted their jurisdiction's consumer protection law to prescribe the use of complicated, unclear, or deceptive language in consumer transaction legal documents. For example, the Pennsylvania courts have held that the Commonwealth's Consumer Protection Law forbids the use of incomprehensible language in a printed form of residential lease.

Plain language law:

The New York "plain language" statute specifically addresses the use of "legalese" in consumer agreements. The act affirmatively requires (1) the use of common and every-day words in a clear and coherent manner, and (2) appropriately divided and captioned sections. The law applies to residential leases and every other written agreement where a consumer is a party and the subject matter, i.e., money,

property, or services, is primarily for personal, family, or household use. A loan used by a consumer to purchase a principal residence, second home, or vacation home which is secured by a note and mortgage is a covered transaction.

Protection is given sellers, creditors, and lessors under New York's law by a penalty limitation of \$50 per consumer and \$10,000 in class action situations. The penalty is in addition to actual damages which the consumer may be able to prove. No action can be brought by a consumer under the "plain language" law after both parties have fully performed their obligations. Good faith in attempting to comply with the law on the part of the seller, creditor, or lessor is a complete defense. Agreements involving amounts over \$50,000 are specifically excluded from the provision's protection. The use of language required by federal law, rule, or regulation or by a governmental instrumentality is allowed without penalty or liability.

For further information, see Chapter 12.

FORMS

(1) Plain language note

NOTE

U.S. \$45,000 Newburgh, New York
November 1,
2002

1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay \$45,000 (this amount will be called "principal"), plus interest, to the order of the Lender. The Lender is Fifth National Bank of Ulster County. I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note will be called the "Note holder."

2. INTEREST

I will pay interest at a rate of 10 percent per year. Interest will be charged on that part of principal which has not been paid. Interest will be charged beginning on the date of this Note and continuing until the full amount of principal has been paid.

3. PAYMENTS

I will pay principal and interest by making payments every month. Each of my monthly payments will be in the amount of U.S. \$394.91.

I will make my monthly payments on the first day of each month beginning on December 1, 2002. I will make these payments every month until I have paid all of the principal and interest and any other charges, described below, that I may owe under this Note. If, on November 1, 2032, I still owe amounts under this Note, I will pay all those amounts, in full, on that date.

I will make my monthly payments at 50 West Main Street, Kingston, New York, or at a different place if required by the Note holder.

4. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charge for Overdue Payments

If the Note holder has not received the full amount of any of my monthly payments by the end of 15 calendar days after the date it is due, I will pay a late charge to the Note holder. The amount of the charge will be 1 percent of my overdue payment of principal and interest.

(B) Notice From Note Holder

If I do not pay the full amount of each monthly payment on time, the Note holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date I will be in default. That date must be at least 30 days after the date on which the notice is mailed to me or, if it is not mailed, 30 days after the date on which it is delivered to me.

(C) Default

If I do not pay the overdue amount by the date stated in the notice described in (B) above, I will be in default. If I am in default, the Note holder may require me to pay immediately the full amount of principal which has not been paid and all the interest that I owe on that amount.

Even if, at a time when I am in default, the Note holder does not require me to pay immediately in full as described above, the Note holder will still have the right to do so if, at a later time, I am in default again.

(D) Payment of Note Holder's Costs and Expenses

If the Note holder has required me to pay immediately in full as described above, the Note holder will have the right to be paid back for all of its reasonable costs and expenses. Those expenses include, for example, reasonable attorney's fees.

5. BORROWER'S PAYMENTS BEFORE THEY ARE DUE

(A) Borrower's Right to Make Prepayments

I have the right to make payments of principal before they are due. Any payment made before it is due is known as a "prepayment." A prepayment of only part of the unpaid principal is known as a "partial prepayment."

If I choose to make a partial prepayment, the Note holder may require me to make the prepayment on the same day that one of my monthly payments is due. The Note holder may also require that the amount of my partial prepayment be equal to the amount of principal that would have been part of my next one or more monthly payments. If I make a partial prepayment, there will be no delays in the due dates or changes in the amounts of my monthly payments unless the Note holder agrees in writing to those delays or changes. The Note holder will use all of my prepayments to reduce the amount of principal that I owe under this Note.

(B) Prepayment Charge

I will pay a prepayment charge to the Note holder only if a percentage and a date are filled in below *and if I make the*

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prepayment using money lent to me by a lender other than the Note holder. [Strike italics if not applicable.]

During any 12-month period ending on an anniversary of the date of this Note, I may make partial prepayments of up to \$5,000 without charge. This amount will be called the "free prepayment amount."

I will pay a prepayment charge if the total of my prepayments during any such 12-month period is greater than the free prepayment amount. The prepayment charge will be a percentage of the amount by which my prepayments in any such 12-month period are greater than the free prepayment amount. That percentage will be 3 percent until November 1, 2003; it will change to 2 percent on that date until November 1, 2004; and it will change to 1 percent on that date until November 1, 2005. After the last date filled in above, there will be no prepayment charge.

6. BORROWER'S WAIVERS

I waive my rights to require the Note holder to do the following things: (A) to demand payment of amounts due (known as "presentment"); (B) to give notice that amounts due have not been paid (known as "notice of dishonor"); (C) to obtain an official certification of nonpayment (known as a "protest"). Anyone else (i) who agrees to keep the promises made in this Note, (ii) who agrees to make payments to Lender if I fail to keep my promises under this Note, or (iii) who signs this Note to transfer it to someone else (known as "guarantors, sureties, and endorsers"), also waives these rights.

7. GIVING OF NOTICES

Any notice that must be given to me under this Note will be given by delivering it or by mailing it addressed to me at the Property Address below. A notice will be delivered or mailed to me at a different address if I give the Note holder a notice of my different address.

Any notice that must be given to the Note holder under this Note will be given by mailing it to the Note holder at the address stated in Section 3 above. A notice will be mailed to the Note holder at a different address if I am given a notice of that different address.

8. THIS NOTE COVERED BY A MORTGAGE

A Mortgage, dated November 1, 2002, protects the Note holder from possible losses which might result if I do not keep the promises which I make in this Note. That Mortgage describes how and under what conditions I may be required to make immediate payment in full of all amounts that I owe under this Note.

9. RESPONSIBILITY OF PERSONS UNDER THIS NOTE

If more than one person signs this Note, each of us is fully and personally obligated to pay the full amount owed and to keep all of the promises made in this Note. Any guarantor, surety, or endorser of this Note (as described in Section 6 above) is also obligated to do these things. The Note holder may enforce its rights under this Note against each of us individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under this Note.

Any person who takes over my rights or obligations under this Note will have all of my rights and must keep all of my promises made in this Note. Any person who takes over the rights or obligations of a guarantor, surety, or endorser of this Note (as described in Section 6 above) is also obligated to keep all of the promises made in this Note.

235 North Elm Street

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Charles T. Conroy

Little Britan, New York

Prop- Ellen C. Conroy
erty
Ad-
dress

(Sign Original Only)

(2) *Plain language mortgage*

MORTGAGE

WORDS USED OFTEN IN THIS DOCUMENT

(A) "Mortgage." This document, which is dated November 1, 2002, will be called the "Mortgage."

(B) "Borrower." Charles T. Conroy and Ellen C. Conroy, husband and wife will sometimes be called the "Borrower" and sometimes simply "I."

(C) "Lender." Fifth National Bank of Ulster County will be called the "Lender." Lender is a corporation or association which was formed and which exists under the laws of the United States of America. Lender's address is 50 West Main Street, Kingston, New York.

(D) "Note." The note signed by Borrower and dated November 1, 2002, will be called the "Note." The Note shows that I owe Lender Forty Five Thousand and no/100 Dollars (\$45,000) plus interest, which I have promised to pay in monthly payments of principal and interest and to pay in full by November 1, 2032.

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(E) "Property." The property that is described below in the section titled "Description Of The Property," will be called the "Property."

BORROWER'S TRANSFER TO LENDER OF RIGHTS IN THE PROPERTY

I mortgage, grant and convey the Property to Lender subject to the terms of this Mortgage. This means that, by signing this Mortgage, I am giving Lender those rights that are stated in this Mortgage and also those rights that the law gives to lenders who hold mortgages on real property. I am giving Lender these rights to protect Lender from possible losses that might result if I do not:

- (A) Pay all the amounts that I owe Lender as stated in the Note;
- (B) Pay, with interest, any amounts that Lender spends under this Mortgage, to protect the value of the Property and Lender's rights in the Property;
- (C) Pay, with interest, any other amounts that Lender lends to me as Future Advances under Paragraph 23 below; and
- (D) Keep all of my promises and agreements under this Mortgage.

DESCRIPTION OF THE PROPERTY

I give Lender rights in the following Property:

(A) The property which is located at 235 North Elm Street, Little Britan, New York. This property is in Orange County in the State of New York. It has the following legal description:

[Insert Description]

If this property is a condominium, the following must be completed: This property is part of a condominium project known as Great Britan Gardens (called the "Condominium Project"). This property includes my unit and all of my rights in the common elements of the Condominium Project.

If this property is in a planned unit development, the following must be completed: This property is in a development which is a planned unit development known as _____ (called the "PUD"). The PUD was created by _____;

- (B) All buildings, structures and other improvements that are located on the property described in paragraph (A) of this section;
- (C) All rights in other property that I have as owner of the property described in paragraph (A) of this section. These rights are known as "easements, rights and appurtenances attached to the property;"
- (D) All rents or royalties from the property described in paragraph (A) of this section;
- (E) All mineral, oil and gas rights and profits, water, water rights and water stock that are part of the property described in paragraph (A) of this section;
- (F) All rights that I have in the land which lies in the streets or roads in front of, or next to, the property described in paragraph (A) of this section;

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(G) All fixtures on the property described in paragraphs (A) and (B) of this section. Usually, fixtures are items that are physically attached to buildings, such as hot water heaters;

(H) All of the property described in paragraphs (B) through (F) of this section that I acquire in the future, and all rights described in paragraphs (B) through (F) of this section that I acquire in the future;

(I) All replacements of or additions to the property described in paragraphs (B) through (F) and paragraph (H) of this section;

(J) All fixtures that: (i) are on the property described in paragraphs (A) and (B) of this section, and (ii) I acquire in the future, except for those fixtures that under the law are "consumer goods" and that I acquire more than ten days after the date of the Note; and

(K) All replacements of or additions to the fixtures that are on the property described in paragraphs (A) and (B) of this section, except for those replacements and additions that are: (i) made to fixtures that under the law are "consumer goods," and (ii) made more than ten days after the date of the Note.

It may be that I do not own the Property but am a tenant under a lease. In that case, the rights I am giving to Lender by this Mortgage are rights in my tenancy.

BORROWER'S RIGHT TO MORTGAGE THE PROPERTY AND BORROWER'S OBLIGATION TO DEFEND OWNERSHIP OF THE PROPERTY

I promise that except for the "exceptions" listed in any title insurance policy which insures Lender's rights in the Property: (A) I lawfully own the Property; (B) I have the right to mortgage, grant and convey the Property to Lender; and (C) there are no outstanding claims or charges against the Property.

I give a general warranty of title to Lender. This means that I will be fully responsible for any losses which Lender suffers because someone other than myself has some of the rights in the Property which I promise that I have. I promise that I will defend my ownership of the Property against any claims of such rights.

UNIFORM PROMISES

I promise and I agree with Lender as follows:

1. BORROWER'S PROMISE TO PAY PRINCIPAL AND INTEREST UNDER THE NOTE AND TO FULFILL OTHER PAYMENT OBLIGATIONS

I will promptly pay to Lender when due: principal and interest under the Note; late charges and prepayment charges as stated in the Note; and principal and interest on Future Advances that I may receive under Paragraph 23 below.

2. AGREEMENTS ABOUT MONTHLY PAYMENTS FOR TAXES AND INSURANCE

(A) Borrower's Obligation to Make Monthly Payments to Lender for Taxes and Insurance

I will pay to Lender all amounts necessary to pay for taxes, assessments, ground rents (if any), and hazard insurance on the Property and mortgage insurance (if any). I will pay those amounts to Lender unless Lender tells me, in writing, that I do not have to do so, or unless the law requires otherwise. I will make those payments on the same day that my

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monthly payments of principal and interest are due under the Note.

The amount of each of my payments under this Paragraph 2 will be the sum of the following:

- (i) One twelfth of the estimated yearly taxes, assessments and ground rents (if any) on the Property which under the law may be superior to this Mortgage; plus
- (ii) One twelfth of the estimated yearly premium for hazard insurance covering the Property; plus
- (iii) One twelfth of the estimated yearly premium for mortgage insurance (if any).

Lender will determine from time to time my estimated yearly taxes, assessments, ground rents and insurance premiums based upon existing assessments and bills, and reasonable estimates of future assessments and bills. (Taxes, assessments, ground rents and insurance premiums will be called "taxes and insurance.")

The amounts that I pay to Lender for taxes and insurance under this Paragraph 2 will be called the "Funds." The Funds are additional protection for Lender in case I do not fulfill my obligations under the Note and under this Mortgage.

(B) Lender's Obligations Concerning Borrower's Monthly Payments for Taxes and Insurance

Lender will keep the Funds in a savings or banking institution the deposits or accounts of which are insured or guaranteed by a federal or state agency. If Lender is such an institution then Lender may hold the Funds. Except as described in this Paragraph 2, Lender will use the Funds to pay taxes and insurance. Lender will give to me, without charge, an annual accounting of the Funds. That accounting must show all additions to and deductions from the Funds and the reason for each deduction.

Lender may not charge me for holding or keeping the Funds on deposit, for using the Funds to pay taxes and insurance, for analyzing my payments of Funds, or for receiving, verifying and totalling assessments and bills. However, Lender may charge me for these services if Lender pays me interest on the Funds and if the law permits Lender to make such a charge. Lender will not be required to pay me any interest or earnings on the Funds unless either (i) Lender and I agree in writing, at the time I sign this Mortgage, that Lender will pay interest on the Funds; or (ii) the law requires Lender to pay interest on the Funds.

If Lender's estimates are too high or if taxes and insurance rates go down, the amounts that I pay under this Paragraph 2 will be too large. If this happens at a time when I am keeping all of my promises and agreements made in this Mortgage, I will have the right to have the excess amount either promptly repaid to me as a direct refund or credited to my future monthly payments of Funds. There will be excess amounts if, at any time, the sum of (a) the amount of Funds which Lender is holding or keeping on deposit, plus (b) the amount of the monthly payments of Funds which I still must pay between that time and the due dates of taxes and insurance, is greater than the amount necessary to pay the taxes and insurance when they are due.

If, when payments of taxes and insurance are due, Lender has not received enough Funds from me to make those payments, I will pay to Lender whatever additional amount is necessary to pay the taxes and insurance in full. I must pay that additional amount in one or more payments as Lender may require.

When I have paid all of the amounts due under the Note and under this Mortgage, Lender will promptly refund to me any Funds that are then being held or kept on deposit by Lender. If, under Paragraph 20 below, either Lender acquires the Property or the Property is sold, then immediately before the acquisition or sale, Lender will use any Funds which Lender is holding or has on deposit at that time to reduce the amount that I owe to Lender under the Note and under this Mortgage.

3. LENDER'S APPLICATION OF BORROWER'S PAYMENTS

Unless the law requires otherwise, Lender will apply each of my payments under the Note and under Paragraphs 1 and 2 above in the following order and for the following purposes:

(A) First, to pay the amounts then due to Lender under Paragraph 2 above;

(B) Next, to pay interest then due under the Note;

(C) Next, to pay principal then due under the Note; and

(D) Next, to pay interest and principal on any Future Advances that I may have received from Lender under Paragraph 23 below.

4. BORROWER'S OBLIGATION TO PAY CHARGES AND ASSESSMENTS AND TO SATISFY CLAIMS AGAINST THE PROPERTY

I will pay all taxes, assessments, and any other charges and fines that may be imposed on the Property and that may be superior to this Mortgage. I will also make payments due under my lease if I am a tenant on the Property and I will pay ground rents (if any) due on the Property. I will do this either by making the payments to Lender that are described in Paragraph 2 above or, if I am not required to make payments under Paragraph 2, by making payments, when they are due, directly to the persons entitled to them. (In this Mortgage, the word "person" means any person, organization, governmental authority, or other party.) If I make direct payments, then promptly after making any of those payments I will give Lender a receipt which shows that I have done so. If I make payment to Lender under Paragraph 2, I will give Lender all notices or bills that I receive for the amounts due under this Paragraph 4.

If the Property includes a unit in a Condominium Project or in a PUD, I will promptly pay, when they are due, all assessments imposed by the owners association or other organization that governs the Condominium Project or PUD. That association or organization will be called the "Owners Association."

Any claim, demand or charge that is made against property because an obligation has not been fulfilled is known as a "lien." I will promptly pay or satisfy all liens against the Property that may be superior to this Mortgage. However, this Mortgage does not require me to satisfy a superior lien if: (A) I agree, in writing, to pay the obligation which gave rise to the superior lien and Lender approves the way in which I agree to pay that obligation; or (B) I, in good faith, argue or defend against the superior lien in a lawsuit so that, during the lawsuit, the superior lien may not be enforced and no part of the Property must be given up.

5. BORROWER'S OBLIGATION TO OBTAIN AND TO KEEP HAZARD INSURANCE ON THE PROPERTY

(A) Generally

I will obtain hazard insurance to cover all buildings, structures and other improvements that now are or in the future will be located on the Property. The insurance must cover loss or damage caused by fire, hazards normally covered by "extended coverage" hazard insurance policies, and other hazards for which Lender requires coverage. The insurance must be in the amounts and for the periods of time required by Lender. It is possible that the insurance policy will have provisions that may limit the insurance company's obligation to pay claims if the amount of coverage is too low. Those provisions are known as "co-insurance requirements." Lender may not require me to obtain an amount of coverage that is more than the larger of the following two amounts: either (i) the amount that I owe to Lender under the Note and

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under this Mortgage; or (ii) the amount necessary to satisfy the co-insurance requirements.

I may choose the insurance company, but my choice is subject to Lender's approval. Lender may not refuse to approve my choice unless the refusal is reasonable. All of the insurance policies and renewals of those policies must include what is known as a "standard mortgage clause" to protect Lender. The form of all policies and the form of all renewals must be acceptable to Lender. Lender will have the right to hold the policies and renewals.

I will pay the premiums on the insurance policies either by making payments to Lender, as described in Paragraph 2 above, or by paying the insurance company directly when the premium payments are due. If Lender requires, I will promptly give Lender all receipts of paid premiums and all renewal notices that I receive.

If there is a loss or damage to the Property, I will promptly notify the insurance company and Lender. If I do not promptly prove to the insurance company that the loss or damage occurred, then Lender may do so.

The amount paid by the insurance company is called "proceeds." The proceeds will be used to repair or to restore the damage Property unless: (a) it is not economically possible to make the repairs or restoration; or (b) the use of the proceeds for that purpose would lessen the protection given to Lender by this Mortgage; or (c) Lender and I have agreed in writing not to use the proceeds for that purpose. If the repair or restoration is not economically possible or if it would lessen Lender's protection under this Mortgage, then the proceeds will be used to reduce the amount that I owe to Lender under the Note and under this Mortgage. If any of the proceeds remain after the amount that I owe to Lender has been paid in full, the remaining proceeds will be paid to me. The use of proceeds to reduce the amount that I owe to Lender will not be a prepayment that is subject to the prepayment charge provisions, if any, under the Note.

If I abandon the Property, or if I do not answer, within 30 days, a notice from Lender stating that the insurance company has offered to settle a claim for insurance benefits, then Lender has the authority to collect the proceeds. Lender may then use the proceeds to repair or restore the Property or to reduce the amount that I owe to Lender under the Note and under this Mortgage. The 30-day period will begin on the date the notice is mailed or, if it is not mailed, on the date the notice is delivered.

If any proceeds are used to reduce the amount of principal which I owe to Lender under the Note, that use will not delay the due date or change the amount of any of my monthly payments under the Note and under Paragraphs 1 and 2 above. However, Lender and I may agree in writing to those delays or changes.

If Lender acquires the Property under Paragraph 20 below, all of my rights in the insurance policies will belong to Lender. Also, all of my rights in any proceeds which are paid because of damage that occurred before the Property is acquired by Lender or sold will belong to Lender. However, Lender's rights in those proceeds will not be greater than the amount that I owe to Lender under the Note and under this Mortgage immediately before the Property is acquired by Lender or sold.

(B) Agreements that Apply to Condominiums and PUD's

(i) If the Property includes a unit in a Condominium Project, the Owners Association may maintain a hazard insurance policy which covers the entire Condominium Project. That policy will be called the "master policy." So long as the master policy remains in effect and meets the requirements stated in this Paragraph 5: (a) my obligation to obtain and to keep hazard insurance on the Property is satisfied; (b) I will not be required to include an amount for hazard insurance premiums in my monthly payment of Funds to Lender under Paragraph 2 above; and (c) if there is a conflict, concerning the use of proceeds, between (1) the terms of this Paragraph 5, and (2) the law or the terms of the declaration, by-laws, regulations or other documents creating or governing the Condominium Project, then that law or the terms of those documents will govern the use of proceeds. I will promptly give Lender notice if the master policy is interrupted or terminated. During any time that the master policy is not in effect the terms of (a), (b) and (c) of this

subparagraph 5(B)(i) will not apply.

(ii) If the Property includes a unit in a Condominium Project, it is possible that proceeds will be paid to me instead of being used to repair or to restore the Property. I give Lender my rights to those proceeds. If the Property includes a unit in a PUD, it is possible that proceeds will be paid to me instead of being used to repair or to restore the common areas or facilities of the PUD. I give Lender my rights to those proceeds. All of the proceeds described in this subparagraph 5(B)(ii) will be paid to Lender and will be used to reduce the amount that I owe to Lender under the Note and under this Mortgage. If any of those proceeds remain after the amount that I owe to Lender has been paid in full, the remaining proceeds will be paid to me. The use of proceeds to reduce the amount that I owe to Lender will not be a prepayment that is subject to the prepayment charge provisions, if any, under the Note.

6. BORROWER'S OBLIGATION TO MAINTAIN THE PROPERTY AND TO FULFILL OBLIGATIONS IN LEASE, AND AGREEMENTS ABOUT CONDOMINIUMS AND PUD'S

I will keep the Property in good repair. I will not destroy, damage or substantially change the Property, and I will not allow the Property to deteriorate. If I do not own but am a tenant on the Property, I will fulfill my obligations under my lease.

If the Property is a unit in a Condominium Project or in a PUD, I will fulfill all of my obligations under the declaration, by-laws, regulations and other documents that create or govern the Condominium Project or PUD. Also, I will not divide the Property into smaller parts that may be owned separately (known as "partition or subdivision"), and I will not consent to any of the following unless I have first given Lender notice and obtained Lender's consent in writing:

(A) The abandonment or termination of the Condominium Project or PUD, unless, in the case of a condominium, the abandonment or termination is required by law;

(B) Any significant change to the declaration, by-laws or regulations of the Owners Association, trust agreement, articles of incorporation, or other documents that create or govern the Condominium Project or PUD, including, for example, a change in the percentage of ownership rights, held by unit owners, in the Condominium Project or in the common areas or facilities of the PUD;

(C) A decision by the Owners Association to terminate professional management and to begin self-management of the Condominium Project or PUD; and

(D) The transfer, release, creation of liens, partition or subdivision of all or part of the common areas and facilities of the PUD. (However, this provision does not apply to the transfer by the Owners Association of rights to use those common areas and facilities for utilities and other similar or related purposes.)

7. LENDER'S RIGHT TO TAKE ACTION TO PROTECT THE PROPERTY

If: (A) I do not keep my promises and agreements made in this Mortgage, or (B) someone, including me, begins a legal proceeding that may significantly affect Lender's rights in the Property (such as, for example, a legal proceeding in bankruptcy, in probate, for condemnation, or to enforce laws or regulations), then Lender may do and pay for whatever is necessary to protect the value of the Property and Lender's rights in the Property. Lender's actions under this Paragraph 7 may include, for example, appearing in court, paying reasonable attorney's fees, and entering on the Property to make repairs. Lender must give me notice before Lender may take any of these actions.

I will pay to Lender any amounts, with interest, which Lender spends under this Paragraph 7. This Mortgage will protect Lender in case I do not keep this promise to pay those amounts with interest.

I will pay those amounts to Lender when Lender sends me a notice requesting that I do so. I will also pay interest on those amounts at the same rate stated in the Note. However, if payment of interest at that rate would violate the law, I will pay interest on the amounts spent by Lender under this Paragraph 7 at the highest rate that the law allows. Interest on each amount will begin on the date that the amount is spent by Lender. However, Lender and I may agree in writing to terms of payment that are different from those in this paragraph.

Although Lender may take action under this Paragraph 7, Lender does not have to do so.

8. LENDER'S RIGHT TO INSPECT THE PROPERTY

Lender, and others authorized by Lender, may enter on and inspect the Property. They must do so in a reasonable manner and at reasonable times. However, before one of those inspections is made, Lender must give me notice stating a reasonable purpose for the inspection. That purpose must be related to Lender's rights in the Property.

9. AGREEMENTS ABOUT CONDEMNATION OF THE PROPERTY

A taking of property by any governmental authority by eminent domain is known as "condemnation." I give to Lender my right: (A) to proceeds of all awards or claims for damages resulting from condemnation or other governmental taking of the Property (or, if the Property includes a unit in a PUD, of the common areas and facilities of the PUD); and (B) to proceeds from a sale of the Property (or, if the Property includes a unit in a PUD, of the common areas and facilities of the PUD) that is made to avoid condemnation. All of those proceeds will be paid to Lender.

If all of the Property is taken, the proceeds will be used to reduce the amount that I owe to Lender under the Note and under this Mortgage. If any of the proceeds remain after the amount that I owe to Lender has been paid in full, the remaining proceeds will be paid to me. Unless Lender and I agree otherwise in writing, if only a part of the Property is taken, (or, if the Property is a unit in a PUD, if all or part of the common areas or facilities of the PUD are taken), the amount that I owe to Lender will only be reduced by the amount of proceeds multiplied by the following amount: (i) the total amount that I owe to Lender under the Note and under this Mortgage immediately before the taking, divided by (ii) the fair market value of the Property immediately before the taking. The remainder of the proceeds will be paid to me. The use of proceeds to reduce the amount that I owe to Lender will not be a prepayment that is subject to the prepayment charge provisions, if any, under the Note.

If I abandon the Property, or if I do not answer, within 30 days, a notice from Lender stating that a governmental authority has offered to make a payment or to settle a claim for damages, then Lender has the authority to collect the proceeds. Lender may then use the proceeds to repair or restore the Property or to reduce the amount that I owe to Lender under the Note and under this Mortgage. The 30-day period will begin on the date the notice is mailed or, if it is not mailed, on the date the notice is delivered.

If any proceeds are used to reduce the amount of principal which I owe to Lender under the Note, that use will not delay the due date or change the amount of any of my monthly payments under the Note and under Paragraphs 1 and 2 above. However, Lender and I may agree in writing to those delays or changes.

10. CONTINUATION OF BORROWER'S OBLIGATIONS

Lender may allow a person who takes over my rights and obligations to delay or to change the amount of the monthly payments of principal and interest due under the Note or under this Mortgage. Even if Lender does this, however, that person and I will both still be fully obligated under the Note and under this Mortgage unless the conditions stated in Paragraph 19 below have been met.

Lender may allow those delays or changes for a person who takes over my rights and obligations, even if Lender is

requested not to do so. Lender will not be required to bring a lawsuit against such a person for not fulfilling obligations under the Note or under this Mortgage, even if Lender is requested to do so.

11. CONTINUATION OF LENDER'S RIGHTS

Even if Lender does not exercise or enforce any right of Lender under this Mortgage or under the law, Lender will still have all of those rights and may exercise and enforce them in the future. Even if Lender obtains insurance, pays taxes, or pays other claims, charges or liens against the Property, Lender will still have the right, under Paragraph 20 below, to demand that I make Immediate Payment In Full (see Paragraph 20 for a definition of this phrase) of the amount that I owe to Lender under the Note and under this Mortgage.

12. LENDER'S ABILITY TO ENFORCE MORE THAN ONE OF LENDER'S RIGHTS

Each of Lender's rights under this Mortgage is separate. Lender may exercise and enforce one or more of those rights, as well as any of Lender's other rights under the law, one at a time or all at once.

13. OBLIGATIONS OF BORROWERS AND OF PERSONS TAKING OVER BORROWER'S RIGHTS OR OBLIGATIONS; AGREEMENTS CONCERNING CAPTIONS

Subject to the terms of Paragraph 19 below, any person who takes over my rights or obligations under this Mortgage will have all of my rights and will be obligated to keep all of my promises and agreements made in this Mortgage. Similarly, any person who takes over Lender's rights or obligations under this Mortgage will have all of Lender's rights and will be obligated to keep all of Lender's agreements made in this Mortgage.

If more than one person signs this Mortgage as Borrower, each of us is fully obligated to keep all of Borrower's promises and obligations contained in this Mortgage. Lender may enforce Lender's rights under this Mortgage against each of us individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under the Note and under this Mortgage. However, if one of us does not sign the Note, then: (A) that person is signing this Mortgage only to give that person's rights in the Property to Lender under the terms of this Mortgage; and (B) that person is not personally obligated to make payments or to act under the Note or under this Mortgage.

The captions and titles of this Mortgage are for convenience only. They may not be used to interpret or to define the terms of this Mortgage.

14. AGREEMENTS ABOUT GIVING NOTICES REQUIRED UNDER THIS MORTGAGE

Unless the law requires otherwise, any notice that must be given to me under this Mortgage will be given by delivering it or by mailing it addressed to me at the address stated in the section above titled "Description Of The Property." A notice will be delivered or mailed to me at a different address if I give Lender a notice of my different address. Any notice that must be given to Lender under this Mortgage will be given by mailing it to Lender's address stated in paragraph (C) of the section above titled "Words Used Often In This Document." A notice will be mailed to Lender at a different address if Lender gives me a notice of the different address. A notice required by this Mortgage is given when it is mailed or when it is delivered according to the requirements of this Paragraph 14.

15. AGREEMENTS ABOUT UNIFORM MORTGAGE AND LAW THAT GOVERNS THIS MORTGAGE

This is a "Uniform Mortgage." It contains "uniform promises" that are in mortgages used all over the country and also "non-uniform promises" that vary, to a limited extent, in different parts of the country.

The law that applies in the place that the Property is located will govern this Mortgage. If any term of this Mortgage or of the Note conflicts with the law, all other terms of this Mortgage and of the Note will still remain in effect if they can be given effect without the conflicting term. This means that any terms of this Mortgage and of the Note which conflict with the law can be separated from the remaining terms, and the remaining terms will still be enforced.

16. BORROWER'S COPY OF THE NOTE AND OF THIS MORTGAGE

I will be given a copy of the Note and of this Mortgage. Those copies must show that the original Note and Mortgage have been signed. I will be given those copies either when I sign the Note and this Mortgage or after this Mortgage has been recorded in the proper official records.

17. AGREEMENTS THAT APPLY TO VA LOANS

A loan that is guaranteed or insured by the United States Veterans Administration is known as a "VA loan." If the loan that I promise to pay in the Note is a VA loan, then my rights and obligations, as well as those of Lender, are governed by that law which is known as Title 38 of the United States Code and the Regulations made under that Title (called the "Title and Regulations"). It is possible that one or more terms of this Mortgage, or of other documents that are signed in connection with my VA loan, conflict with the Title and Regulations. For example, it is possible that the prepayment terms in the Note or Paragraph 19 of this Mortgage conflict with the Title and Regulations. Lender and I agree that if there is a conflict, the conflicting terms of this Mortgage or other documents are modified or eliminated as much as is necessary to make all of the conflicting terms agree with the Title and Regulations.

18. BORROWER'S OBLIGATION TO PAY MORTGAGE INSURANCE PREMIUMS

If Lender required mortgage insurance as a condition of making the loan that I promise to pay under the Note, then I will pay the premiums for that mortgage insurance. I will pay the premiums until the requirement for mortgage insurance ends according to my written agreement with Lender or according to law. Lender may require me to pay the premiums in the manner described in Paragraph 2 above.

NON-UNIFORM PROMISES

I also promise and agree with Lender as follows:

19. AGREEMENTS ABOUT ASSUMPTION OF THIS MORTGAGE AND ABOUT LENDER'S RIGHTS IF BORROWER TRANSFERS THE PROPERTY WITHOUT MEETING CERTAIN CONDITIONS

If I sell or transfer all or part of the Property or any rights in the Property, any person to whom I sell or transfer the Property may take over all of my rights and obligations under this Mortgage (known as an "assumption of the Mortgage") if: (A) I give Lender notice of the sale or transfer; (B) Lender agrees that the person's credit is satisfactory; (C) the person agrees to pay interest on the amount owed to Lender under the Note and under this Mortgage at whatever rate Lender requires; and (D) the person signs an assumption agreement that is acceptable to Lender and that obligates the person to keep all of the promises and agreements made in the Note and in this Mortgage. If I sell or transfer the Property and each of the conditions in (A), (B), (C) and (D) of this Paragraph 19 are satisfied, Lender will release me from all of my obligations under the Note and under this Mortgage.

However, if I sell or transfer the Property and the conditions in (A), (B), (C) and (D) of this Paragraph 19 are not satisfied, I will still be fully obligated under the Note and under this Mortgage and Lender may require Immediate Payment in Full, as that phrase is defined in Paragraph 20 below. However, Lender will not have the right to require Immediate Payment In Full as a result of any of the following: (i) the creation of liens or other claims against the

Property that are inferior to this Mortgage; (ii) a transfer of rights in household appliances, to a person who provides me with the money to buy those appliances, in order to protect that person against possible losses; (iii) a transfer of the Property to surviving co-owners, following the death of a co-owner, when the transfer is automatic according to law; or (iv) leasing the Property for a term of three years or less, as long as the lease does not include an option to buy.

If Lender requires Immediate Payment In Full under this Paragraph 19, Lender will send me a notice, in the manner described in Paragraph 14 above, which states this requirement. The notice will give me at least 30 days to make the required payment. The 30-day period will begin on the date the notice is mailed or, if it is not mailed, on the date the notice is delivered. If I do not make the required payment during that period, Lender may bring a lawsuit for "foreclosure and sale" under Paragraph 20 below without giving me any further notice or demand for payment. (See Paragraph 20 for a definition of "foreclosure and sale.")

20. LENDER'S RIGHTS IF BORROWER FAILS TO KEEP PROMISES AND AGREEMENTS

If all of the conditions stated in subparagraphs (A), (B), and (C) of this Paragraph 20 are satisfied, Lender may require that I pay immediately the entire amount then remaining unpaid under the Note and under this Mortgage. Lender may do this without making any further demand for payment. This requirement will be called "Immediate Payment In Full."

If Lender requires Immediate Payment In Full, Lender may bring a lawsuit to take away all of my remaining rights in the Property and to have the Property sold. At this sale Lender or another person may acquire the Property. This is known as "foreclosure and sale." In any lawsuit for foreclosure and sale, Lender will have the right to collect all costs allowed by law.

Lender may require Immediate Payment In Full under this Paragraph 20 only if all of the following conditions are satisfied:

(A) I fail to keep any promise or agreement made in this Mortgage, including the promises to pay when due the amounts that I owe to Lender under the Note and under this Mortgage; and

(B) Lender sends to me, in the manner described in Paragraph 14 above, a notice that states:

(i) The promise or agreement that I failed to keep;

(ii) The action that I must take to correct that failure;

(iii) A date by which I must correct the failure. That date must be at least 30 days from the date on which the notice is mailed to me, or, if it is not mailed, from the date on which it is delivered to me;

(iv) That if I do not correct the failure by the date stated in the notice, I will be in default and Lender may require Immediate Payment In Full, and Lender or another person may acquire the Property by means of foreclosure and sale;

(v) That I may speak with a named representative of Lender to discuss any questions which I have about the things stated in the notice;

(vi) That if I meet the conditions stated in Paragraph 21 below, I will have the right to have any lawsuit for foreclosure and sale discontinued and to have the Note and this Mortgage remain in full force and effect as if Immediate Payment In Full had never been required; and

(vii) That I have the right in any lawsuit for foreclosure and sale to argue that I did not fail to keep any of my promises or agreements under the Note or under this Mortgage, and to present any other defenses that I may have; and

(C) I do not correct the failure stated in the notice from Lender by the date stated in that notice.

21. BORROWER'S RIGHT TO HAVE LENDER'S LAWSUIT FOR FORECLOSURE AND SALE DISCONTINUED

Even if Lender has required Immediate Payment In Full, I may have the right to have discontinued any lawsuit brought by Lender for foreclosure and sale or for other enforcement of this Mortgage. I will have this right at any time before a judgment has been entered enforcing this Mortgage if I meet the following conditions:

(A) I pay to Lender the full amount that would have been due under this Mortgage, the Note, and any notes for Future Advances under Paragraph 23 below if Lender had not required Immediate Payment In Full; and

(B) I correct my failure to keep any of my other promises or agreements made in this Mortgage; and

(C) I pay all of Lender's reasonable expenses in enforcing this Mortgage including, for example, reasonable attorney's fees; and

(D) I do whatever Lender reasonably requires to assure that Lender's rights in the Property. Lender's rights under this Mortgage, and my obligations under the Note and under this Mortgage continue unchanged.

If I fulfill all of the conditions in this Paragraph 21, then the Note and this Mortgage will remain in full force and effect as if Immediate Payment In Full had never been required.

22. LENDER'S RIGHTS TO RENTAL PAYMENTS FROM THE PROPERTY AND TO TAKE POSSESSION OF THE PROPERTY

As additional protection for Lender, I give to Lender all of my rights to any rental payments from the Property. However, until Lender requires Immediate Payment In Full under Paragraphs 19 or 20 above, or until I abandon the Property, I have the right to collect and keep those rental payments as they become due. I have not given any of my rights to rental payments from the Property to anyone else, and I will not do so without Lender's consent in writing.

If Lender requires Immediate Payment In Full under Paragraphs 19 or 20 above, or if I abandon the Property, then Lender, persons authorized by Lender, or a receiver appointed by a court at Lender's request may: (A) collect the rental payments, including overdue rental payments, directly from the tenants; (B) enter on and take possession of the Property; (C) manage the Property; and (D) sign, cancel and change leases. I agree that if Lender notifies the tenants that Lender has the right to collect rental payments directly from them under this Paragraph 22, the tenants may make those rental payments to Lender without having to ask whether I have failed to keep my promises and agreements under this Mortgage.

If there is a judgment for Lender in a lawsuit for foreclosure and sale, I will pay to Lender reasonable rent from the date the judgment is entered for as long as I occupy the Property. However, this does not give me the right to be a tenant on the Property.

All rental payments collected by Lender or by a receiver, other than the rent paid by me under this Paragraph 22, will be used first to pay the costs of collecting rental payments and of managing the Property. If any part of the rental payments remains after those costs have been paid in full, the remaining part will be used to reduce the amount that I owe to Lender under the Note and under this Mortgage. The costs of managing the Property may include the receiver's fees, reasonable attorney's fees, and the cost of any necessary bonds. Lender and the receiver will be obligated to account only for those rental payments that they actually receive.

23. AGREEMENTS ABOUT FUTURE ADVANCES

I may ask Lender to make one or more loans to me in addition to the loan that I promise to pay under the Note. Lender may, before this Mortgage is discharged, make those additional loans to me. This Mortgage will protect Lender from possible losses that might result from my failure to fulfill my obligation to pay the amounts of any of those additional loans plus interest, only if the notes which contain my promises to pay those additional loans state that this Mortgage will give Lender such protection. Additional loans made by Lender that are protected by this Mortgage will be called "Future Advances." The principal amount that I owe to Lender under the Note and under all notes for Future Advances, not including the amounts spent by Lender to protect the value of the Property and Lender's rights in the Property, may not be greater than the original amount of the Note plus U.S. \$ _____.

24. LENDER'S OBLIGATION TO DISCHARGE THIS MORTGAGE WHEN THE NOTE AND THIS MORTGAGE ARE PAID IN FULL

When Lender has been paid all amounts due under the Note, under this Mortgage and under any notes for Future Advances, Lender will discharge this Mortgage by delivering a certificate stating that this Mortgage has been satisfied. I will not be required to pay Lender for the discharge, but I will pay all costs of recording the discharge in the proper official records.

25. AGREEMENTS ABOUT NEW YORK LIEN LAW

I will receive all amounts lent to me by Lender subject to the trust fund provisions of Section 13 of the New York Lien Law. This means that if, on the date this Mortgage is recorded in the proper official records, construction or other work on any building, structure, or other improvements located on the Property has not been completed for at least four months, I will: (A) hold all amounts, which I receive and which I have a right to receive from Lender under the Note and as Future Advances, as a "trust fund," and (B) use those amounts to pay for that construction or work before I use them for any other purpose. The fact that I am holding those amounts as a "trust fund" means that I have a special responsibility under the law to use the amounts in the manner described in this Paragraph 25.

By signing this Mortgage I agree to all of the above.

Witnesses:

Charles T. Conroy--Borrower

2-Forms Federal Taxes Affecting Real Estate [B]

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State of New York, Orange County ss:

On this first day of November, 2002, before me personally came Charles T. Conroy and Ellen C. Conroy, husband and wife, to me known and known to me to be the individual(s) described in and who executed the foregoing instrument, and _____ he _____ duly acknowledged to me that _____ he _____ executed the same.

Notary Public



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Federal Taxes Affecting Real Estate

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Appendix Forms: CHECKLISTS AND FORMS

2-Forms Federal Taxes Affecting Real Estate Appendix Forms:.syn

§ Forms.syn Synopsis to Appendix Forms: CHECKLISTS AND FORMS

[C] Real Estate Leases



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Federal Taxes Affecting Real Estate

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Appendix Forms: CHECKLISTS AND FORMS

2-Forms Federal Taxes Affecting Real Estate [C]

[C] Real Estate Leases

C.1 Option for ground lease

COMMENT

An option to lease a parcel of land often represents the first step in the development of a commercial project. Generally, it is during the option period that the developer will prepare feasibility studies and preliminary plans and specifications, and obtain preliminary cost estimates, commitments for financing, and indications of interest from major tenants.

Lease annexed to option:

This form follows the better practice of having the complete lease agreed upon in advance and annexed to the option as an exhibit. Occasionally, counsel may find an option to lease which contains specific provisions as to the rental and the term of lease and, ostensibly, the other provisions are covered by a clause to the effect that "the lease will also provide for such other terms and conditions as are generally contained in leases of the same nature." However, the developer soon finds that he is unable to obtain anything more than preliminary indications of interest from lenders and prospective tenants, due to the absence of a definitive lease. It is at this point, when considerable time and money may already have been expended, that the developer may discover there can be an honest difference of opinion as to what the "other provisions" of the lease should be and he may find that he must renegotiate what he had assumed to be agreed upon.

For further information, see Chapter 4.

FORM

For and in consideration of \$500, receipt of which is hereby acknowledged, and other valuable consideration, Stone Centers, Inc. (the "Optionors"), grants to Castle Co., a Florida corporation, its successors or assigns (the "Optionee"),

An Option to lease the following described property, together with all the buildings and improvements thereon and all rights and appurtenances thereunto appertaining, more particularly described as follows:

2-Forms Federal Taxes Affecting Real Estate [C]

[Insert legal description from title policy]

On the following terms and conditions:

1. *Lease appended; conflicting provisions.* The parties shall use the Lease form, marked Exhibit A and attached to and made a part of this Option, as the Lease to be executed at closing. However, the terms and conditions provided below shall be incorporated in the Lease. If there is any conflict between the provisions of the Lease form and those of this Option, the latter provisions shall prevail.

2. *Notice; exercise; termination.* The Optionee must give written notice to the Optionors of its election to lease the premises described below not later than 6 p.m., July 1, 2002. If the Optionee fails to give such notice, this Option shall terminate.

3. *Suitability studies.* The Optionors will permit the Optionee, at any time after this option agreement is executed and either before or after its exercise, to make engineering studies, including soil tests and borings and estimated cost of grading, on the premises to determine the suitability of the premises for the Optionee's proposed use.

4. *Zoning contingency.* If the premises are not zoned so as to permit their proposed use by the Optionee for the construction and operation of an office building, the Optionors shall, at their expense, secure the necessary zoning as soon as possible. If proceedings to obtain a change in zoning have been commenced but not completed by the date specified as the last date for exercising this Option, the time for giving notice of election to lease hereunder shall be extended to a date two weeks after the Optionee has received notice from the Optionors that they have obtained the proper zoning variance or exception. If the zoning change is finally denied, this Option shall terminate and the Optionors shall return to the Optionee all monies paid to them.

5. *Delivery of possession.* Possession will be given upon delivery and execution of the Lease, and Optionors will cause any Tenants in possession to vacate the premises prior to such time.

6. *Taxes.* Real estate taxes, whether or not then due or payable, shall be prorated to the date of closing. The Optionors will pay all assessments or installments thereof which become due prior to the execution and delivery of the Lease.

7. *Water; sewers.* This option is conditioned upon the Optionee being able to obtain an 8' Water Service to the Property to sustain a Sprinkler System and Permits to hook up to the Public Sewer System.

8. *Title policy; closing.* The Optionee shall have 30 days after the giving of notice of its election to lease the subject premises in which to secure title insurance. At such time the parties will proceed with the closing and the payment of the first rental.

9. *Notices.* Notice given hereunder must be in writing, and may be served personally or by mail. The time of service shall be the date of actual delivery to the address personally or the time of deposit in the mail, postage prepaid, directed to the last known address of the party to be served. Notice shall be directed to the Optionors at the office of _____ and to the Optionee at _____ or such other address as they may hereafter designate.

10. *Binding effect.* The provisions of this Option shall be binding upon and inure to the benefit of both parties and their respective heirs, assigns, executors, administrators, and successors.

11. *Non-waiver.* No delay or failure by either party to exercise any right under this Option, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

12. *Headings.* Headings in this Option are for convenience only and shall not be used to interpret or construe its provisions.

13. *Governing law.* This Option shall be construed in accordance with and governed by the laws of the State of Florida.

14. *Counterparts.* This Option may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

15. *Time of essence.* Time is expressly declared to be of the essence of this Option.

16. *Entire agreement.* This Option supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

In witness whereof the parties have signed this Option on this January 30, 2001.

_____ Optioners

Optionee

Witnesses:

[Acknowledgment] [Exhibit A: Lease Form]

C.2 Ground lease--shopping center

COMMENT

This form of ground lease contains several features which are favorable to the lessee that are not always found in long-term leases. The lease contemplates that the lessee will build a shopping center or other commercial buildings upon the leased premises, and that in addition to a fixed minimum rent which the lessee is to pay to the lessor (yearly, and in advance) the lessee will also pay percentage rent which is based upon percentage rent that the lessee will receive from its subtenants. It should be noted, however, that the lessee is not required to construct any improvements, as discussed below.

Construction of improvements:

Although the lease contemplates that a shopping center is to be built, Article XIII of the lease specifically provides that the lessee is under no obligation to do so. The lessee is not permitted to construct any improvements on the premises unless they are in the nature of a commercial building or shopping center. However, should the lessee elect to do so, he may continue the lease in effect merely by paying the minimum rent and the lessor would never receive the anticipated percentage rent. As a practical matter it is doubtful that the lessee would continue to pay rent indefinitely for bare land which produces no income and, upon failure to pay rent, the lessor could terminate the lease. In this respect, it should be noted that the fixed minimum rent increases by more than 100% within a period of five years (see Article III). It is more common, however, to provide that the lessor may terminate the lease in the event that the

lessee fails to commence and complete construction of the improvements by specified dates.

Mortgage financing:

Another feature contained in this lease, which should be useful to the lessee, is the requirement that the lessor mortgage his fee ownership in the land in order to help the lessee obtain temporary and permanent financing to construct the desired improvements (see Article XIV).

Nonrecourse mortgage as to lessor:

If the lessor is willing to go along with the basic concept of mortgaging his fee ownership, he will generally insist on additional provisions (similar to those contained in Article XIV below) which are designed to protect him from personal liability for the mortgage debt and offer some assurance that, although it is possible for him to lose his land in a mortgage foreclosure action, it is not probable. Nevertheless, the lessor must be made aware of the fact that if the lessor is unwilling or unable to cure a possible default of the developer (which may involve the payment of substantial sums) the lessor runs the risk of losing his land in a mortgage foreclosure action.

If the lessor is a "sophisticated" landowner who is unwilling to mortgage his fee ownership, he will generally permit the lessee to mortgage his leasehold interest in the land on terms and conditions that an institutional lender would require in order to make the leasehold mortgage acceptable security for temporary and permanent construction financing.

Table of contents:

Long-term leases are inherently lengthy documents due to the fact that they provide, as a matter of contract, for the rights and obligations of the lessor and the lessee with respect to a wide variety of matters, under varying circumstances, over a long period of time. Accordingly, a table of contents frequently precedes the agreement in order to give interested parties quick access to various contractual matters that are generally covered by all leases. These tables of contents are reproduced for two basic reasons. First, they serve as a basic checklist for broad problems that are normally covered in most leases. They also enable counsel to compare the manner in which the same problem receives comparable or different treatment in other leases provided in this section.

For further information, see Chapter 4.

FORM

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THIS LEASE made and entered into at Bel Air, Harford County, State of Maryland, on March 1, 2002, by and between James Hackney Enterprises (the "Lessor") and Hebditch Holders, Inc., a Maryland corporation (the "Lessee");

The Lessor and the Lessee, for and in consideration of the keeping by the parties of their respective obligations hereinafter contained agree as follows:

Article I Demised Premises

1. *Lessor's demise.* Upon the terms and conditions hereinafter set forth, and in consideration of the payment of the rents and the prompt performance by the Lessee of the covenants and agreements, to be kept and performed by the Lessee, the Lessor does lease, let, and demise to the Lessee and the Lessee hereby leases from the Lessor, the following described premises, situate, lying, and being in Harford County, State of Maryland:

[Insert legal description or refer to attached exhibit]

2. *Conditions.* The demise is likewise made subject to the following:

- (a) All conditions, restrictions, and limitations now appearing of record;
- (b) Zoning ordinances of any municipality, the County of Harford, State of Maryland, and any other competent governmental body now existing or which may hereafter exist during the life of this Lease;
- (c) Any questions of survey, the Lessee having satisfied itself as to the boundary lines and contents of the above described premises as well as with the sufficiency of the Lessor's present title; and

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(d) The Lessee's proper performance of all the terms and conditions contained in this Lease.

Article II Term

To have and to hold the demised premises for a term commencing February 28, 2002 and ending February 28, 2052, inclusive, unless terminated sooner as provided below.

Article III Rent

1. *Annual rentals.* The Lessee shall pay the Lessor the following rent:

1st year_____	\$11,000

2nd year_____	17,500

3rd year_____	20,000

4th year_____	22,500

5th year_____	25,000

6-50th year_____	25,000

All rent payments shall be paid annually and in advance.

2. *Cost of fill; offset.* The Lessee shall pay the first \$35,000 of the cost of filling the subject property to the specifications of its subtenants, state and local building codes, and all other applicable authorities. The cost of fill shall be determined by three qualified bidders, approved by the Lessor and Lessee. If the cost exceeds \$35,000, all excess amounts shall be deducted from the minimum rent payment at the rate of 10% per annum between the sixth and fifteenth years of this Lease.

3. *Supplementary rent.* (a) The Lessee shall pay Supplementary Rent to the Lessor. Supplementary Rent shall be 10% of the net amount of "Percentage Rent" (as hereinafter defined) paid to the Lessee during the preceding calendar year by all subtenants of portions of the demised premises used for retail or other shopping center purposes, plus 5% of "Gross Rents" (as hereinafter defined) received by the Lessee during the preceding calendar year from subtenants of portions of the shopping center used for other purposes. If the premises leased to a subtenant are used principally or primarily for retail or other shopping center purposes, and the applicable lease provides for the payment of Percentage Rent, for the purpose of computing Supplementary Rent it shall be deemed that all thereof are used for retail or shopping center

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purposes. The operation of the following businesses shall be deemed to be shopping center uses (without limitation thereto): bank, finance company office, insurance company office, barber shop and beauty parlor, launderette, supermarket, dry cleaning store, variety store, department store, restaurant, discount store, or real estate office. Supplementary Rent shall be paid on July 1 of each year during the term.

(b) After the receipt of such statements of Gross Sales (as defined in the applicable sublease) and payments of Percentage Rent and Gross Rent from subtenants, the Lessee shall compile a schedule thereof and furnish a copy to Lessor on or before July 1 of each year.

(c) In lieu of Article III, Section 3(a), above, the Lessor may compute Percentage Rent as follows:

The sixth year that the Shopping Center is in operation will be considered the Base Year. Rental Incomes attributed to stores that were in operation during that year may increase, the amount of such increase to be deemed Percentage Rent, whether by having the stores in operation pay additional rent or procuring new tenants to replace such stores. The Lessor will receive 10% of these increases. On any new building the Base Year will be the first year's rental.

4. *Due date.* All rental payments shall be made on the anniversary of the payment of the first rental.

5. *Place of payment.* Rent shall be payable at such place as the Lessor may specify, in writing, from time to time.

6. *Net lease.* All rent shall be absolutely net to Lessor, so that this Lease shall, except as hereinafter provided to the contrary, yield net to Lessor the rent, to be paid in each year during the term of this Lease. Accordingly, the Lessee shall pay all costs, expenses, and obligations of every kind or nature, relating to the demised premises, or any improvements thereon, which may arise or become due during the term of this Lease, and shall indemnify and hold harmless the Lessor from and against the same. Nothing in this Lease shall be deemed to require the Lessee to pay or discharge any liens or mortgages of any character which may later be placed upon the demised premises by the Lessor's affirmative acts. However, the Lessee shall pay and discharge temporary and permanent mortgages referred to in Article XIV hereof.

Article IV Definitions

As used in this Lease, the following terms have the following definitions:

1. "Percentage Rent" shall mean rent payable by a subtenant of a part of the demised premises to the Lessee, computed in the following or similar manner:

(a) As the extent to which a specified percentage of certain sales (subject to exclusions and deductions) exceeds a fixed minimum rent and possibly other charges payable under the applicable sublease; or

(b) As a percentage of the extent to which certain sales (subject to exclusions and deductions) made in such premises exceeds a specified minimum sales figure; or the difference between such percentage and other charges payable by the subtenant.

If any subtenants are permitted to deduct sums or are entitled to refunds from the percentage rents, the amounts shall be deductible from the Percentage Rent referred to herein.

2. "Gross Rent" shall mean all rent payable to Lessee by subtenants minus Subtractions, as follows:

(a) The utility charges segregated in any sublease from the rent payable thereunder and paid to Lessee as a

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reimbursement for the supplying of utilities to such subtenant; and

(b) Such subtenant's pro rata share of the cost to Lessee of maintaining, repairing and operating common areas of the demised premises.

3. "Pro Rata Share" shall mean the proportion that the floor area of the premises leased to a subtenant bears to the square foot area of all of the space of the buildings (excluding any covered mall or any buildings used as common facilities) situated in the demised premises. For purposes of this formula, the floor area shall be computed on the basis of exterior dimensions.

Article V Payment of Taxes

1. *Lessee's obligations.* The Lessee shall pay, before any fine, penalty, interest, or cost may be added, become due, or be imposed for nonpayment thereof, the following: all taxes, assessments, water and sewer rents, rates and charges, transit taxes, charges for public utilities, excises, levies, licenses and permit fees and other governmental charges, general and special, ordinary and extraordinary, unforeseen and foreseen, of any kind and nature, which at any time during the term of this Lease may be assessed, levied, confirmed, imposed upon, or grow or become due and payable out of or in respect of, or become a lien on, the demised premises, or any improvements thereon, or any part thereof or any appurtenance thereto, or otherwise arising out of the rent and income received by the Lessee from subtenants, any use or occupation of the demised premises, and such franchises as may be appurtenant to the use of the demised premises, or any document (to which the Lessee is a party) creating or transferring an interest or estate in the demised premises.

2. *Obligations altered.* Nothing herein shall require the Lessee to pay municipal, state, or federal income taxes assessed against the Lessor, the Lessor's municipal, state, or federal capital levy, estate, succession, inheritance, or transfer taxes, or corporate franchise taxes imposed upon any corporate owner of the fee of the demised premises. However, if at any time during the term of this Lease the methods of taxation prevailing at the commencement of its term are altered so as to cause the whole or any part of the taxes, assessments, levies, impositions, or charges now levied, assessed and imposed, wholly or partially as a capital levy, or otherwise, on the rents received therefrom, or of any tax, corporation franchise tax, assessments, levy (including, but not limited to any municipal, state, or federal levy), imposition or charge, or any part thereof, are measured by or based in whole or in part upon the demised premises and are imposed upon the Lessor, then all such taxes, assessments, levies, impositions, or charges, or the part thereof so measured or based, shall be paid and discharged by the Lessee.

3. *Mode of payment.* The Lessee shall pay the taxes and other charges enumerated in this Article and deliver to the Lessor official receipts evidencing payment, at least 30 days before the tax itself would become delinquent in accordance with the then applicable law governing such payments. If, however, the Lessee desires to contest the validity of any tax or tax claim, it may do so without being in default hereunder, provided it gives the Lessor written notice of its intention to contest the tax or claim, and also furnishes the Lessor with a bond with a surety made by a surety company qualified to do business in the State of Maryland, or pays cash to a recognized Escrow Agent in Hartford County equal to 150 percent of the amount of the tax item or items it intends to contest, conditioned to pay the tax or tax items when their validity has been determined. The Lessee shall give the Lessor the notice and bond (or cash equivalent) not later than 60 days before the tax item or items it proposes to contest would otherwise become delinquent.

4. *Lessee's default.* If the Lessee fails, refuses, or neglects to make any payment required in this Article, the Lessor may do so. In that event, the Lessee shall, upon the Lessor's demand, repay to it the amounts so paid, including reasonable attorneys' fees and all other expenses reasonably incurred because of or in connection with the payments, together with interest thereon at the rate of 10 percent per annum. The Lessor may collect or enforce any payment in the same manner as though it were an installment of rent specifically required by the terms of the Lease to be paid by the Lessee, on the day when the Lessor demands repayment of or reimbursement therefor. However, the Lessor's election to pay the taxes

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shall not waive the Lessee's default.

5. *Proration.* Notwithstanding the above, the taxes for the first and last years of this Lease shall be prorated proportionately between Lessor and Lessee.

Article VI Mechanics' Liens

1. *No lien.* The Lessee shall not subject the Lessor's interest in the premises to any mechanics' or materialmens' liens or other lien of any kind, except to the extent that the creation of such lien or liens is specifically authorized by a provision in this Lease.

2. *Release of lien.* The Lessee shall not allow a lien or claim of any kind (except for the mortgage referred to in Article XIV) to be filed or claimed against the Lessor's interest in the demised premises during the continuance of this Lease. If such lien is claimed or filed, the Lessee shall cause the premises to be released from the claim within 30 days after the Lessor is given written notice that a claim has been filed, or within 30 days after the Lessor is given written notice of the claim and transmits written notice of its receipt to the Lessee, whichever 30-day period expires earlier. The Lessee will cause such release either by paying to the court the amount necessary to relieve and release the premises from the claim, or in any other manner which, as a matter of law, will result, within the 30-day period, in releasing the Lessor and its title from the claim.

Article VII Governing Law, Cumulative Remedies

1. *Governing law.* All of the rights and remedies of the parties shall be governed by the provisions of this instrument and by the laws of the State of Maryland.

2. *Cumulative remedies.* During the continuance of the Lease, the Lessor shall have all rights and remedies which this Lease and the laws of the State of Maryland assure to it. All rights and remedies accruing to the Lessor shall be cumulative; that is, the Lessor may pursue all rights that the law and this Lease afford to it, in whatever order the Lessor desires and the law permits without being compelled to resort to any one remedy in advance of any other.

Article VIII Indemnification of Lessor

1. *Indemnification by Lessee.* During the entire term of the Lease, the Lessee will indemnify and hold harmless the Lessor against any and all claims, debts, demands, or obligations which may be made against the Lessor or against its title in the premises, arising out of, or in connection with, any alleged act or omission of the Lessee or any person claiming under, by, or through the Lessee. If it becomes necessary for the Lessor to defend any action seeking to impose any such liability, the Lessee will pay the Lessor all costs of court and attorneys' fees incurred by the Lessor in effecting such defense in addition to all other sums that the Lessor may be called upon to pay by reason of the entry of a judgment against it in the litigation in which such claim is asserted.

2. *Insurance.* As soon as the Lessee commences construction on the demised premises or any part of it, or from and after any earlier date when the Lessee makes actual use of and occupies the demised premises or any part of it, the Lessee shall cause to be written a policy or policies of insurance in the form generally known as public liability policies. In addition, if any boilers or elevators are included in improvements located on the demised premises, the Lessee shall cause to be written boiler insurance and elevator insurance policies. The policies shall insure the Lessee against all claims and demands made by any person or persons for injuries received in connection with the operation and maintenance of the premises, improvements, and buildings located on the demised premises and for any other risk

insured against by such policies. Each class of policies shall be written within limits of not less than \$500,000 for damages incurred or claimed by any one person for bodily injury, or otherwise, plus \$100,000 for damages to property, and for not less than \$1,000,000 for damages incurred or claimed by more than one person for bodily injury, or otherwise, plus \$100,000 for damages to property. All such policies shall name the Lessee and the Lessor, as their respective interests may appear, as the insured persons. Lessee shall promptly deliver the original or a duplicate original of each policy or policies to the Lessor as soon as they are written, together with adequate evidence of the fact that the premiums are paid.

Article IX Insurance

1. *Lessee's obligation.* From and after the time the Lease commences, the Lessee will keep insured any and all buildings and improvements upon the premises against all loss or damage by fire and windstorm, together with "extended coverage." The amount of insurance shall at all times be sufficient to prevent any party in interest from being or becoming a co-insurer on any part of the risk, and shall not be less than 80 percent of the full insurable value. All of the insurance policies shall include the Lessor as one of the insured parties and shall fully protect both the Lessor and the Lessee, as their respective interests may appear. All insurance received by the Lessor and the Lessee for the destruction of buildings or improvements by fire, windstorm, or other casualty shall be deposited in a joint account in a bank designated by the Lessee in the County in which the demised premises are located. These funds shall be made available to the Lessee for the construction or repair, as the case may be, of any building or buildings damaged or destroyed by fire, windstorm, or other casualty for which insurance is payable. The Lessor and the Lessee shall periodically pay out these funds from the joint account on the estimate of any reliable and authorized architect licensed in the State of Maryland, who must certify that the amount of the estimate is reasonable and is being applied to the payment of the reconstruction or repair. However, the Lessee shall provide the total amount of money necessary for the reconstruction or repair of any destroyed or damaged building or buildings and shall assure the application of the money for such purpose. The Lessee shall rebuild and repair any buildings and improvements, or any part thereof, that are destroyed or damaged by fire, windstorm, or other casualty. The rebuilt or repaired building or improvement, or the replaced or repaired personal property on the demised premises, shall be of the same or higher value as prior to the damage or destruction, and shall be rebuilt and ready for occupancy within 15 months from the time of the loss or destruction. The 15-month period for reconstruction shall be extended by delays caused without the Lessee's fault or neglect by act of God, strikes, lockouts, or other conditions (other than matters of finance) beyond the Lessee's control.

2. *Delivery of policies.* The Lessee shall deliver to the Lessor the originals of all such policies along with the receipted bills evidencing payment of the premiums for them. However, nothing contained herein shall prohibit the Lessee from financing the premiums when the terms of the policies are for three years or more. In that event the receipts shall evidence that the installment premium payment or payments are paid at or before their respective maturities. If, however, there is a mortgage on the premises created pursuant to the provisions contained in Article XIV of this Lease ("Mortgage Financing"), and if the terms of that mortgage require the Lessee to cause the originals of the policies to be delivered to the mortgagee, the Lessee shall deliver to the Lessor duplicate certificates of the policies. The Lessee shall deliver to the Lessor the policies (or duplicate certificates thereof) at least 10 days before their effective date.

3. *Proceeds payable to mortgagee.* Any mortgagee holding a mortgage created under the provisions of Article XIV may, in accordance with its terms, require that the insurance proceeds be paid to it. However, even if the mortgagee so elects, the Lessee shall still be required to create the complete fund in the manner set forth in this Article to assure and complete the payment for the reconstruction and repair work.

4. *Damages; insurance proceeds; joint bank account.* If the Lessee is not in default, it shall be paid any excess money received from insurance remaining in the joint bank account after the building or buildings are reconstructed or repaired. If, after damage or destruction caused by fire, windstorm, or other cause, the Lessee does not commence reconstruction or repair within 6 months from the date of payment of the loss and prosecute the reconstruction or repair

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so that it will be completed within 15 months after the damage or destruction occurs, it shall pay to the Lessor the amount collected, or the balance thereof remaining in the joint account. If the Lessee fails promptly, within the time specified, to complete the reconstruction and repair work, the Lessor may terminate this Lease and retain the amount as liquidated and agreed upon damages. The 15-month period for reconstruction shall be extended by delays caused without the Lessee's fault or neglect by act of God, strikes, lockouts, or other conditions (other than matters of finance) beyond the Lessee's control.

5. *Direct repayment.* Notwithstanding the above, if the insurance proceeds are \$25,000 or less, no joint bank account shall be created but the proceeds shall be paid directly to the Lessee, who shall use the funds to make the necessary replacements or repairs.

Article X Insurance Premiums

The Lessee shall pay premiums for all of the insurance policies it is required to carry under the terms of this Lease, and shall deliver to the Lessor evidence of such payment before the payment of any premiums become in default. The Lessee shall also cause renewals of expiring policies to be written and the policies or copies thereof, as required by the Lease, to be delivered to the Lessor at least 10 days before the policies' expiration dates.

Article XI Assignment

1. *Written assignment; filing.* This Lease is freely assignable, but no assignment or transfer shall be valid unless the assignee expressly assumes and agrees to perform every covenant of this Lease which, by its terms, the Lessee agrees to keep and perform. The assignee's assumption shall be evidenced by a recordable instrument, either by joinder in the assignment itself or by separate instrument. The assignment shall not be deemed valid unless it and the assumption agreement are promptly filed for record in the appropriate office, and an executed original thereof delivered to the Lessor.

2. *Estoppel certificates.* Both the Lessor and Lessee shall, within 20 days after written notice that the status of the Lease is required, give a written statement showing that the Lease is in good standing, and, if it is not, the particulars thereof. Failure within the 20-day period to give a written reply shall constitute a representation, which any person may rely upon as being true and correct, that the Lease is in good standing. Notice and the subsequent reply shall be deemed given, and time shall begin to run, when they are deposited in the United States Registered or Certified Mails, with sufficient prepaid postage to deliver them to their addressed destinations. The notice and reply shall be addressed to the parties at the required places and in the required manner for giving notice. The notice shall contain the exact language set forth in this Section 2.

3. *Lessee's primary liability.* If the Lessee's interest in and to this Lease Agreement is assigned, its liability for the performance of every term, condition, covenant, or agreement contained herein shall remain in full force and effect.

Article XII Condemnation

1. *Eminent domain; cancellation.* If, at any time during the continuance of this Lease, all or any portion of the demised real estate or the improvement of any building located thereon is taken, appropriated or condemned by reason of eminent domain, the Lessor and Lessee shall divide the proceeds and awards in the condemnation proceedings, abate the rent, and make other adjustments in a just and equitable manner under the circumstances. If the parties cannot agree on a just and equitable division, annual abatement of rent, or other adjustments within 30 days after the award has been made, the disputed matters shall, by appropriate proceedings, be submitted to a court having jurisdiction of the subject

matter for its decision and determination. If legal title to the entire premises is wholly taken by condemnation, the Lease shall be cancelled.

2. *Apportionment.* Although title to the building and improvements placed by the Lessee upon the demised premises will pass to the Lessor, for purpose of condemnation, the fact that the Lessee placed the buildings on the demised premises shall be taken into account. The deprivation of the Lessee's use of the buildings and improvements shall, together with the remaining term of the lease, be an item of damage in determining the Lessee's portion of the condemnation award. It is the general intent of this Section that, upon condemnation, the parties shall share in their awards to the extent that their respective interests are depreciated, damaged, or destroyed by the exercise of the right of eminent domain. If the condemnation is total, the condemnation award shall be allocated so that the then value of the property, as if it were unimproved property, is allocated to the Lessor, and the then value of the building or buildings thereon is allocated between the Lessor and Lessee after giving due consideration to the number of years remaining in the term of this lease and the condition of the buildings at the time of condemnation.

Article XIII Construction

1. *Building not mandatory.* This Lease is executed with the understanding and agreement that the Lessee is obligated to construct buildings or improvements on the demised premises that will be commercial buildings or a shopping center.

2. *Lessee to bear expenses.* The Lessee shall pay the entire cost of all buildings constructed by it on the demised premises.

3. *Financial commitment.* Before commencing the building or buildings, the Lessee shall arrange for sufficient financing to pay for the entire construction.

Article XIV Mortgage Financing

1. *Construction mortgages.* Upon the circumstances and subject to the terms contained in this Article, the Lessee may, in conjunction with the construction work on the property and permanent financing, require the Lessor to join with it in executing a mortgage or mortgages to provide temporary and permanent financing for a shopping center or commercial buildings to be erected on the demised premises.

2. *Institutional lender.* Any such mortgage will be in favor of an institutional lender as mortgagee. As used herein, "institutional lender" means any bank, trust company, savings and loan association, insurance company, pension fund or title insurance company, real estate investment trust (REIT), or similar organization, authorized to make mortgage loans in Harford County, Maryland.

3. *Nonrecourse.* Any such mortgage must contain a provision that the mortgagee recognizes that the Lessor's joinder in the mortgage is primarily for the purpose of creating a mortgage lien against the property encumbered by it and that no personal liability shall ever attach to or personal judgment be sought or obtained against the Lessor by reason of the Lessor's joinder in the mortgage. Similarly, if any mortgagee requires the Lessor's joinder in the note or notes secured by the respective mortgages referred to in this Lease, no personal liability shall attach to, and no personal judgment shall be sought or obtained against, the Lessor by reason of its joinder in the note or notes.

4. *Debt service.* The Lessee shall submit satisfactory evidence to the Lessor that the total base rental to be due each month from all major credit tenants in the shopping center under signed leases will not be less than 100% of the debt service on a permanent loan in an amount then committed to be advanced under such mortgage or deed of trust. As used herein, "Debt Service" means the monthly installment of principal and interest necessary to amortize the loan; and

"Major Credit Tenant" means a tenant having a net worth of not less than \$10,000,000, established by generally accepted accounting practices as of the end of its last official year as shown by an audit by an independent certified public accountant. The net worth of all such tenants and all guarantors executing a single lease shall be combined for the purpose of determining whether the group collectively constitutes a "Major Credit Tenant." A prospective tenant who does not meet these requirements will still be deemed a Major Credit Tenant if it can obtain lease insurance or a guaranty by a surety company with assets of at least \$50 million.

5. *Expenses.* Before and during construction the Lessee shall draw Demised Premises Expenses from a Construction and Development Loan. As used in this lease the term "Demised Premises Expenses" means expenses incurred in connection with the demised premises or their development; the construction, reconstruction, and/or alteration of buildings, structures, and improvements thereto; allowances which may be paid to subtenants required by their respective subleases; development costs, including site preparation, site investigation, off-site improvements, temporary improvements, maintenance of off-site improvements, test borings, piling, filling, compacting, dredging, excavation, and demolition; bringing utilities to the demised premises; customary and reasonable related professional fees and disbursements, including those of attorneys, architects, brokers, surveyors, and engineers; contractors' overhead and profit; fees, charges, and expenses of the applicable Mortgagee; commitment fees and other charges with respect to all mortgage loans; interest charges with respect to construction loans; real estate taxes; and insurance premiums incurred before the consummation of the loan secured by the first Permanent Mortgage executed by the Lessor. This loan may be obtained from a noninstitutional source as long as it complies with subparagraph (c) above.

6. *Conditions of construction loan.* The Construction Loan shall be subject to the following restrictions:

(a) *Amount.* The amount of the Construction Loan shall not exceed that on the Permanent Mortgage Commitment.

(b) *Bid amount.* If construction is to be started before a Permanent Mortgage Commitment is obtained, the Construction Loan can only be for the amount bid for the construction of the Proposed Shopping Center. If the successful bidder is an organization owned by the Lessee, this bid must be less than the amount of bids obtained from outside general contractors presently working in Arundel and Harford Counties, Maryland.

(c) *Guarantee.* In addition to the requirements of subparagraph (b) above, during the period of construction there must be a Performance Guarantee to Lessee from Tydings Factors, a Maryland corporation, or a substitute corporation or individual having a net worth of at least \$2,200,000, or the total projected value of the Shopping Center, which shall be authenticated by a Certified Financial Statement 60 days prior to commencement of construction.

This Guarantee will be waived if a Permanent Mortgage Commitment is obtained and the successful bidder for the construction of the Shopping Center is bonded in full by a bonding company authorized to do business in the State of Maryland.

7. *Proceeds of loan application.* The Lessor hereby directs any lender to pay the proceeds of the loan directly to the Lessee. The Lessor shall execute all appropriate documents required by the lender for that purpose. If the lender refuses to pay the loan proceeds to any person other than the Lessor or to the Lessor and Lessee jointly, the Lessor shall pay over the proceeds to the Lessee immediately on receipt, and endorse and deliver to the Lessee any check made payable jointly to the Lessee and Lessor.

8. *Power of attorney.* The Lessor shall give the Lessee a General Power of Attorney so that the Lessee may sign on behalf of the Lessor all Mortgages, Consent Agreements, Subordination Agreements, and other necessary documents for the leasing or financing of the demised premises. Any mortgage must comply with the above provisions. The Lessor must approve all documents or instruments executed under the General Power of Attorney before their execution thereunder.

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9. *Refinancing.* The Lessee may refinance the permanent mortgage periodically provided that the following conditions are met:

- (a) The new permanent mortgage must provide for a sufficient principal amount to pay all the expenses of the refinancing and the unpaid principal balance of the then existing permanent mortgage;
- (b) The holder or mortgagee of the new permanent mortgage must be an institutional lender as defined in Section 2, Article XIV of this Lease; and
- (c) The new permanent mortgage shall provide for self-liquidation by its maturity date as a result of the application of the amortization payments provided for therein, shall not have a term longer than 25 years, and shall not bear interest at a rate in excess of the then prevailing rate of interest on similar institutional financing.

If the Shopping Center is refinanced, all excess funds received by the Lessee after paying off the original mortgage in full, and if there is new construction, all items covered in Sections 1 through 6 of Article XIV, shall be distributed equally between the Lessee and Lessor. If the new permanent mortgage complies with the above conditions, the Lessor and Lessee shall join in the execution, acknowledgment, and delivery of the new first mortgage for the purpose of subjecting their respective interests in the demised premises to the lien thereof, and the permanent mortgage shall cover and be a lien on the entire premises. Each shall also execute, acknowledge, and deliver all other agreements, certificates, and papers that are necessary or desirable in order to accomplish the replacement or refinancing of the existing permanent mortgage. However, the Lessor shall incur no personal liability for the payment of any portion of the principal amount secured by any permanent mortgage or the interest thereon, or the payment of any other sum that may be secured or required thereby, or for the performance of any term, agreement, covenant, condition, or provision thereof. Moreover, each mortgage shall provide that it be paid in full before the last five years of the term of this Lease.

- (d) Any such mortgage given for refinancing shall comply with the provisions of Section 1, Article XIV of this Lease.

Article XV Default

1. *Effect of default by lessee.* If at any time the Lessee defaults in the payment of any rent on the day it is due and payable, or if the Lessee fails to perform any other covenant under this Lease, the Lessor may declare the lease term ended. In that event, the Lessor may re-enter upon any part of the premises and the building or buildings and improvements situated on it, either with or without process of law, the Lessee waiving any demand for possession of the premises and all buildings and improvements situated thereon. The Lessor shall also have all other remedies provided by law and this instrument. Immediately upon termination of the demised term, at the Lessor's election or in any other way, the Lessee shall peaceably surrender and deliver up the demised premises and all real and personal property to the Lessor, or its agent or attorney. If the Lessee, or its agent, attorney, or tenants, holds the premises, or any part thereof, one day after the date for their surrender, according to the terms of this Lease, the Lessee shall be deemed guilty of forcible detainer of the premises under the statutes and shall be subject to eviction or removal, forcibly or otherwise, with or without process of law.

2. *Landlord-tenant relationship only.* The relationship between the parties is that of Landlord and Tenant. The Lessee specifically acknowledges that all statutory proceedings regulating the relationship of Landlord and Tenant respecting collection of rent or possession of the premises, accrue to the Landlord.

3. *Lessor's remedies.* Nothing herein shall be construed as authorizing the Lessor to declare this Lease in default, however, unless the default is for the nonpayment of rent, security, insurance premiums, or taxes in violation of the terms of this Lease and the nonpayment continues for 30 days after the respective due dates for payment of these items. If the alleged default consists of any other violation, the Lessor may not declare this Lease in default until the violation

continues for 30 days after the Lessor gives the Lessee written notice thereof. However, nothing contained herein shall be construed as precluding the Lessor from having any other remedy that may be necessary to preserve its right and its interest in the premises and this Lease, even before expiration of the grace or notice periods provided for in this Section, if under the then existing circumstances, the allowance of the grace or the giving of the notice would prejudice or endanger the Lessor's rights and estate in this Lease and the demised premises.

4. *Default period.* All default and grace periods shall be deemed to run concurrently and not consecutively.

5. *Legal costs; receiver.* Subject to the rights of the holder of any first mortgage to which this Lease has been subordinated, the Lessee pledges with, and assigns to, the Lessor all rents, issues, and profits that might otherwise accrue to the Lessee for the use, enjoyment, and operation of the demised premises. In connection with such pledging of the rents, the Lessee covenants and agrees with the Lessor that if the Lessor, upon the Lessee's default, elects to file suit in chancery to enforce the Lease and protect its rights, the Lessor may, as ancillary to such suit, apply to any court of competent jurisdiction for the appointment of a receiver of all and singular the demised premises, and the improvements and buildings located thereon. Thereupon, the parties expressly covenant and agree that the court shall immediately appoint a receiver with the usual powers and duties of receivers in like cases. The court shall make the appointment as a matter of strict right to the Lessor, without reference to the adequacy or inadequacy of the value of the property subject to the Lessor's lien, to the Lessee's solvency or insolvency, or to the commission of waste. Nothing contained in this Section shall be construed as empowering the Lessor to collect rents accruing from the premises, unless and until the Lessee is in default.

Article XVI Repair Obligations

During the continuance of this Lease the Lessee shall keep in good state of repair and in first class condition all buildings, furnishings, fixtures, and equipment which Lessee brings, constructs, or places upon the demised premises. The Lessee shall not suffer or permit any strip, waste, or neglect of any building or other property to be committed. The Lessee shall repair, replace, and renovate the property as often as necessary to keep the buildings and other property subject to this Lease in first class repair and condition.

Article XVII Demolition

1. *Conditions precedent to demolition by lessee.* Although it is the Lessee's duty under the terms hereof to keep and maintain all buildings and improvements on the demised premises in good repair, this shall not be construed as empowering the Lessee to demolish any buildings on the demised premises or any substantial part thereof or to cause any item of major repair and construction to be made unless and until the Lessee:

(a) Causes plans for the new buildings or the new construction to be prepared in full accordance with all applicable laws, building codes, and zoning ordinances, and delivers the plans to the Lessor for its approval (which the Lessor shall not unreasonably withhold) at least 30 days before the proposed work is actually commenced;

(b) Furnishes the Lessor with a performance and payment bond with corporate surety, guaranteeing the doing and completion of the work; or, in lieu of furnishing such bond; and

(c) Creates an escrow fund with any bank or trust company selected by the Lessee, into which it shall pay the full cost of the repair and replacement. The cost shall be evidenced by the bona fide bid of a responsible general contractor or the aggregate of the bona fide estimates of reliable subcontractors and materialmen. The Lessee shall submit all the evidence to the Lessor not later than 30 days before the work starts. The escrow fund shall be utilized to pay for the work as it progresses upon the requisition of the contractor and the certificate of an architect supervising the work, but

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disbursements from the escrow fund shall be made by written order of the Lessor and Lessee. If the Lessor elects to exercise joint control over the escrow fund, it shall promptly approve or cause to be approved progress payments so long as the balance remaining in the fund is sufficient to cause the work to be carried through to completion and paid for, and full and final waivers and releases are procured from all persons who furnish work, labor, services, or materials to the job.

2. *Replacement value.* The value of the reconstruction, repair, and replacement must not be less than the value of the building or buildings, or portion thereof, then being demolished, replaced, and repaired.

3. *Demolition defined.* For the purposes of this Article, no work shall be deemed a "demolition" or a major repair so as to bring it within the terms of this Section of the Lease unless it constitutes either the actual destruction of all or a substantial part of a building or a remodeling which, in substance, requires the tearing down of a substantial part of a building. The changing of openings or the removal and/or relocating of partition walls, or other work inside the building designed to accommodate itself to better occupancy, shall not be deemed major repair and construction within the meaning of this Article. The provisions of this Article shall not be applicable to the removal of any building or structure on the premises at the time of execution of this Lease.

Article XVIII Additional Covenants of Lessee

1. *Legal use.* The premises shall be used for legal purposes only.

2. *Insurance claims.* No damage or destruction to any building or improvements by fire, windstorm, or any other casualty shall be deemed to entitle the Lessee to surrender possession of the premises, to terminate this Lease, to violate any of its provisions, or to cause any rebate or reduction in the rent when due or thereafter becoming due under its terms. If the Lease is cancelled because of the Lessee's default while any obligation from an insurance company to pay for all or any part of the damage remains outstanding, the claim against the insurance company shall, upon cancellation of the Lease, be deemed immediately to become the absolute and unconditional property of the Lessor.

3. *Termination.* Upon termination of this Lease, the Lessee shall peaceably and quietly deliver to the Lessor possession of the premises and all improvements, including all furnishings, fixtures, and equipment which the Lessee has brought, placed, or constructed upon the premises, under the provisions of Article XIII of this Lease.

4. *Costs of suits.* If, at any time, the Lessor is required to enforce this Lease or to defend any action arising out of the facts connected with or caused by reason of the Lessee's ownership of this Lease or occupancy of the leased premises, the Lessee shall owe and pay to the Lessor all court costs and reasonable attorneys' fees incurred or expended by Lessor in conducting the defense or in enforcing the terms of this Lease. The Lessor may collect the amount of costs and fees as though it was rent then maturing and coming due.

Article XIX Quiet Enjoyment

So long as the Lessee keeps and performs all of its covenants and conditions under this Lease, it shall have quiet, undisturbed, and continued possession of the premises, free from all claims against the Lessor and all persons claiming under, by, or through the Lessor.

Article XX Right of Entry

The Lessor and its agents may enter upon the premises at all reasonable times to examine their condition and use, so

long as that right is exercised in a manner that does not interfere with the Lessee in the conduct of its business on the premises. If the premises are damaged by fire, windstorm, or other casualty which causes them to be exposed to the elements, the Lessor may enter upon them to make emergency repairs. However, if it does so, the act or acts shall not be deemed to excuse the Lessee from its obligation to keep the premises in repair, and the Lessee shall, upon the Lessor's demand, immediately reimburse it for the cost of the emergency repairs.

Article XXI Separate Parcels

1. *Multiple leases.* (a) It is contemplated that, from time to time, Lessee may find it desirable to develop, transfer, use, sublet, and/or mortgage the demised premises in separate portions. If Lessee so requests in writing, the Lessor shall execute four Leases for portions of the demised premises containing all the provisions hereunder, with the following exceptions: the applicable rent for each lease shall be as set forth below; and each lease may contain additional provisions which provide, in effect, that the respective lessees and persons designated by them may use certain portions of the premises designated by the lessees in common with each other.

(b) The portions of the demised premises may be two areas ("Front Parcels"). Neither Parcel shall front more than 250 feet on State Route 192 nor exceed one acre and another parcel in the shopping center of one 21/2 acre ("Interior Parcel") and the balance of the demised premises ("Balance Parcel"). In that event, the annual basic rent shall be \$2,500 for each Front Parcel, \$1,000 for the Interior Parcel, and the balance of rent then due for the Balance Parcel. The Lease for the Balance Parcel shall provide that if a default occurs with respect to the Front Parcels or Interior Parcel, the lessee of the Balance Parcel shall be required to cure the default.

2. *Single lease.* If some or all of the lessees under the new leases ("Multiple Leases") give written notice to the Lessor that they desire the premises demised under their respective leases to be governed by a single lease, and the Lessor agrees that it will execute a single lease of the premises containing all the provisions of this Lease (except that the applicable "Basic Rent" shall be the sum of the applicable basic rents provided in each such lease), the applicable multiple leases shall be cancelled.

3. *Performance.* If a subtenant performs any of the Lessee's obligations under this Lease for the Lessee's account or on its behalf in accordance with the subtenant's authority to do so under its sublease, the Lessor shall accept the performance as if it were performed by the Lessee.

Article XXII Miscellaneous

1. *Force majeure.* If the Lessor or Lessee is delayed, hindered, or prevented from performing any act required hereunder by reason of strikes, lockouts, labor troubles, inability to procure materials, failure of power, restrictive government laws or regulations, riots, insurrection, the act, failure to act or default of the other party, war, or other reason beyond its control, then performance of the act shall be excused for the period of the delay. In that event, the period for the performance of the act shall be extended for a period equivalent to the period of the delay.

2. *Estoppel certificates.* Either party shall, without charge, at any time and from time to time hereafter, within ten days after the others' written request of the other, certify by instrument duly executed and acknowledged to any mortgagee or purchaser or proposed mortgagee or proposed purchaser, or any other person, firm, or corporation specified in the request as to:

(a) Whether this Lease has been supplemented or amended, and, if so, the substance and manner of the supplement or amendment;

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- (b) The validity and force and effect of this Lease, in accordance with its tenor as then constituted;
- (c) The existence of any default thereunder;
- (d) The existence of all offsets, counterclaims, or defenses thereto on the part of the other party;
- (e) The commencement and expiration dates of the term of this Lease; and
- (f) All other matters that may reasonably be so requested.

Any such certificate may be relied upon by the party who requested it and any other person, firm, or corporation to whom it may be exhibited or delivered, and the contents of the certificate shall be binding on the party executing it.

3. *Duplicates; recordation.* Either party shall, at any time, at the other's request, promptly execute duplicate originals of an instrument, in recordable form, which shall constitute a short form of lease. This will set forth a description of the demised premises, the term of this Lease, and any other portion thereof, except for the rental provisions, requested by either party.

4. *No recourse.* Notwithstanding anything to the contrary, the Lessor shall look solely to the interest of the Lessee hereunder for the satisfaction of any remedy it may have hereunder or in connection herewith and shall not look to any other assets of the Lessee or of any other person, firm or corporation. If the Lessee is a corporation, no personal liability shall attach to any of its present or future shareholders, officers, or directors, or its successors or assigns, for any obligation hereunder or in connection herewith. If the Lessee is a firm, partnership, joint venture, or association, it shall have no personal liability for any obligation hereunder or in connection herewith. If the Lessee assigns its Leasehold Interest to Lessor, it shall be completely relieved of all liability hereunder or in connection herewith, regardless whether accrued at the time of assignment and whether a cause of action exists at such time or arises thereafter.

5. *Consent not to be unreasonably withheld.* The Lessor shall not unreasonably withhold its consent, permission, or approval for any act which may be required or desired by the Lessee under the provisions of this Lease. Such consent, permission, or approval shall be deemed to have been granted if, within 45 days after the Lessor receives the request, it fails to notify the Lessee of its express disapproval and the reasons therefor.

6. *Right of first refusal to purchase.* The Lessor shall not sell or grant options with respect to, or otherwise dispose of, the demised premises unless it has first (i) received a bona fide arm's-length offer from an unaffiliated party for the sale or disposition, (ii) notified the Lessee in writing of the offeror's identity and address all of the provisions of the offer, and (iii) afforded the Lessee the prior option to purchase or otherwise acquire the demised premises on the same terms and provisions as those contained in the offer.

7. *Option procedure.* The Lessee shall exercise its option by giving written notice to the Lessor within 30 days after it receives the Lessor's notice of the offer. The Lessor shall give such notice within 10 days after it receives the offer. If the Lessee fails to exercise its option and the Lessor does not subsequently sell or dispose of the demised premises under the provisions of the offer, the above prohibition against the Lessor's sale or other disposition shall continue in full force and effect. In that event, the Lessee's option to purchase shall apply to any subsequent offer on the same terms as set forth above.

8. *Notice of exercise of option.* The notice provided in Section 7 shall set forth the time and place of closing (which may not be more than 50 miles from the demised premises unless the Lessor so consents). The time of closing shall be designated in the notice of exercise but not later than 60 days after the notice is given.

9. *Closing.* At such closing conference; (i) the Lessee shall pay to Lessor (by good certified check or an official check of

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a bank or trust company) the applicable purchase price; (ii) the Lessor shall convey good and marketable title of the demised premises to the Lessee free and clear of all encumbrances and title defects other than those which arose at the Lessee's request or by virtue of the its tenancy; and (iii) the Lessor and Lessee shall execute all documents which may be necessary to effectuate the closing and the transfer of title contemplated hereunder.

10. *Related transactions; inapplicability.* The foregoing provisions of this Section shall not apply to the sale, transfer, or other disposition of the demised premises to (i) any parent, sibling, child, or grandchild of the Lessor, or (ii) a corporation or other entity owned or controlled by any or all of them.

11. *Income tax deductions and credits.* Only the Lessee may take deductions and credits on its tax returns for the buildings, structures, improvements, changes, alterations, repairs, additions, and installations, and for their depreciation or cost recovery.

12. *Covenants running with land; binding effect.* All covenants, conditions, and obligations contained herein or implied by law are covenants running with the land and shall attach and bind and inure to the benefit of the Lessor and Lessee and their respective heirs, legal representatives, successors, and assigns, except as otherwise provided herein.

13. *Non-waiver.* No waiver of a breach of any covenant in this Lease shall be construed to be a waiver of any succeeding breach of the same covenant. No delay or failure by either party to exercise any right under this Lease, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

14. *Arrears.* All arrearages in the payment of rent shall bear interest from the date when due and payable at the then prime rate of CitiBank, New York, New York per annum until paid.

15. *Written modifications.* No modification, release, discharge, or waiver of any provision hereof shall be of any force, effect, or value unless signed in writing by the Lessor, or its duly authorized agent or attorney.

16. *Entire agreement.* This instrument contains the entire agreement between parties as of this date. The execution hereof has not been induced by either party by representations, promises, or understandings not expressed herein. There are no collateral agreements, stipulations, promises, or undertakings whatsoever upon the respective parties in any way touching the subject matter of this instrument which are not expressly contained in it.

17. *Notices.* All notices between the parties in connection with this Lease shall be in accordance with its terms. Notice shall be given by registered or certified mail, deposited in the United States mails with postage prepaid. The notices shall be addressed as follows:

For the Lessor:

For the Lessee:

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[Acknowledgments]

C.3 Commercial lease--tenant oriented clauses--retail use

COMMENT

The form of lease illustrated here is a commercial lease for retail use by the tenant. It contains many clauses which benefit or protect the tenant's interests. Several of these clauses may be useful in other types of forms of leases on behalf of the tenant. For example, the tenant, who is required to pay real estate taxes (§§ 3.2, 29.1(1)), is permitted to contest the amount of tax (§ 6.1), and is expressly entitled to any refund (§ 6.2). The tenant is permitted to provide the required insurance coverage under blanket policies, which may also cover other tenant locations (§ 9.2). In addition the landlord agrees to mitigate damages in the event of an eviction of the tenant. This may obligate the landlord to relet the premises, and thereby possibly reduce the tenant's liability for a deficiency in rent. The tenant's obligation for a rent deficiency is limited to basic rent, and specifically excludes the percentage rent under this lease (§ 24.2).

Future changes by tenant:

This lease contains several clauses which allow the tenant to surrender the premises or to move to another location. These provisions are aimed at allowing flexibility in future business planning. For example, the lessee is expressly permitted to assign or sublet the premises to a business which will use the property for the same purpose as the tenant (§ 12.1). A strongly pro-tenant clause in this lease allows the tenant to terminate the lease if, after a specified period, the use is uneconomical (§ 19.1). However, if the lease is terminated on this basis during the initial term, the tenant must offer to purchase the property from the landlord for a specified price (§ 12.2). During the initial term, however, the tenant is permitted to change locations, in effect, by exchanging property at another location with the landlord for the leased property (§ 20.1). These clauses give the tenant much future planning leeway. Future planning is anticipated by the required, but unspecified, operating hours, which cannot be less than those of similar businesses in the area, but may be as long as 24 hours per day (§ 11.2).

Purchase options:

This lease gives the tenant the opportunity to purchase the leased property from the landlord. The lease contains a purchase option (§ 17.1), and a right of first refusal (§ 18.1). On the last day of the initial term

or any extended term, the lessee can purchase the property for its fair market value, if prior notice is given (§ 17.1). Fair market value, if disputed, is to be determined by appraisers (§ 29.1(i)). The right of first refusal permits the tenant the option to purchase on substantially the same terms as a bona fide offer (§ 18.1).

For further information, see Chapter 4.

FORM

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- 27. Lessor's Negative Covenants
- 28. Miscellaneous
- 29. Definitions

Lease agreement, by and between 1995 Main Street Corp. ("Lessor"), whose address is 1995 Main Street, Los Angeles, California 90000, and Greenwood Foods, Inc. ("Lessee"), whose address is 1000 State Street, San Francisco, California 90000.

Witnesseth: Article 1 Demised Property

1.1 Lessor hereby leases to Lessee and Lessee hereby leases from Lessor the Property in San Francisco, California, more particularly described in the Exhibit "A" attached hereto and made a part hereof. The Property has been improved with a restaurant building, which is included in this Lease as part of the Property. Lessee has inspected the Property and by the execution of this Lease accepts it in its present condition.

Article 2 Term

2.1 The term of this Lease shall begin on the Commencement Date and, unless terminated or extended, shall end on the Termination Date (the "Basic Term"). Lessee may extend the term for up to two consecutive periods of five years each ("Extended Terms"). The term shall automatically be extended for each Extended Term unless Lessee shall notify Lessor of its intention to terminate this Lease at least three months prior to the expiration of the then existing term.

Article 3 Rent, Percentage Rent

3.1. *Rent.* Lessee shall pay the minimum rent and percentage rent to Lessor, during the term of this Lease, in the amounts and at the times prescribed below in lawful money of the United States of America, at Lessor's address for notice hereunder or otherwise as Lessor may designate.

3.2. *Impositions.* Lessee will also pay all Impositions and all charges for utility, communications, and other services rendered or used on or about the Property during the term, before any interest or penalty may be added; and will furnish to Lessor, upon request, satisfactory proof evidencing such payment. If Lessee may legally pay any Imposition or other charge in installments and elects to do so, it shall only be liable for those installments coming due within the term. Lessor shall be responsible for all installments becoming due after the expiration of this Lease.

3.3. *Basic rent.* Lessee covenants and agrees to pay Lessor, as rent for the Property during the Basic Term, the minimum rent of:

--Dollars per annum (herein the "Basic Rent"), in equal monthly payments, in arrears, on the fifteenth business day of each month (herein the "Rent Payment Dates"), each in the sum of

--Dollars, commencing on the fifteenth day of the month next succeeding the Commencement Date. However, on the Commencement Date Lessee shall pay to Lessor a sum equal to one month's Basic Rent, to be applied against the final payment of Basic Rent due thereunder.

3.4. *Percentage rent.* In addition to the payment of the Basic Rent, Lessee shall pay to Lessor monthly in the manner, upon the conditions, and at the times hereinafter set forth, during the Basic Term of this

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Lease and each Extended Term additional rent. The additional rent shall equal 5 percent of the annual "gross sales," as hereinafter defined, from all business conducted on the Property by or under Lessee during the term of this Lease, less (a) the monthly installment of the Basic Rent, (b) the aggregate amount of all general real estate taxes and special assessments on the Property paid by Lessee and (c) the aggregate amount of all premiums paid by Lessee in connection with insurance maintained pursuant to Article 9. Amounts deducted from the sum representing 5% of gross sales pursuant to (b) and (c) above may be deducted either in the Lease Year in which such amounts are paid by Lessee or in which they accrue according to Lessee's election.

3.5. *Gross sales.* The term "gross sales" as used herein shall (subject to the exceptions and authorized deductions hereinafter set forth) mean the gross amount received for everything sold upon or from the Property, either for cash or credit, with the full amount of credit sales being reported as gross sales in the month in which said credit sales are made. The term "gross sales" as used herein shall not include the following: (i) commissions or location rentals received from vending machines or coin operated devices, provided they only constitute an incidental portion of Lessee's business; (ii) the amount of sales or excise taxes collected from customers; (iii) receipts from the sales of meals to the restaurant's employees on the Property, in the course of their employment, provided such sales are registered and recorded separately from other sales; (iv) any service charge made, collected and turned over to employees in lieu of tips or gratuities from patrons; (v) the proceeds of the sale of any franchise or joint venture interest in the restaurant on the Property, and all fees, charges or rentals charged to or received from any such franchisee or joint venturer; (vi) the proceeds of the sale of any of Lessee's trade fixtures or restaurant equipment used on the Property; (vii) the value of any promotional meals; (viii) service charges or commissions paid to any issuer of credit cards accepted by Lessee in lieu of cash; and (ix) sales and/or exchanges made to or with other restaurants owned or controlled by Guarantor.

3.6. *Statement.* On each Rent Payment Date, Lessee shall pay to Lessor any additional rent due hereunder, and shall concurrently therewith submit to lessor a statement of Lessee's gross sales during the preceding month. The statement shall be certified to be correct by a representative of Lessee or Guarantor.

3.7. *Annual adjustment.* Within 30 days after the close of each Lease Year, Lessee shall pay to Lessor any additional rent due hereunder, and shall concurrently submit to Lessor a statement of Lessee's gross sales during the preceding Lease Year. The statement shall be certified to be correct by a Representative of Lessee or Guarantor. If the aggregate percentage rent paid to Lessor exceeds the amount actually payable by Lessee, the excess amount shall be credited against rent thereafter becoming due.

3.8. *Audit.* Lessor may, by giving written demand within 60 days after the end of each Lease Year, and at Lessor's sole expense, have Lessee's records of gross sales for the period inspected at the Lessee's offices by an impartial, reputable licensed accountant of Lessor's choice. If such audit discloses an error of 5% or more in Lessee's monthly statements of gross sales, as adjusted, Lessee shall bear the costs of inspection. Lessor's failure to make written demand shall constitute a waiver of its rights for that Lease Year. Lessor shall be deemed to have accepted each annual statement as correct unless, within 30 days of receipt thereof, it notifies Lessee of any objection.

3.9. *Business records.* Lessee shall, at all times during the terms, keep in a manner consistent with good accounting practice accurate and complete records of all business transactions made in, on, or from the Property.

3.10. *Confidence.* Lessor shall hold in confidence all sales figures and other financial data or information relating to Lessee's operations obtained from Lessee or upon inspection and audit of Lessee's books and

records.

3.11. *No representations.* Lessee makes no representation or warranty to Lessor as to the gross sales to be made from the Property.

Article 4 Compliance with Requirements

4.1. Lessee will promptly procure, maintain and comply with all permits, licenses and other authorizations required for the use of the Property as a restaurant and for the lawful operation, maintenance, and repair of the Property or any part thereof. Lessee will not do any act or thing which constitutes a public or private nuisance. Lessor will join, if necessary, in the application for any permit or authorization with respect to any Legal Requirements.

Article 5 Covenant against Liens

5.1. *Liens of Lessee.* If because of any act or omission of Lessee, any mechanic's lien or other lien, charge, or order for the payment of money is filed against any portion of the Property, Lessee shall, at its expense, cause the lien or liens to be discharged of record or bonded within 90 days after it receives written notice from Lessor of their filing, unless Lessee contests their validity in accordance with Section 6.1.

5.2. *Removal of liens.* If Lessee fails to cause the liens to be discharged of record or bonded within the required 90-day period (unless it contests their validity as provided above) or to satisfy them within 60 days after any final (nonappealable) judgment in favor of the lien holders, Lessor may cause the liens to be discharged. All payments by Lessor to have liens discharged shall constitute additional Basic Rent payable to it by Lessee.

5.3. *Liens of Lessor.* If, because of any act or omission of Lessor, any lien, charge, or order for the payment of money is filed against the Property, Lessor shall, at its expense, cause the lien or liens to be discharged of record or bonded within 90 days after it receives written notice from Lessee of their filing. In that event, Lessor shall indemnify and save harmless Lessee against and from all costs, liabilities, suits, penalties, claims, and demands. If Lessor fails to cause the liens to be discharged or bonded within the required 90-day period, or if before that period expires Lessee's quiet enjoyment of the Property is affected or threatened as a result thereof, Lessee may cause the liens to be discharged. All payments by Lessee may be deducted from subsequent installments of rent payable under this Lease.

Article 6 Permitted Contests

6.1. *Contest proceedings.* Lessee may contest by appropriate proceedings, the amount, validity, or application of any Imposition, Legal Requirement, or any lien arising therefrom, provided that: (a) such proceedings suspend the collection thereof; (b) no part of the Property or of any rent would be subject to loss, sale, or forfeiture before determination of any contest; (c) Lessor would not be subject to any criminal liability for failure to pay; (d) such proceedings do not affect the payment of rent hereunder or prevent Lessee from using the Property for its intended purposes; and (f) Lessee notifies Lessor of any such proceedings at which the amount in contest exceeds \$25,000 within 20 days after the commencement thereof, and describes such proceedings in reasonable detail. Lessee will conduct all such contests in good faith and with due diligence and will, promptly after the determination of such contest, pay and discharge all amounts determined to be payable therein.

6.2. *Refunds.* All refunds or rebates of Impositions paid by Lessee shall belong to Lessee. All refunds

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received by Lessor shall be deemed trust funds and as such shall be received by it in trust and paid to Lessee forthwith. Lessor shall, at Lessee's request, sign all receipts which may be necessary to secure the payment of any refund or rebate, and shall pay over to Lessee all refunds or rebates received by it.

Article 7 Maintenance, Alterations, and Additions

7.1. *Maintenance.* Lessee shall keep the Property in good order and condition (except for ordinary wear and tear or damage caused by casualty or a Taking) and shall make all repairs and take all other action necessary or appropriate to keep and maintain the Property in good order and condition. Lessor will not be liable for any labor, services, or materials furnished or to be furnished to Lessee, or to anyone holding the Property or any part thereof through or under Lessee. No mechanics' or other liens for any such labor or materials shall attach to or affect the interest of Lessor in and to the Property.

7.2. *Alterations and additions.* If there is no continuing Event of Default, Lessee may make additions or improvements to or alterations of the Property. All maintenance and repair, and each such addition, improvement, or alteration (i) must not, individually or in the aggregate, substantially lessen the Fair Market Value of the Property or materially affect the Property's usefulness in Lessee's business, (ii) shall be completed expeditiously in a good and workmanlike manner, and in compliance with all Legal Requirements and all Insurance Requirements, and (iii) shall become part of the Property and subject to this Lease.

7.3. *Replacements.* Lessee may install or place or reinstall or replace upon and, if there is no continuing Event of Default, remove from the Property any trade fixtures, signs, machinery, and equipment. Such trade fixtures, signs, machinery, and equipment shall not become the property of Lessor. However, replacements of Lessor's trade fixtures, machinery, and equipment shall be its property.

Article 8 Indemnification

8.1. Lessee hereby indemnifies, and shall protect and hold Lessor harmless from and against all liabilities, losses, claims, demands, costs, expenses, and judgments of any nature arising, or alleged to arise, from or in connection with the following: (a) any injury to, or the death of, any person or loss or damage to property on or about the Property or any adjoining property arising from or connected with the Lessee's use of the Property during the term; (b) performance of any labor or services or the furnishing of any materials or other property in respect of the Property or any part thereof by or at the Lessee's request of Lessee; (c) any contest permitted by Article 6. Lessee will resist and defend any action, suit or proceeding brought against Lessor by reason of any such occurrence by counsel designated by Lessee.

Article 9 Insurance

9.1. *Insurance coverage.* Lessee will maintain with insurers authorized to do business in the state in which the Property is located and which are well rated by any recognized national rating organization:

(a) fire insurance and insurance with respect to risks from time to time included under the standard extended coverage endorsement, including vandalism and malicious mischief, in amounts sufficient to prevent Lessor and Lessee from becoming co-insurers of any loss, but in any event not less than the then Full Insurable Value of the Property as determined from time to time (but not less often than once every three years) by the insurer or insurers;

(b) comprehensive general public liability insurance against claims for bodily injury, death, or property

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damage arising out of the use or occupancy of the Property by Lessee, in a combined single limit amount of not less than \$300,000.

9.2. *Policy terms and conditions.* All insurance policies that Lessee must maintain under this Article shall name it and Lessor as the insured parties, as their respective interests may appear. The policies may be carried under blanket policies maintained by Lessee if they comply with the provisions of this subsection. The fire policies may provide for the same deductible amounts, not to exceed \$25,000, that Lessee customarily provides for in its insurance for similar properties owned or leased by it. The policies shall provide for a reserved amount with respect to the Property so as to assure that the amount of insurance required by section 9.1(a) will be available notwithstanding any losses with respect to other property covered by such blanket policies. All policies of insurance that Lessee must maintain under Section 9.1(a) shall: (i) bear a standard first mortgagee endorsement in favor of any holder or holders of a first mortgage lien or security interest in the Property with loss payable to the holder or holders for application as provided in Article 10; (ii) provide for the benefit of the holder or holders, that ten days' prior written notice of cancellation, termination, modification, or lapse of coverage shall be given; and (iii) not contain a provision relieving the insurer thereunder of liability for any loss by reason of the existence of other insurance policies covering the Property against the perils involved, regardless of collectibility.

9.3. *Insurance certificate.* Lessee shall deliver to Lessor, promptly after this Lease commences, insurers' certificates evidencing all insurance that Lessee must maintain under this Lease, and, within 30 days before any such insurance expires, other certificates evidencing its renewal.

9.4. *Waiver of claim.* If and so long as the insurance that Lessee must maintain under Section 9.1 is in full force and effect, Lessor waives, releases, and discharges Lessee from all claims or demands that Lessor may have or subsequently acquire arising out of damage or destruction of the Property occasioned by fire or extended coverage risks, whether the claim or demand arises because of the negligence of Lessee, its agents, or otherwise. Lessor shall look to the insurance coverage only in the event of such loss.

Article 10 Condemnation and Casualty

10.1. *Condemnation or insurance awards.* Lessee hereby assigns to Lessor any award or payment on account of any damage, destruction, or Taking which is payable in connection with the Property. However, Lessee shall be entitled to that portion of the net award representing payment for its leasehold interest, trade fixtures, moving expenses, business interruption, or loss of profits. All amounts paid pursuant to an agreement with a condemning authority in connection with any Taking shall be deemed to constitute an award on account of such Taking. Lessee agrees that this Lease shall control the rights of both parties in any such award, and any contrary provision of any present or future law is hereby waived.

10.2. *Notice.* If there is any damage to or destruction of the Property or if any proceedings or negotiations are instituted which do or may result in a Taking, each party will promptly give notice thereof to the other, describing its nature and extent.

10.3. *Lessee restoration.* Subject to subsection 10.5, if the cost of Restoration is less than \$25,000, Lessee will promptly commence and complete Restoration of the Property and Lessor shall cause the Net Award to be made available to Lessee for such purpose.

10.4. *Substantial restoration.* Subject to subsection 10.5, if the cost of Restoration exceeds \$25,000 and can be completed within 180 days after the occurrence, Lessor will promptly commence and complete

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Restoration of the Property in accordance with plans and specifications to be prepared by Lessee within 20 days after the occurrence reflecting the requisite nature and scope of the Restoration improvements. Lessee shall prepare such final plans and specifications and submit copies of them to Lessor within 20 days from the date it receives notice under subsection 10.2. The final plans and specifications shall be deemed approved by Lessor unless it notifies Lessee, within five days after receipt, of any reasonable objections to them, and specifies the nature of the objections. Lessor shall not unreasonably withhold approval of the final plans and specifications. If within ten days after Lessee receives Lessor's objections the parties are unable to agree upon the final plans and specifications, either party may terminate the Lease by giving ten days' prior written notice to the other.

10.4.1. *Ownership of plans.* Lessor acknowledges that the said plans and specifications are the sole property of Lessee and Guarantor, that the architectural design of Lessee's restaurant building is unique and that such plans and specifications will be furnished to Lessor in confidence. Lessor agrees not to knowingly permit or suffer any person to utilize same for any purpose other than the Restoration improvements.

10.4.2. *Contractor bids, contracts.* Within ten days after Lessor has approved or is deemed to have approved the final plans and specifications, Lessee, on Lessor's behalf, shall solicit and obtain a bid from a reputable and responsible contractor for the construction and completion of the Restoration improvements. A qualified, reputable, and bondable contractor designated by Lessor shall be allowed to submit a bid to Lessee, provided that Lessor submits the name of the contractor to Lessee within 30 days after the notice of occurrence, as foresaid. Within five days after receipt of bid(s), Lessee, on Lessor's behalf, shall designate the contractor who has submitted the acceptable bid to construct the Restoration improvements and shall forward to Lessor the general construction contract to be executed by Lessor on Lessee's approved contract form. Lessor agrees that no contractor shall be deemed any agent of Lessee and that Lessee assumes no obligations with respect to the manner or quality of construction or any other matter relating to the construction, and that Lessee shall have the right to insist upon compliance by Lessor with all terms and provisions hereof.

10.4.3. *Construction extras.* Lessee may require the Lessor to amend the construction contract to include Extras, provided however, that their aggregate cost shall not exceed the Net Award.

10.4.4. *Completion date.* Lessor shall diligently proceed with the construction of the Restoration improvements and shall complete them within 180 days after the occurrence, but this date shall be extended for all delays in construction resulting from causes beyond Lessor's reasonable control. However, if for any reason, including causes beyond Lessor's reasonable control, construction is not completed within one year from the date of occurrence, Lessee may terminate this Lease. Lessee's right to terminate is in addition to any other remedies provided herein or by law.

10.4.5. *Work standards and completion.* Lessor shall cause the general contractor to construct the Restoration improvements in a good workmanlike manner and in compliance with plans and specifications and all Legal Requirements. Lessor shall furnish to Lessee satisfactory evidence of completion in the form of (1) a certificate of occupancy (where appropriate) issued by the appropriate governmental authority, if available, and (2) Lessor's certificate of completion.

10.4.6. *Lessee inspection and work.* During the course of construction, Lessee or its representatives may enter upon the Property at all reasonable times for the purpose of inspecting the construction to determine that the work is being completed in accordance with the plans and specifications. When construction is substantially completed, Lessee may enter the Property for the purpose of installing improvements, fixtures, and other equipment, upon the condition that Lessee does not unreasonably

interfere with completion of construction of the Restoration improvements.

10.4.7. *Clean-up.* Lessor shall deliver the Property to Lessee on the completion of Restoration in broom clean condition, free and clear of all debris, rubbish, and discarded building materials.

10.4.8. *Construction bonds.* Before commencement of construction of Restoration improvements Lessor shall cause its contractor to procure performance and payment bonds issued by a duly qualified corporate surety in the full amount of the construction contract, naming Lessor as the Obligee. The bonds shall be: (a) conditioned upon the full and complete and faithful performance of the terms and conditions and of the work to be performed under the contract, and (b) further conditioned upon payment in full of the claims of all persons performing labor upon, or furnishing materials to be used in, or furnishing appliances, equipment or power contributing to such work. The bonds shall meet the statutory requirements of the governing jurisdiction of the work site, be recordable in form, and be in the form and written by the companies that Lessee reasonably approves. If any contractor defaults under a construction contract and Lessor receives sums under the bonds, Lessor shall hold the sums in trust to be applied to the cost of completion of Restoration improvements.

10.5. *Termination events.* This Lease shall terminate as of the date of the occurrence or Taking if any of the following termination events occur: (a) Restoration cannot be completed within 180 days after the occurrence; (b) the damage, destruction, or Taking occurs during the last five years of the Basic Term or during any Extended term; or (c) within 30 days after a Taking, Lessee determines in good faith and notifies Lessor that, as a result thereof, the Property no longer is suitable for use as a restaurant. In that event, the Basic Rent, Percentage Rent, and other payments to be made by Lessee shall be apportioned as of the date of the occurrence or Taking.

10.6. *Lessor's failure to restore.* If Lessor does not commence Restoration within 30 days after the occurrence, or does not prosecute the Restoration with due diligence, Lessee, upon ten days notice to Lessor, may either (i) commence and complete Restoration at Lessor's expense, in which event Lessor shall make the Net Award available to Lessee for such purpose, or (ii) terminate this Lease. If the Award is not adequate to complete Restoration, Lessor shall promptly pay the deficiency to Lessee.

10.7. *Rent abatement.* Upon damage or destruction to the Property or upon its Taking which does not result in termination under subsection 10.5, the Basic Rent, Percentage Rent, and all other payments to be made by Lessee hereunder shall abate as of the date of the occurrence. In the case of partial damage, destruction or Taking which does not cause Lessee to discontinue use of the Property as a restaurant, the above payments shall be equitably apportioned.

10.8. *Restoration trust funds.* If damage or destruction to the Property or the Taking thereof does not result in termination under subsection 10.5, the Net Award shall be paid to the Depository to be held in trust for Restoration.

10.9. *Arbitration.* If Lessor and Lessee are unable to agree upon the period required to complete Restoration or upon its cost, such matters shall be determined as follows: Each party shall appoint an arbiter. If the two arbiters cannot agree upon the disputed matter, it shall be determined by a third arbiter selected by them. If the two arbiters cannot agree upon a third arbiter, he shall be appointed by a federal district court judge, acting in a nonjudicial capacity, for the district in which the Property is located.

10.10. *Application of award.* If there is no continuing Event of Default and unless this Lease has been terminated under Section 10.5, the Net Award shall be applied as follows: (a) any Net Award received by Lessor as compensation for a Taking of temporary use or occupancy during the term of this Lease shall

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be paid over immediately to Lessee; (b) any portion of the Net Award allocable to a period after the expiration or earlier termination of this Lease shall become the property of Lessor and shall be paid to it; and (c) any portion of the Net Award which is received for damage to or destruction of the Property shall be paid to the Depository and applied as provided in subsections 10.3, 10.4, or 10.6.

Article 11 Use, Operation of Business

11.1. *Use.* Lessee shall use the Property only for the operation of a restaurant and for no other purpose without Lessor's prior written consent. However, at Lessor's option, Lessee may use the property for any legally permissible use which proves to be economically feasible, to be determined by Lessee within its good faith discretion.

11.2. *Operation.* During the term, Lessee shall operate a restaurant upon the Property not less than the hours similar businesses are open for business in the immediate area of the Property and may operate on a 24 hour per day, seven day per week basis if permitted by Legal Requirements. However, temporary discontinuance of business due to strikes, lockouts, fire, casualty, remodeling, Legal Requirements, or other causes beyond Lessee's control shall not be deemed a breach of this section 11.2.

Article 12 Assignment, Subletting

12.1. *Assignment and sublease.* Lessee may not mortgage, pledge, or otherwise encumber its interest in this Lease or in any sublease of the Property. Lessee may assign this Lease or sublet the Property to any person whose business is to operate a restaurant, provided that the sublease or assignment is expressly subject to the provisions of this Lease, and that the sublease or assignment does not affect or reduce Lessee's obligations hereunder, which shall continue in full effect as the obligations of a principal and not as a guarantor or surety, to the same extent as though no assignment or sublease had been made.

12.2. *Performance.* Any act required to be performed by Lessee under this Lease may be performed by its sublessees or assignees. Their performance shall be deemed to be that of Lessee and shall be acceptable as its act by Lessor.

Article 13 Right to Cure Defaults

13.1. *Lessor defaults.* If Lessor fails to pay any liens or encumbrances affecting the Property and to which this Lease may be subordinate when any of them become due or otherwise fails to perform any of its covenants or agreements under this Lease, and the failure or default continues for 30 days after Lessee gives notice to Lessor (notwithstanding any delay or forbearance in giving notice), Lessee may pay the lien or encumbrance and cure the default. Lessee may further make all necessary payments in connection therewith, including, but not limited to, the payment of reasonable attorney's fees, costs, and charges of or in connection with any pending legal action. Lessor shall immediately pay Lessee all amounts paid by Lessee, including interest thereon at the maximum legal rate, or, if no such rate is established, at 15 percent per annum. All sums charged to Lessor by Lessee hereunder shall be Lessor's indebtedness to Lessee, payable on demand. If all Lessor's indebtedness is not fully paid within 30 days after demand, Lessee may (i) deduct such amount from rent subsequently becoming due hereunder, (ii) terminate this Lease by giving 30 days notice to Lessor (unless Lessor cures the default), or (iii) extend this Lease on the same covenants and conditions as herein provided until the indebtedness is fully paid by application to rents.

13.2. *Lessee defaults.* If Lessee fails to make or perform any required payment or act, Lessor may do so for Lessee's account. Lessee shall pay to Lessor on demand all amounts so paid by Lessor and all

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incidental costs and expenses (including attorney's fees and expenses) incurred in connection with the payment or performance, including interest thereon at the maximum legal rate, or, if no such rate is established, at 15 percent per annum from the date the payment is made or the costs and expenses are incurred.

Article 14 Subordination and Nondisturbance

14.1. This Lease and all rights of Lessee hereunder are and shall be subject and subordinate to the lien of any and all mortgages, or consolidated mortgage or mortgages, which may now or hereafter affect the Property, or any part thereof, and to all renewals, modifications, consolidations, replacements, and extensions thereof, subject to the following conditions. Any mortgage placed upon the Property shall provide that so long as there is not outstanding a continuing Event of Default by Lessee in any term, condition, covenant, or agreement of this Lease, (i) the leasehold estate of Lessee created hereby and Lessee's peaceful and quiet possession of the Property shall be undisturbed by any foreclosure of the mortgage, (ii) the Net Award will be made available for Restoration, and (iii) the lien will be released if Lessee purchases the Property pursuant to Article 17 and pays the purchase price to the mortgagee to the extent that a balance is due on the mortgage.

Article 15 Lessee's Trade Fixtures and Equipment

15.1. All trade fixtures, signs, equipment, furniture, or other personal property of whatever kind and nature kept or installed on the Property by Lessee shall not become the property of Lessor or a part of the realty no matter how affixed to the Property and may be removed by Lessee at any time and from time to time during the entire term of this Lease. Upon request of Lessee or its assignees or any subtenant, Lessor shall execute and deliver any real estate consent or waiver forms submitted by any vendors, lessors, chattel mortgagees, or holders or owners of any trade fixtures, signs, equipment, furniture, or other personal property of any kind and description kept or installed on the Property setting forth that Lessor waives, in favor of the vendor, lessor, chattel mortgagee, or any holder or owner, any Superior lien, claim, interest or other right therein. Lessor shall further acknowledge that property covered by the consent or waiver forms is personal property and is not to become a part of the realty no matter how affixed thereto, and that such property may be removed from the Property by the vendor, lessor, chattel mortgagee, owner, or holder at any time upon default in the terms of such chattel mortgagee or other similar documents, free and clear of any claim or lien of Lessor.

Article 16 Surrender

16.1. Upon the expiration or earlier termination of this Lease, Lessee shall surrender the Property to Lessor in good order and condition, except for ordinary wear and tear, existing Legal Requirements, and the results of any damage, destruction, or Taking. Lessee shall remove from the Property on or prior to the expiration or earlier termination all of its property situated thereon and shall repair any damage caused by the removal. Property not so removed shall become the property of Lessor.

Article 17 Purchase Option

17.1. Lessee may purchase the Property on the last day of the Basic Term or of any Extended Term at a price equal to the Fair Market Value of the Property as of the date of purchase. Lessee shall give notice of the exercise of the option within 180 days prior to the expiration of the effective term. On the date of such purchase, Lessor shall convey marketable title to the Property to Lessee against payment of the purchase price therefor in accordance with Article 21.

Article 18 Right of First Refusal

18.1. If at any time during any term of this Lease, Lessor receives and is willing to accept a bona fide offer from a third party to purchase the Property, other than an offer to purchase it at any sale incidental to the exercise of a remedy provided for in a mortgage or other security instrument creating a lien on the Property, or if Lessor offers to sell the Property to a third party, Lessor shall, if there is no continuing Event of Default, promptly transmit to Lessee its offer to sell the Property to Lessee upon terms and conditions substantially similar to those offered by or to the third party, together with a true copy of such original offer. If Lessee does not accept such offer within 30 days after it is made, Lessor may, within 180 days after the 30-day period expires, sell the interest to a third party upon terms and conditions substantially similar to those offered to Lessee. If Lessee accepts such offer by notice to Lessor within the time permitted, the offer and acceptance shall constitute a contract for the sale by Lessor and the purchase by Lessee of the Property at a closing to be held within 30 days following the receipt by Lessor of Lessee's notice of acceptance. On the date of such purchase, Lessor shall convey marketable title to the Property to Lessee against payment of the purchase price therefor in accordance with Article 21.

Article 19 Termination for Uneconomic Use

19.1. *Termination option.* If at any time two years or more after this lease commences the Leased Property is no longer economic or suitable for Lessee's continued use and occupancy, Lessee may give notice to Lessor of its intention to terminate the lease. The notice shall specify that it is being given under this Article 19, and shall contain the following: (a) the termination date, which shall be the Payment Date as set forth below first occurring at least 180 days after notice is given; (b) Lessee's certification that its board of directors has made a determination that the Leased Property is no longer economic or suitable for Lessee's continued use and occupancy and that Lessee has discontinued or will discontinue its use on or before the termination date, and, after that date, Lessee will discontinue the use of the Leased Property in its ordinary course of business for a period of at least three years; and (c) if the termination date occurs during the Basic Term, Lessee's irrevocable offer to purchase the Leased Property on that date at a purchase price previously determined in accordance with Section 19.2. If Lessor rejects the offer by giving notice to Lessee not later than 30 days before the termination date, or if that date occurs during an Extended Term, this lease shall terminate on the termination date. Unless Lessor has rejected the offer provided in the preceding sentence, Lessor shall be conclusively presumed to have accepted it and, on the termination date Lessor shall transfer, and Lessee shall purchase, the Leased Property in accordance with Article 21.

19.2. *Purchase prices.* The payment dates and purchase prices, referred to above, are as follows:

Payment Date.....	Purchase Price

January 1, 2002.....	\$1,130,000
January 1, 2003.....	\$1,143,000
January 1, 2004.....	\$1,157,300
January 1, 2005.....	\$1,173,000
January 1, 2006.....	\$1,190,000

Article 20 Substitution of a New Lease

20.1. If, at any time during the Basic Term, the Leased Property is no longer economic or suitable for

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Lessee's continued use and occupancy, Lessee may give notice to Lessor of its intention to terminate the lease. The notice shall specify that it is being given under this Article 20, and shall contain the following: (a) the termination date, which shall be the Payment Date first occurring at least 180 days after notice is given; (b) Lessee's certification that its board of directors has made a determination that the Leased Property is no longer economic or suitable for Lessee's continued use and occupancy and that Lessee will discontinue its use on or before the termination date for a period of at least three years; and (c) a description, in reasonable detail, of the new property that Lessee intends to convey or assign to Lessor as the purchase price for the Leased Property payable under this Article 20. The new property shall consist of a fee interest in improved real property. However, if the Leased Property is subject to a Ground Lease, the new property may consist of a fee interest in improved real property or, with Lessor's consent, a leasehold interest created by a ground lease and its assignment. The term of the ground lease, including renewals, shall expire not earlier than 15 years after the expiration date of the lease referred to in the following sentence as that lease may be extended under its terms, and the ground lease shall otherwise be satisfactory to Lessor. Upon the date specified for termination of this Lease, Lessee shall convey or assign to Lessor a parcel of property which shall be unencumbered by any lien or charge and suitable for use in Lessee's business as a restaurant. Lessee shall then enter into a lease of the property with Lessor, provided the following conditions are met: (A) the Fair Market Value of the property is not less than the greater of (i) the Fair Market Value of the Leased Property, as determined by a member of the American Institute of Real Estate Appraisers, not more than 60 days before the termination date, or (ii) the purchase price of the Leased Property at the purchase date which would be payable upon a purchase under Article 19; (B) the new lease (i) provides for payments of basic rent on each Payment Date that are not less than the Basic Rent payable under this Lease, (ii) provides for a term ending on a date not earlier than the Termination Date, (iii) provides for purchase prices for the property that are not less than the respective purchase prices that would be payable upon a purchase of the Leased Property by Lessee under this Lease, (iv) has substantially the same other terms and provisions as this Lease, and (v) is guaranteed by the Guarantor on the same terms and conditions as set forth in the Guaranty; and (C) all of the documents and proceedings relating to the conveyance or assignment and new lease and its substitution, including the terms and provisions of the new lease, are reasonably satisfactory in form and substance to Lessor. Lessee shall pay all costs, charges, and expenses incident to the conveyance or assignment of the property and the lease thereof and any mortgage thereof by Lessor and any assignment of the lease thereof, including attorney's fees and expenses, recording fees, the costs of appraisals, title insurance premiums covering title insurance for Lessor and for the mortgagee under such mortgage, and all applicable taxes which may be incurred or imposed by reason of such transactions. On the termination date, Lessor shall transfer to Lessee, and Lessee shall purchase from Lessor, the Leased Property in accordance with Article 21.

Article 21 Procedure for Purchase

21.1. *Marketable title, liens.* Upon the purchase by Lessee of the Property under this Lease, Lessor shall transfer marketable title to Lessee. Title shall, however, be subject to all liens, encumbrances, charges, exceptions, and restrictions affecting the Property as of the Commencement Date (excluding any monetary liens or encumbrances) and those attaching thereto on or after such date (a) which shall be or have been expressly consented to in writing by Lessee, or (b) for the discharge of which Lessee is responsible under this Lease, and subject to all Legal Requirements, but free of all liens which secure amounts or obligations which Lessee is not obligated to pay or discharge under this Lease.

21.2. *Settlement.* Upon the date fixed for any such purchase, Lessee shall pay to Lessor at its address for notices hereunder or otherwise as the Lessor may designate, the purchase price specified herein, by certified or official bank check payable to the order of Lessor or its designee, and Lessor shall deliver to Lessee an appropriate instrument or instruments of transfer of the interest in the Property. Upon

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completion of the purchase, this Lease and all obligations hereunder shall terminate, except for actual or contingent obligations and liabilities which arose on or prior to the purchase date.

Article 22 Short Form Lease

22.1. *Recordable form.* The parties will, simultaneously with the execution of this Lease, execute counterparts of an instrument, in recordable form, which, when completed to include a metes and bounds description of the Property and the Commencement Date and Termination Date of this Lease, will constitute a short form of lease. Lessor authorizes and appoints Lessee as its attorney-in-fact to complete the document when the omitted data is available and thereupon to record it.

22.2. *Nondisclosure of rent.* Lessor shall not record this Lease or any short form lease or other document which sets forth the rent to be paid by Lessee. Any such recording or attempted recording by Lessor shall constitute a breach of this Lease.

Article 23 Certificates

23.1. Either party shall, without charge, at any time within ten days after the other's written request, from time to time, certify by written instrument duly executed and acknowledged to any actual or proposed mortgagee or purchaser, or any other Person specified in the request, as to the following: (a) whether this Lease has been supplemented or amended, and if so, the substance and manner of such supplement or amendment; (b) the validity and force and effect of this Lease, in accordance with its tenor as then constituted; (c) the existence of any default thereunder; (d) the existence of any offsets, counterclaims, or defenses thereto by the other party; (e) the commencement and expiration dates of the term of this Lease; and (f) all other matters that may reasonably be so requested. Any such certificate may be relied upon by the party requesting it and any other Person to whom it may be exhibited or delivered. The contents of the certificate shall be binding on the party executing it.

Article 24 Events of Default, Remedies

24.1. *Default.* Any of the following occurrences, conditions, or acts shall constitute an "Event of Default" under this Lease:

(a) if Lessee

(i) defaults in making payment when due of any Basic Rent or Percentage Rent, and the default continues for 30 days after Lessor gives written notice to Lessee specifying the default and demanding that it be cured, or

(ii) defaults in the observance or performance of any other provision of this Lease, and the default continues for 60 days after Lessor gives written notice to Lessee specifying the default and demanding that it be cured. However, if the default cannot be cured by the payment of money and cannot with due diligence be wholly cured within the 60-day period, Lessee may have any longer period that is necessary to cure the default, so long as Lessee proceeds promptly to cure it within that period, prosecutes the cure to completion with due diligence, and advises Lessor from time to time, upon Lessor's request, of the actions that Lessee is taking and the progress being made;

(b) if the Property is abandoned by Lessee for a period of 45 consecutive days;

(c) if Lessee or the Guarantor files a petition in bankruptcy, for reorganization or for an arrangement

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under the Bankruptcy law or any similar federal or state law, is adjudicated a bankrupt or becomes insolvent, is unable to meet Lessee's obligations as they become due, or takes any corporate action in furtherance of any of the foregoing;

(d) if a petition or answer is filed proposing the adjudication of Lessee or the Guarantor, if any, as a bankrupt or the reorganization of Lessee or the Guarantor under the Bankruptcy law or any similar federal or state law, and (i) Lessee or the Guarantor consents to the filing thereof, or (ii) the petition or answer is not discharged or denied within 60 days after its filing;

(e) if a receiver, trustee, or liquidator (or other similar official) of Lessee or the Guarantor, of all or substantially all of their respective businesses or assets, or of the estate or interest of Lessee in the Property is appointed and is not discharged within 60 days thereafter or if Lessee or the Guarantor consents to or acquiesces in the appointment; or

(f) if Lessee's estate or interest in the Property is levied upon or attached in any proceeding and the process is not vacated or discharged within 60 days after the levy or attachment, unless the levy or attachment is being contested under Article 6.

(g) Notwithstanding the provisions of subparagraphs (c), (d), and (e) above, if at any time during the term of this lease, proceedings in bankruptcy, insolvency, or similar proceedings are instituted by or against Lessee, whether or not they result in an adjudication against Lessee, or if a receiver of Lessee's business or assets is appointed, the proceedings or adjudications shall not affect the validity of this lease so long as rent and additional rent reserved under it continues to be paid to Lessor and Lessee performs all its other terms, covenants, and conditions under this lease. In that event, this lease shall continue to remain in full force and in accordance with its terms.

24.2 Remedies. If there is any default under the above Section 24.1, the following shall occur: (a) the rent shall immediately become due and be paid up to the time of reentry, expiration, and/or dispossession; (b) Lessor may relet the Property or any part or parts of it, either in Lessor's name or otherwise, for a term or terms which may, at Lessor's option, be less than or exceed the then remaining term of this lease; and (c) Lessee shall also pay to Lessor, as liquidated damages for Lessee's failure to observe and perform its covenants under this lease, any deficiency between the Basic Rent hereby reserved and/or agreed to be paid and the net amount, if any, of the rents collected on account of the Property's lease or leases for each month of the period which would otherwise have constituted the balance of the term of this Lease. However, any such deficiency shall be paid as the Basic Rent becomes due and payable in monthly installments. In computing the liquidated damages, there shall be added to the deficiency all reasonable expenses that Lessor may incur in connection with reletting, such as brokerage and preparation for reletting. Lessee shall pay any such liquidated damages in monthly installments on the Rent Payment Dates specified in the lease. Any suit brought to collect the deficiency for any month shall not prejudice in any way Lessor's rights to collect the deficiency for any subsequent month by a similar proceeding. Lessor may make all alterations, repairs, replacements, and decorations in the Property that it, in its sole judgment, considers advisable and necessary for the purpose of reletting the premises. Such action by Lessor shall not operate or be construed to release Lessee from its liability under this lease. Lessor shall use its best effort to mitigate all damages and to relet the Property if there is any Event of Default by Lessee.

Article 25 Notices

25.1. All notices, demands, requests, consents, approvals, offers, statements, and other instruments or communications required or permitted to be given hereunder shall be in writing and be deemed to have

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been given when delivered, or when mailed by first class registered or certified mail, postage prepaid, addressed, (a) if to Lessee, at its address set forth above, Attention: Corporate Counsel, with a copy addressed to Guarantor, Attention: Corporate Counsel, at the address specified in the guarantee instrument, or at any other address that Lessee or the Guarantor may furnish in writing to Lessor, or (b) if to Lessor, at the address set forth above.

Article 26 Amendments

26.1. This Lease may not be amended, modified, or terminated, nor may any obligation under it be waived orally. No amendment, modification, termination, or waiver shall be effective for any purpose unless it is in writing and signed by the party against whom enforcement thereof is sought.

Article 27 Lessor's Negative Covenants

27.1. *Restaurant leases.* During the term Lessor shall not, without Lessee's prior written consent, directly or indirectly engage in, or acquire any financial or beneficial interest in, or grant a lease to any Person to operate a restaurant business for the sale or furnishing of food, excluding only ethnic type establishments.

27.2. *Application of restriction.* The provisions of subsection 27.1 shall apply to all officers, directors, subsidiaries, and affiliates of Lessor, shall be covenants running with any land owned by Lessor, and shall be binding upon its successors and assigns.

Article 28 Miscellaneous

28.1. *Severability.* If any provision of this Lease or any application thereof shall be invalid or unenforceable, the remainder of this Lease and any other application of such provision shall not be affected thereby.

28.2. *Binding effect.* The provisions of this Lease shall be binding upon and inure to the benefit of both parties and their respective successors and assigns.

28.3. *Quiet Enjoyment.* Upon due performance by Lessee of its covenants and agreements under this Lease, Lessor covenants that Lessee shall and may at all times peaceably and quietly have, hold, and enjoy the Property during the Lease term. If this covenant of quiet enjoyment is breached and Lessee is made a party to any legal proceedings affecting its right of possession, Lessor shall reimburse Lessee for all reasonable attorneys' fees or other expenses incurred by it in defending its right to this Lease. Lessee may apply all such expenses to rent due or to become due.

28.4. *Headings.* The table of contents, Article, and Section headings are for convenience and reference only and shall not be used to limit or otherwise affect the meaning of any provision of this Lease.

28.5. *Counterparts.* This Lease will be simultaneously executed in two or more counterparts, each of which shall be deemed a fully enforceable original but all of which together shall constitute one and the same instrument.

28.6. *Governing law.* This Lease shall be construed in accordance with and governed by the laws of the State of California.

28.7. *Relationship of parties.* Lessor and Lessee shall not be considered or deemed to be joint venturers

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or partners and neither shall have the power to bind or obligate the other except as set forth herein.

28.8. *Default of Lessor's Trustee.* If Lessee is unable to use the Property for the use intended because Lessor is involved in a bankruptcy or insolvency proceeding and Lessor's Trustee fails to perform any of Lessor's obligations under this Lease, Lessee may terminate the Lease.

28.9. *Construction.* All terms used in this Lease, regardless of the number or gender in which they are used, shall be deemed and construed to include any other number, singular or plural, and by other gender, masculine, feminine, or neuter, as the context or sense of this Lease or any section, subsection, or clause herein may require as if such terms had been fully and properly written in such number or gender.

28.10. *Investment tax credit.* It is the parties intent that Lessee shall at all times be considered the owner and original user of all fixtures, trade fixtures, equipment, and other property upon or used in connection with the Property and that Lessee shall be entitled to and may claim an investment tax credit in accordance with Sections 38 and 46 through 48 of the Internal Revenue Code of 1954 or corresponding provisions of subsequent law. Lessor shall at no time take any action or file any document which is inconsistent with the foregoing intent and Lessor shall take such action and execute all documents that may be lawful, reasonable, and necessary to facilitate accomplishment of this intent.

28.11. *Modification.* No changes, additions, or interlineations made to this Lease shall be binding unless initialed by both parties.

28.12. *Non-waiver.* No delay or failure by either party to exercise any right under this Lease, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

28.13. *Time of essence.* Time is expressly declared to be of the essence of this Lease.

28.14. *Entire Agreement.* This Lease supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

Article 29 Definitions

29.1. As used in this Lease, the following terms have the following respective meanings:

(a) *Basic rent:* defined in Article 3.

(b) *Basic rent payment date:* the fifteenth day of each consecutive month during the term.

(c) *Basic term:* defined in Article 2.

(d) *Commencement date:* the date on which the Lessee takes possession of the premises.

If the Commencement Date falls on other than the first day of a month, Lessee shall pay a prorated rent for the partial month and the Commencement Date for the Basic Term of the Lease shall be adjusted to be the first day of the following month.

(e) *Date of this Lease:* the date of acknowledgment of the signatures of the Lessee's officers executing this Lease.

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(f) *Default*: an event or condition the occurrence of which would, with the lapse of time or the giving of notice or both, become an Event of Default.

(g) *Depository*: any bank, savings institution, trust company, or national banking associations located in the jurisdiction in which the Property is located.

(h) *Event of default*: defined in Article 24.

(i) *Fair market value*: The Fair Market Value of the Property shall be the amount a willing buyer would pay to a willing seller (neither party being forced to buy or sell) if such property were being used for its highest and best use. If Lessor and Lessee are unable to agree on the Fair Market Value of the Property, it shall be determined by two appraisers, one appointed by Lessor and the other by Lessee. If the two appraisers are unable to agree upon a Fair Market Value, it shall be determined by a third appraiser to be selected by them. If the two appraisers are unable to agree on a third appraiser, the appraiser shall be appointed by a federal district court, acting in a nonjudicial capacity, for the district in which the Property is located.

(j) *Full insurable value*: actual replacement costs, including the costs of debris removal, less physical depreciation, but not including the costs of soil tests, trenches, foundations, and other improvements below ground which are not ordinarily insurable.

(k) *Guarantor*: Greenwood, Inc., a California corporation, together with any successor thereto by way of merger, consolidation, or acquisition of all or substantially all its assets.

(l) *Impositions*: all taxes, assessments (including all assessments for public improvements or benefits), water, sewer, or other rents, rates and charges, excises, levies, license fees, permit fees, inspection fees, and other authorization fees and charges, in each case whether general or special (including all interest and penalties thereon), which at any time during or in respect of the term hereof may be assessed, levied, confirmed, or imposed on or in respect of or be a lien upon the Property or any part thereof.

(m) *Insurance requirements*: all terms of any insurance policy required to be maintained by Lessee under section 9.1 hereof, and all requirements of the National Board of Fire Underwriters (or any other body exercising similar function) applicable to or affecting all or any part of the Property.

(n) *Lease year*: the period between the Commencement Date for the Basic Term and the first anniversary of the Commencement Date and each successive annual period thereafter during the term.

(o) *Legal requirements*: all statutes, codes, ordinances, rules, regulations, orders, judgments, or decrees of governments, authorities, agencies, officials, and officers, which now or at any time hereafter may be applicable to the Property of any part of it.

(p) *Lessee*: the party defined as such in the first paragraph of this Lease together with any successor thereto by way of merger, consolidation, or acquisition of all or substantially all of its assets.

(q) *Lessor*: the party defined as such in the first paragraph of this Lease, together with any successor or successors to its rights and obligations as Lessor hereunder, including at any time after the date hereof, the then owner of Lessor's interest in the Property.

(r) *Net award*: any insurance proceeds or condemnation award payable in connection with any damage, destruction, or Taking, less the costs, fees, and expenses incurred in the collection thereof.

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(s) *Person*: any individual, partnership, corporation, trust, unincorporated association, or joint venture, a government or any department or agency thereof, or any other entity.

(t) *Property*: the parcel of land described in Exhibit "A," together with all improvements at any time existing thereon, all fixtures at any time affixed thereto and all easements, rights, and appurtenances at any time relating thereto but not including trade fixtures, machinery, and equipment which remains the property of Lessee under section 7.3.

(u) *Restoration*: the restoration, replacement, or rebuilding of the Property or any portion thereof as nearly as practicable to its value, condition, and character immediately prior to damage, destruction, or Taking.

(v) *Subsidiary*: any corporation which is at least 50% owned or controlled by Guarantor.

(w) *Taking*: a taking of all or any part of the Property, or any interest therein or right accruing thereto, as a result of or in lieu of or in anticipation of the exercise of the right of condemnation or eminent domain pursuant to any law, general or special, or by reason of the temporary requisition of the use or occupancy of the Property or any part thereof, by any governmental authority, civil or military.

(x) *Termination date*: the fifth anniversary after the Commencement Date.

In witness whereof the parties have executed this Lease as of the date first above written.

Witness:

Lessor:

1995 Main Street Corp.

by _____

Lessee:

Greenwood Foods, Inc.

by _____

Guaranty

Greenwood, Inc. hereby unconditionally guarantees the performance by Lessee of its obligations under this Lease for a period of five years from the Commencement Date of this Lease.

Greenwood, Inc.

by _____

C.4 Shopping center lease

COMMENT

A shopping center lease provides not only (1) for the lease of store space by a tenant from a landlord, but also (2) for the use of common facilities with other tenants and customers, as well as (3) for the rules regulating the relationship among the tenants and the landlord for the success of their cooperative merchandizing venture. Another significant factor affecting the shopping center lease is the prospective assignment of the lease as additional collateral security for the landlord's mortgage lender. The realities of the bargaining powers of the tenants vis-a-vis the landlord will also affect the shopping center lease. A large desirable department store, which would draw a large number of customers will be better able to

obtain concessions from the shopping center owner than will a smaller "satellite" or "line" tenant.

Minimum and percentage rent:

Shopping center leases, as many store leases, generally require the tenant to pay not only a monthly installment of rent, in a minimum amount, but in addition, a percentage rental. The percentage rental is generally based on gross sales from the tenant's premises, and may be adjusted by subtracting the minimum rental, returned merchandise, credits, or similar items. Clear delineation of what amounts received by the tenant are included in "gross sales" is advisable. For example, gross sales may not include:

- **delivery and installation charges;**
- **mail order or catalogue purchases;**
- **finance charges on credit sales;**
- **sales, use or excise taxes; or**
- **receipts from vending machine, snack bar, or amusement devices installed for the tenant's employees sole use.**

Common areas:

Common areas in a shopping center generally include the malls, promenades, parking facilities, loading docks and area, landscaping and similar areas. A tenant should receive a right to the use of and access to common areas as an appurtenance to the lease.

Regulation of the use of the common elements is usually a right reserved by the landlord. This provides for uniformity for all tenants. Such regulations would include matters such as prohibition against "sidewalk" sales by tenants and restrictions of parking by tenant employees to areas further away from the shopping center.

Although maintenance of the common areas is most often the landlord's responsibility, the common area maintenance costs are generally shared proportionately among tenants and the owner. Maintenance may include the landlord's overhead and management expenses, as well as depreciation or maintenance equipment and overall insurance premiums.

Merchants' association:

A merchants association is a useful organization for considering planning, promotional, and operating functions within the shopping center. Tenant voting rights and the method of membership fee assessment are points to consider here.

Use restrictions and exclusives:

Use restrictions in a shopping center lease requires extreme care. Not only does a landlord seek a good tenant mix by carefully defining each tenant's use, but he must also avoid breach of "exclusives" or clauses barring competing product lines contained in other tenant leases. This can be a problem area.

Rather than entering a lease prohibiting another tenant from selling, for example, men's hats, a landlord may avoid future problems by agreeing not to lease to a tenant whose main business is selling men's hats, or even men's clothing.

Restrictions against competition:

In addition to tenant leases containing "exclusives" (whereby the landlord agrees not to lease to a tenant selling the same product as, or engaged in a business similar to, the subject tenant), a lease may also restrict a tenant from opening a store within a specified radius of the shopping center. If a tenant, prior to entering the shopping center lease, already maintains a store within the proposed radius, he should seek a specific exception. Such restrictions are aimed at preventing the diversion of business from the shopping center and diminishing the amount of the landlord's percentage rent.

Any restriction which involves restraints on trade should not be so strict as to be in violation of the federal or local anti-trust laws. A review of the current state of the anti-trust law should be made to avoid violation and insure enforceability.

Store hours:

A landlord, as well as most tenants, seeks to keep the shopping center in continuous operation, six to seven days a week including evenings. Many leases may therefore contain a clause requiring the tenant to be open at specified times or at such times as may be set by the merchants' association.

Signs:

In the interest of overall appearance of the shopping center, a landlord will generally retain control over the design and appearance of individual tenant signs. Usually a tenant and landlord should agree on both interior and exterior sign design and appearance before signing the lease.

Mortgage lender protection:

If a tenant enters and records its lease prior to the recording of the landlord's mortgage, the lease will not be subject, generally, to termination by foreclosure. A lender, on the other hand, may be restricted by government regulation to first lien priority on its loans. A tenant does not usually want to lose its lease because of a foreclosure against a landlord. A resolution of this conflict is found in this lease. In exchange for subordination of its lease to the mortgage, the tenant should receive a side agreement from the mortgage lender to honor the lease (despite the landlord's default in the mortgage) so long as the tenant is not in default under the lease, i.e., a nondisturbance agreement.

Mortgage lenders who maintain a substantial interest in upholding the value of the shopping center as a whole by assuring a steady flow of rental income, disfavor, generally, certain types of clauses. Included would be a clause giving the tenant the right to repair defects which the landlord failed to repair, and deduct the cost of such repairs from rent; a clause giving the tenant the right to terminate for breach of its "exclusive" right to sell a particular item or line.

For further information, see Chapter 4.

FORM

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Article	Title
I	Definitions and Contract Basic Provisions
II	Granting Clause
III	Construction and Acceptance of Premises
IV	Rent
V	Sales Reports and Records
VI	Common Areas
VII	Use and Care of Premises
VIII	Maintenance and Repair of Premises
IX	Alterations
X	Landlord's Right of Access, Use of Roof
XI	Signs, Store Fronts
XII	Utilities
XIII	Indemnity and Public Liability Insurance
XIV	Nonliability for Certain Damages
XV	Damages by Casualty
XVI	Eminent Domain
XVII	Assignment and Subletting
XVIII	Taxes and Insurance
XIX	Default by Tenant and Remedies
XX	Landlord's Contractual Security Interest
XXI	Holding Over
XXII	Subordination
XXIII	Merchants Association
XXIV	Radius Restriction
XXV	Notices
XXVI	Commissions
XXVII	Government Regulations
XXVIII	Miscellaneous

THIS LEASE is entered into on December 31, 2001, by and between the Landlord and the Tenant named below.

Article I Definitions and Contract Basic Provisions

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1.1. *Definitions.* (a) "Landlord": Center Associates, a Texas Limited Partnership.

(b) Landlord's address: 1020 Marshall Tower, Dallas, Texas

(c) "Tenant": Big Star Clothes, Inc., a Texas corporation.

(d) Tenant's address: 224 King's Court, Center, Dallas, Texas.

(e) Tenant's trade name: Big Star Clothes Store.

(f) "Agent": Marshall Real Estate Company, 1020 Marshall Tower, Dallas, Texas.

(g) "Cooperating Agent": Lone Star Country Real Estate, Inc.

(h) "Demised Premises": King's Court Shopping Center (the "Shopping Center") in the City of Dallas, Dallas County, Texas. The store is approximately 9,198 square feet in area (outlined in red on Exhibit A attached hereto and made a part hereof) measured to the exterior of outside walls and to the center of interior walls, and the premises are known as 224 King's Court Center.

(i) Lease term: Commencing on January 1, 2002, except as may be modified by exhibits which will be attached to this lease if a building is to be constructed for Tenant (the "Commencement Date"), and continuing for ten years. However, if the Commencement Date is not the first day of a calendar month, the 10-year lease term shall be extended by adding the remainder of the calendar month following the Commencement Date.

(j) Minimum guaranteed rental: Minimum guaranteed rental shall be \$1,336.29 per month during the first five years of the term hereof. Minimum guaranteed rental during the second five years of the term shall be \$1,336.29 per month adjusted by the percentage increase in the Consumer Price Index for the last full month of the first five years of the term as compared to the last full month prior to the Commencement Date. The term "Consumer Price Index" shall, for the purpose of this lease, be the "Consumer Price Index for all Urban Consumers" specified for "All Items", (United States City Average, 1967 + 100) and issued by the Bureau of Labor Statistics of the United States Department of Labor. If the price index is in the future compiled upon a different basis, a proper adjustment shall be made therein, for the purposes of this paragraph, to reflect the change in the cost of living that has occurred since the date of this lease. If at the time of the computation the United States Department of Labor no longer compiles and publishes a price index, the index for "All Items" compiled and published by any other branch or department of the federal government shall be used for the purpose of this paragraph. If there is no such index, the basis for the adjustments shall be the statistics reflecting cost of living increases as compiled by any institution, organization, or individual generally recognized as an authority by financial and insurance institutions. The minimum guaranteed rental during the second five years of the lease term shall not be less than that during the first five years.

(k) Percentage rental rate: 21/2 percent of all gross sales over \$400,000 per year.

(l) Common area maintenance charge: A minimum of \$268.28 per month, payable in advance.

(m) Prepaid rental: \$_____ as rent for the_____ month(s) of the lease term.

(n) Security deposit: \$_____

(o) Permitted use: Operation of a men's, women's, boys' and girls' department or specialty store.

1.2. *Interpretation.* Each of the above definitions and basic provisions shall be construed in conjunction with and

limited to the references thereto in the other provisions of this lease.

Article II Granting Clause

2.1. In consideration of Tenant's obligation to pay rent and of the other terms, covenants, and conditions hereof, Landlord leases to Tenant, and Tenant takes from Landlord, the Demised Premises as described in Section 1.1(h), TO HAVE AND TO HOLD the premises for the lease term specified in Section 1.1(i), all upon the terms and conditions set forth in this lease. If Tenant performs all of its covenants and agreements herein, it shall, subject to the terms of this lease, at all times during the continuance thereof, have peaceful and quiet possession of the Demised Premises. [NOTE: If this lease provides for construction prior to occupancy, refer to the appropriate exhibits attached hereto. In such case Article II shall be deemed modified to the extent inconsistent with such exhibits.]

Article III Construction and Acceptance of Premises

3.1. *Occupancy deemed compliance.* By occupying the Demised Premises, Tenant shall be deemed to have accepted them and to have acknowledged that they comply fully with Landlord's covenants and obligations hereunder.

3.2. *Holdover of prior tenant.* If this lease is executed before the Demised Premises become vacant, or if any present tenant or occupant of the premises holds over, the Landlord cannot acquire possession of the Demised Premises before the Commencement Date (as defined in Section 1.1(i)), it shall not be deemed to be in default under the lease, and Tenant shall accept possession of the Demised Premises whenever Landlord is able to tender them. Landlord waives the payment of rent covering any period before possession is tendered to Tenant.

3.3. *Recordable lease memorandum.* Landlord and Tenant, at either's request, shall execute and deliver a short form lease in recordable form containing the basic provision of this agreement, acknowledging that Tenant has accepted possession and reciting the exact Commencement Date and termination date of this lease.

Article IV Rent

4.1. *Payment of rent.* Rental shall accrue hereunder from the Commencement Date, and shall be payable to Landlord in care of Agent at the address specified in Section 1.1(f).

4.2. *Minimum rent.* Tenant shall pay to Landlord minimum guaranteed rental in monthly installments in the amounts specified in Section 1.1(j). The first monthly installment shall be due and payable on or before the Commencement Date, and subsequent installments shall be due and payable on or before the first day of each succeeding calendar month during the demised term. However, if the Commencement Date is not the first day of a calendar month, Tenant shall, on or before that date, pay as minimum guaranteed rental for the balance of that month a percentage of the rent specified for the first full calendar month. This percentage shall be determined by a fraction, the numerator of which is the number of days from the Commencement Date to the end of the calendar month within which that date falls, and the denominator of which is the total number of days in the month.

4.3. *Percentage rent.* (a) In addition to the minimum guaranteed rental, Tenant shall pay to Landlord, for each year during the term of this lease, percentage rental determined by (i) multiplying the total gross sales made in or from the Demised Premises during the particular calendar year by the percentage rental rate stated in Section 1.1(k), and (ii) subtracting from the resulting product the minimum guaranteed rental paid by Tenant to Landlord for the calendar year. The percentage rental shall be paid in monthly installments as follows: On or before the 10th day of each calendar month during the term of this lease, Tenant shall pay to Landlord, after deducting therefrom the minimum guaranteed

rental paid for the preceding calendar month, an amount equal to the product of the specified percentage rental rate multiplied by the total gross sales made in or from the Demised Premises during that month. If the total monthly payments of percentage rental for any calendar year do not equal the annual percentage rental computed on the amount of gross sales for the calendar year in accordance with the specified rate, Tenant shall pay the deficiency to Landlord, or Landlord shall refund the overpayment to Tenant, as the case may be, within 60 days after the end of the calendar year. The rent to be paid by Tenant and retained by Landlord for any calendar year shall not be less than the annual minimum guaranteed rental specified above.

(b) If the designation of a percentage rental rate in Section 1.1(k) includes a breakpoint of gross sales (e.g., "5 percent of gross sales over \$100,000"), then: (a) subsection (ii) in the first sentence of this Section 4.3 shall be deemed to have been deleted and all other formula references in this Article IV adjusted accordingly, (b) the breakpoint shall be divided by 12 for purposes of computing monthly percentage rental installments in the second sentence of Section 4.3, and (c) during all periods when minimum guaranteed rentals are reduced (e.g., under Section 15.4 or Section 16.2) the breakpoint shall be reduced proportionately.

4.4. *Partial calendar years.* If this lease commences on a date other than the first day of a calendar year or terminates on a date other than the last day of a calendar year, percentage rental for the fractional part of the calendar year following the Commencement Date or preceding the termination date, as the case may be, shall be paid at the specified rate for all sales made during the fractional part that, after deducting from the percentage rental all payments of minimum guaranteed rental for the fractional period. The percentage rental shall be paid in monthly installments as provided above with respect to full calendar years.

4.5. *Gross sales.* The term "gross sales" as used herein shall be construed to include the entire amount of the sales price whether for cash or otherwise, of all sales of merchandise (including gift and merchandise certificates), services and other receipts whatsoever of all business conducted in or from the Demised Premises, including mail or telephone orders received or filled at the Demised Premises, deposits not refunded to purchasers, orders taken (even if they are filled elsewhere), sales to employees, sales through vending machines or other devices, and sales by any sublease, concessionaire or licensee or otherwise in the premises. Each sale upon installment or credit shall be treated as a sale for the full price in the month during which the sale was made, regardless of when Tenant receives payment from its customer. No deduction shall be allowed for uncollected or uncollectible credit accounts. Gross sales shall not, however, include the following: amounts collected and paid out for any sales or excise tax imposed by a duly constituted governmental authority; the exchange of merchandise between Tenant's stores if made solely for the convenient operation of its business, and not for the purpose of consummating a previous sale, or of depriving Landlord of the benefit of a sale which would otherwise be made, in or from the Demised Premises; returns to shippers or manufacturers; cash or credit refunds on sales if all or part of the merchandise is later returned by the purchaser and accepted by Tenant; and sales of Tenant's fixtures.

4.6. *Late payment penalty.* The minimum guaranteed rental shall be payable on or before the first day of the month (in accordance with Section 4.2). Percentage rental shall be payable on or before the 10th day of each calendar month, without any offset or deduction. If either rental is not received within 10 days after its due date for any reason, the amount due shall bear interest at the maximum contractual rate that could legally be charged if a loan of the rental were made to Tenant in the state where the Demised Premises are located (but not to exceed 11/2 percent per month). This interest shall accrue continuously on any unpaid balance due to Landlord by Tenant during the period commencing with the above due date and terminating with the date on which Tenant makes full payment of all amounts owing to Landlord at the time of payment. Any such increase shall be payable as additional rent hereunder, shall not be considered as a deduction from percentage rental, and shall be payable immediately on demand.

4.7. *Partial acceleration.* If Tenant fails in two consecutive months to make rental payments within ten days after due, Landlord, in order to reduce its administrative costs, may require, by giving written notice to Tenant, that minimum guaranteed rentals be paid in advance quarterly instead of monthly, that all future rental payments be made on or before

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the due date by cash, cashier's check, or money order, and that delivery of Tenant's personal or corporate check no longer constitutes a payment of rental under this lease. (The above rights are in addition to Landlord's right under Section 4.6 to receive accrued interest, as well as its other rights and remedies accruing under other terms, provisions, and covenants (including Articles XIX and XX) of this lease). Any subsequent acceptance by Landlord of a monthly rental payment or a personal or corporate check shall not be construed as a waiver of its rights.

Article V Sales Reports and Records

5.1. *Certified sales statements.* On or before the tenth day of each calendar month during the term of this lease, Tenant shall prepare and deliver to Landlord at the place where rental is then payable a certified statement of gross sales made during the preceding calendar month. In addition, within 60 days after the expiration of each calendar year, and within 60 days after the termination of this lease if it does not terminate at the end of a calendar year, Tenant shall prepare and deliver to Landlord at the place rental is then payable a statement of gross sales during the preceding calendar (or partial calendar) year, certified to be correct by an independent certified public accountant. Tenant shall furnish similar statements for its licensees, concessionaires, and subtenants. All statements shall be in the form required by Landlord.

5.2. *Books and records.* Tenant shall keep in the Demised Premises or at some other location in the city where they are located a permanent, accurate set of books and records of all sales of merchandise and revenue derived from business conducted in the Demised Premises, and all supporting records such as tax reports and banking records. All books and records shall be retained and preserved for at least 24 months after the end of the calendar year to which they relate and be subject to inspection and audit by Landlord and its agents at all reasonable times.

5.3. *Audit; adjustments.* If Landlord is not satisfied with the statements of gross sales submitted by Tenant, Landlord may have its auditors make a special audit of all books and records wherever located pertaining to sales made in or from the Demised Premises. If the statements are found to be incorrect by more than 2 percent over the figures submitted by Tenant, it shall pay promptly to Landlord any deficiency, or Landlord shall promptly refund to it any overpayment, as the case may be, established by the audit. In either case, however, Tenant shall pay for the audit.

Article VI Common Areas

6.1. *Common area; parking.* The term "Common area" is defined for all purposes of this lease as that part of the Shopping Center, including applicable facilities, that are intended for the common use of all tenants. For purposes of this definition, facilities include the parking area, private streets and alleys, landscaping, curbs, loading area, sidewalks, malls and promenades (enclosed or otherwise), lighting facilities, drinking fountains, meeting rooms, public toilets, and the like. Not included, however, are space in existing or future buildings designed for commercial rental purposes and streets and alleys maintained by a public authority. Landlord may from time to time change the dimensions and locations of the Common Area, as well as the dimensions, identity, and type of all buildings in the Shopping Center. Tenant, and its employees and customers, when duly authorized under the provisions of this lease, its subtenants, licensees, and concessionaires, shall have the nonexclusive right to use the Common Area as constituted from time to time. The use shall be in common with Landlord, other tenants to the Shopping Center, and other persons permitted by Landlord to use the Shopping Center. The use shall be subject to all reasonable rules and regulations prescribed by Landlord, including the designation of specific areas within the Shopping Center or in reasonable proximity to it for parking automobiles owned by Tenant and its employees, subtenants, licensees, and concessionaires. In this regard, Tenant shall furnish to Landlord, at its request, a complete list of the license numbers of all automobiles operated by Tenant and its employees, subtenants, licensees, and concessionaires. If automobiles or other vehicles owned or operated by Tenant or the above persons are at any time parked in a part of the Shopping Center that is not specifically designated for employee parking, Tenant shall pay to Landlord, as additional rent, an amount equal to the daily or hourly charge established by Landlord for each automobile or other vehicle so parked. Tenant shall not solicit business

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within the Common Area or take any action that would interfere with the rights of other persons to use it. Landlord may temporarily close any part of the Common Area for any period necessary to make repairs or alterations or to prevent the public from obtaining prescriptive rights.

6.2. *Substitute parking.* Landlord may from time to time substitute for any parking areas other areas, whether elevated, surface, or underground, reasonably accessible to tenants of the Shopping Center.

6.3. *Management and maintenance.* Landlord shall be responsible for the operation, management, and maintenance of the Common area. The manner of and expenditures for maintenance shall be in Landlord's sole discretion.

6.4. *Common area charges.* In addition to rentals and other charges prescribed in this lease, Tenant shall pay to Landlord Tenant's proportionate share of the cost incurred by Landlord of operating and maintaining the Common Area, including costs for lighting, painting, cleaning, policing, inspecting, repairing, and replacing, and for heating and cooling any enclosed mall or promenade in the Shopping Center, as well as a reasonable allowance for Landlord's overhead costs, for depreciation of maintenance equipment, and the cost of hazard insurance. However, such costs shall not include general real estate taxes, assessments, and depreciation of Landlord's original investment. Tenant's proportionate share of the cost of operating and maintaining the Common Area shall be computed on the ratio that the total ground floor area of the Demised Premises bears to the total ground floor area of all buildings within the Shopping Area. However, Tenant's share shall not be less than the amount specified in Section 1.1(l) above. Tenant shall make the payments to Landlord on demand, at monthly or longer intervals. Landlord may require Tenant to pay in advance monthly or other periodic charges based upon the estimated annual cost of operating and maintaining the Common Area. However, such charges shall be subject to adjustment after the end of the year on the basis of the actual cost for that year.

Article VII Use and Care of Premises

7.1. *Use; name; continuous operation.* The Demised Premises may be used only for the purpose or purposes specified in Section 1.1(o) unless Landlord gives prior written consent. In transacting business in the Demised Premises Tenant shall use only the trade name specified in Section 1.1(e) unless Landlord gives prior written consent. Tenant shall not at any time leave the Demised Premises vacant, but shall in good faith continuously throughout the term of this lease conduct and carry on the type of business for which the Demised Premises are leased. Tenant shall operate its business in an efficient, high class, and reputable manner so as to produce maximum sales from the premises. Tenant shall also, except during reasonable periods for repairing, cleaning, and decorating, keep the premises open to the public for business and have adequate personnel in attendance on all days and during all hours (including evenings) established by Landlord as store hours for the Shopping Center, and during all other hours the Center is open to the public for business, except when Tenant is prohibited from being open for business by applicable law, ordinance, or governmental regulation.

7.2. *Compliance with insurance requirements.* Tenant shall not, without Landlord's prior written consent, keep anything within the premises or use the premises for any purpose which increases the insurance premium cost or invalidates any insurance policy carried on the Demised Premises or other parts of the Shopping Center. All property kept, stored or maintained within the premises by Tenant shall be at its sole risk.

7.3. *Discount sales; nuisance.* Tenant shall not do any of the following acts: conduct within the Demised Premises any fire, auction, bankruptcy, "going-out-of-business," "lost-our-lease," or similar sales or operate within the Demised Premises a "wholesale" or "factory outlet" store, a cooperative store, a "second hand" store, a "surplus" store or a store commonly referred to as a "discount house"; advertise that it sells its products or services at "discount," "cut price," or "cut-rate" prices; permit any objectionable or unpleasant odors to emanate from the premises; place or permit any radio, television, loudspeaker or amplifier on the roof or outside the Demised Premises or where it can be seen or heard from

outside the building; place any antenna, awning or other projection on the exterior of the Demised Premises; take any other action that would constitute a nuisance or would disturb or endanger other tenants of the Shopping Center or unreasonably interfere with their use of their respective premises; or do anything that would tend to injure the reputation of the Shopping Center.

7.4. *Rubbish.* Tenants shall take good care of the Demised Premises and keep them free from waste at all times. Tenants shall keep the Demised Premises and sidewalks, serviceways and loading areas adjacent to the premises neat, clean and free from dirt or rubbish at all times, and shall store all trash and garbage within the premises, arranging for the regular pick up of such trash and garbage at Tenant's expense. Receiving and delivery of goods and merchandise and removal of garbage and trash shall be made only in the manner and areas prescribed by Landlord. Tenant shall not operate an incinerator or burn trash or garbage within the Shopping Center area.

7.5. *Display windows.* Tenant shall maintain all display windows in a neat, attractive condition, and shall keep all display windows, exterior electric signs and exterior lighting under any canopy in front of the Demised Premises lighted from dusk until 11:00 p.m. every day, including Sundays and holidays.

7.6. *Address in advertising.* Tenant shall include the address and identity of its business activities in the Demised Premises in all advertisements made by Tenant in which the address and identity of any similar local business activity of Tenant is mentioned.

7.7. *Licenses.* Tenant shall procure at its expense all permits and licenses required for the transaction of business in the Demised Premises and otherwise comply with all applicable laws, ordinances, and governmental regulations.

Article VIII Maintenance and Repair of Premises

8.1. *Landlord obligations.* Landlord shall keep the foundation, the exterior walls (except plate glass windows, doors, door closure devices and other exterior openings; window and door frames, molding, locks, and hardware; special store fronts; lighting, heating, air-conditioning, plumbing and other electrical, mechanical and electromotive installation, equipment and fixtures, signs, placards, decorations or advertising media of any type; and interior painting or other treatment of exterior walls) and roof of the Demised Premises in good repair. Landlord, however, shall not be required to make any repairs caused by the act or negligence of Tenant or of its agents, employees, subtenants, licensees, or concessionaires, subject, however, to the provisions of Articles XV and XVI of this lease. Tenant shall give Landlord immediate written notice of all repairs that Landlord is required to make on or in the Demised Premises, but it shall have a reasonable time after receipt of the notice to make the necessary repairs.

8.2. *Tenant obligations.* Tenant shall keep the Demised Premises in good, clean, and habitable condition and at its expense free of insects, rodents, vermin, and other pests. Tenant shall also make all needed repairs and replacements (including replacement of cracked or broken glass), except for those required of Landlord under Section 8.1 and Articles XV and XVI. Without limiting the foregoing, Tenant shall repair and replace all lighting, heating, air-conditioning, plumbing, and other electrical, mechanical, and electromotive installation, equipment, and fixtures, make all utility repairs in ducts, conduits, pipes, and wiring, and clear up any sewer stoppage located in, under, and above the Demised Premises. If Tenant does not make a required repair within 10 days after it receives Landlord's written notice, Landlord may make the repair without liability to Tenant for resulting loss or damage to Tenant's stock or business. In that case, Tenant shall pay to Landlord upon demand, as additional rent under this lease, the cost of repairs plus the maximum contractual interest (not to exceed 11/2 percent per month) that Landlord could charge to Tenant for a comparable loan in the state where the Demised Premises are located. Such interest shall accrue continuously from the date of payment by Landlord until repayment by Tenant. Upon expiration of the lease, Tenant shall surrender the Demised Premises in good condition, excepting reasonable wear and tear and losses required to be restored by Landlord under Section 8.1 and Articles XV and XVI.

Article IX Alterations

9.1. *Tenant installations.* Tenant shall not make any alterations, additions or improvements, to the Demised Premises without Landlord's prior written consent, except for the installation of unattached, movable trade fixtures, which may be installed without drilling, cutting or otherwise defacing the premises. All alterations, additions, improvements and fixtures (other than Tenant's unattached, readily movable furniture and office equipment) made or installed by either party upon the Demised Premises shall remain upon and be surrendered with the premises and become Landlord's property upon the termination of this lease. However, if Landlord requests removal of the above installations, Tenant shall at its expense do so and restore the premises to their original condition.

9.2. *Construction work.* All construction work done by Tenant within the Demised Premises shall be performed in a good and workmanlike manner, in compliance with all governmental requirements, and in a manner that causes a minimum of interference with other construction in progress and with the transaction of business in the Shopping Center. Tenant shall indemnify Landlord and hold it harmless from and against all loss, liability, or damage resulting from Tenant's work, and shall, if requested by Landlord, furnish satisfactory bond or other security against such loss, liability, or damage.

Article X Landlord's Right of Access, Use of Roof

10.1. *Access.* Landlord may enter upon the Demised Premises at any time for the purposes of inspection, repairs, alterations, or additions to adjacent premises, or to show the Demised Premises to prospective purchasers, lessees, or lenders.

10.2. *"For Sale" or "For Lease" signs.* Landlord may place and maintain "For Rent" or "For Lease" signs on the Demised Premises during the last 90 days of the lease term. The signs shall not affect Tenant's obligations under Section 7.3, Article XI, or any other provision of this lease.

10.3. *Roof.* Landlord shall have exclusive use of the roof above the Demised Premises.

Article XI Signs, Store Fronts

11.1. Tenant shall not, without Landlord's prior written consent, (a) make any changes to the store front, (b) install any exterior lighting decorations, paintings, awnings, canopies, or the like, or (c) erect or install any signs, window or door lettering, placards, decorations or advertising media of a type which can be viewed from the exterior of the Demised Premises, excepting only dignified displays of customary type for its display windows. All signs, lettering, placards, decorations and advertising media shall conform in all respects to the sign criteria established by Landlord for the Shopping Center, from time to time, and be subject to its prior written approval as to construction, method of attachment, size, shape, height, lighting, color and general appearance. All signs shall be kept in good condition and in proper operating order at all times.

Article XII Utilities

12.1. *Utility conduits.* Landlord shall cause to be provided and maintained all necessary mains, conduits, and other facilities for the supply of water, gas, electricity, telephone service, and sewerage service to the Demised Premises.

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12.2. *Tenant expense.* Tenant shall promptly pay all charges for electricity, water, gas, telephone service, sewerage service, and other utilities furnished to the Demised Premises. Landlord may furnish one or more utility services to Tenant. In such event, Tenant shall purchase the use of all such services and pay on demand as additional rent the rates established for them by Landlord. The rates shall not exceed those that local public utility companies would charge for directly furnishing the same services. Landlord may at any time discontinue a service without obligation to Tenant other than to connect the Demised Premises to the public utility furnishing such service.

12.3. *Interrupted service.* Landlord shall not be liable for any interruption in utility services not furnished by it, or for interruptions in utility services furnished by it that are due to fire, accident, strike, acts of God, or other causes beyond its control or are necessary to make alterations, repairs, or improvements.

Article XIII Indemnity and Public Liability Insurance

13.1. *Release and indemnity.* Landlord shall not be liable to Tenant, its employees, agents, or visitors, or any other person for injury to person or damage to property on or about the Demised Premises or the Common Area, if: caused by the negligence or misconduct of Tenant, its employees, subtenants, licensees, or concessionaires, or any other person entering the Shopping Center under Tenant's express or implied invitation; arising out of Tenant's use of the premises and the conduct of its business therein; or arising out of a breach or default by Tenant in performing its obligations under this lease. Tenant shall indemnify Landlord and hold it harmless from and against all losses, expenses, or claims arising out of such damage or injury.

13.2. *Public liability insurance.* Tenant shall procure and maintain throughout the term of this lease a policy or policies of insurance, at its expense, insuring both Landlord and Tenant against all claims, demands, or actions arising out of or in connection with Tenant's use or occupancy of the Demised Premises or by the condition of the Demised Premises. Each policy shall have a limit of at least \$200,000 for injuries to or death of any one person, \$500,000 for any one accident or disaster, and \$100,000 for damage or destruction to property, and shall be written by an insurance company satisfactory to Landlord. Tenant shall obtain a written obligation from each insurance company that it will notify Landlord at least 10 days before the insurance is cancelled. The policies or duly executed certificates of insurance shall be promptly delivered to Landlord, and all required renewals thereof shall be delivered to Landlord at least 30 days before the respective policy terms expire. If Tenant fails to comply with the above requirements, Landlord may obtain the insurance. In that case, Tenant shall pay to Landlord on demand, as additional rent under this lease, the premium cost of the insurance plus interest at the maximum contractual rate (not to exceed 11/2 percent per month) from the date of payment by Landlord until repayment by Tenant.

Article XIV Nonliability for Certain Damages

14.1. Neither Landlord nor its agents or employees shall be liable to Tenant for any injury to person or damage to property caused by the Demised Premises or other portions of the Shopping Center becoming out of repair, by defect or failure of any structural element of the Demised Premises or of any equipment, pipes, or wiring, by broken glass, by the backing up of drains, or by gas, water, steam, electricity, or oil leaking, escaping, or flowing into the Demised Premises, except when due to Landlord's wilful failure to make required repairs within a reasonable time after it receives written notice that repairs are needed. Landlord also shall not be liable to Tenant for any loss or damage occasioned by or through the acts or omissions of other tenants of the Shopping Center or of other persons, other than Landlord's duly authorized employees and agents.

Article XV Damages by Casualty

15.1. *Notice.* Tenant shall give immediate written notice to Landlord of any damage caused to the Demised Premises by fire or other casualty.

15.2. *Repair or termination.* If the Demised Premises are damaged or destroyed by fire or other casualty insurable under standard fire and extended coverage insurance and Landlord does not elect to terminate this lease (as provided below), it shall proceed with reasonable diligence and at its expense to repair or rebuild the Demised Premises. Landlord may either terminate this lease or proceed to repair or rebuild the Demised Premises if: (a) the building in which the Demised Premises are located is destroyed or substantially damaged by a casualty not covered by Landlord's insurance; (b) the building is destroyed or made untenable to the extent of over 50 percent of the first floor area by a casualty covered by Landlord's insurance; or (c) the holder of a mortgage, deed of trust, or other lien on the Demised Premises at the time of the casualty elects, under such particular lien, that all or part of Landlord's insurance proceeds be used in satisfaction of all or part of the indebtedness secured by the lien. Landlord shall give written notice to Tenant of the election within 60 days after the casualty occurs. If Landlord elects to rebuild or repair it shall proceed to do so with reasonable diligence and at its expense.

15.3. *Restoration work.* Landlord's above obligation to rebuild or repair shall be limited to restoring (a) the Demised Premises to substantially the same condition as before the casualty, exclusive of any alterations, additions, improvements, fixtures, and equipment installed by Tenant; or (b) Landlord's work (if any) to substantially the same condition as before the casualty, as the case may be. Promptly after Landlord completes the work, Tenant shall proceed with reasonable diligence and at its expense to restore, repair, and replace all alterations, additions, improvements, fixtures, signs, and equipment installed by or belonging to Tenant.

15.4. *Store operation; rent abatement.* During any period of reconstruction or repair, Tenant shall continue to operate its business within the Demised Premises to the extent practicable. During the period from occurrence of the casualty until Landlord's completion of the repairs, the minimum guaranteed rental shall be reduced by an amount that is fair and reasonable under the circumstances. However, there shall be no abatement of the percentage rental or other charges provided for in this lease.

Article XVI Eminent Domain

16.1. *Substantial taking.* This lease shall terminate if more than 30 percent of the floor area of the Demised Premises is taken for any public or quasi-public use under a governmental law, ordinance, or regulation, or by right of eminent domain or by private purchase in lieu thereof. In any such case, the rent shall be abated during the unexpired portion of the lease, effective on the date the condemning authority takes physical possession.

16.2. *Partial taking.* This lease shall not terminate if less than 30 percent of the floor area of the Demised Premises is taken as provided in Section 16.1. However, the minimum guaranteed rental (but not percentage rental) payable during the unexpired portion of this lease shall be reduced in proportion to the area taken, effective on the date the condemning authority takes physical possession. Following the partial taking, Landlord shall make all necessary repairs or alterations to the remaining premises or within the scope of its work, as the case may be, to make the remaining portions of the Demised Premises an architectural whole.

16.3. *Common area.* If any part of the Common Area is taken as provided above, this lease shall not terminate and the rent payable hereunder shall not be reduced. However, either Landlord or Tenant may terminate this lease if the area of the Common Area following the taking plus any additional parking area provided by Landlord in reasonable proximity to the Shopping Center is less than 70 percent of the area of the Common Area immediately before the taking. Either party may evidence its election to terminate this lease by delivering written notice of termination to the other within 30 days after the condemning authority takes physical possession.

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16.4. *Condemnation proceeds.* All compensation awarded for any taking (or the proceeds of private sale in lieu thereof) of the Demised Premises or Common Area shall be the property of Landlord, and Tenant hereby assigns its interest in any such award to Landlord. However, Landlord shall have no interest in any separate award made to Tenant for its moving and relocation expenses or for the loss of its fixtures and other tangible personal property.

Article XVII Assignment and Subletting

17.1. *Consent required; non-waiver.* Tenant shall not assign or in any other manner transfer this lease or any estate or interest therein, sublet all or part of the Demised Premises, or grant a license, concession, or other right of occupancy of any portion of the Demised Premises without Landlord's prior written consent. Landlord's consent to one or more assignments or sublettings shall not operate as a waiver of its rights as to any subsequent assignment or subletting.

17.2. *Corporate stock transfers.* If Tenant is a corporation and at any time during the primary term (or any renewal or extension) of this lease the majority owner or owners of either the outstanding voting shares or all outstanding shares of Tenant's capital stock at the time of execution of this lease cease to own a majority of the shares (except as the result of transfers by devise or descent), the loss of majority status shall be deemed an assignment of this lease by Tenant and therefore subject in all respects to the provisions of Section 17.1. The previous sentence shall not apply, however, if at the time of execution of this lease the outstanding voting shares of Tenant's capital stock are listed on a recognized security exchange or over the counter market.

17.3. *No release; excess rent.* Notwithstanding any assignment or subletting, Tenant and any guarantor of its obligations under this lease shall remain fully responsible and liable for the payment of rent and compliance with all of its obligations hereunder (even if future assignments and sublettings occur after the assignment or subletting by Tenant, and regardless of whether Tenant's approval has been approved for them). Moreover, Tenant shall be bound and obligated to pay Landlord the following excess amounts: if the rental due and payable by a sublessee for both the sublease rental and any bonus or other consideration for or incident to it exceeds the rental payable under this lease; or, if respect to an assignment, license, or other transfer by Tenant permitted by Landlord, the consideration payable to Tenant by the assignee, licensee, or other transferee exceeds the rental payable under this lease. Tenant shall pay Landlord the excess rental and other excess consideration within 10 days after its receipt from the sublessee, assignee, licensee, or other transferee. If there is any assignment or subletting, Tenant shall receive all rentals paid to it by the assignee or sublessee in trust for Landlord, and shall forward the amounts immediately to Landlord without offset or reduction of any kind. Landlord may require Tenant to pay such rentals directly to it as specified in Section 4.1, in which case they shall be applied as a credit and offset to Tenant's rental obligations.

17.4. *Leasehold mortgages.* Tenant shall not mortgage, pledge, or otherwise encumber its interest in this lease or in the Demised Premises.

17.5. *Landlord assignment.* If Landlord assigns and transfers its interest in this lease and in the building containing the Demised Premises to a person expressly assuming its obligations under the lease, Landlord shall thereby be released from all further obligations hereunder, and Tenant shall look solely to Landlord's successor in interest for performance of the obligations. Landlord may assign and transfer to the successor in interest any security given by Tenant to secure performance of its obligations under this lease, and Landlord shall thereby be discharged of all further related obligations.

Article XVIII Taxes and Insurance

18.1. *Personal property taxes.* Tenant shall be liable for all taxes levied against personal property and trade fixtures placed by it in the Demised Premises. If the taxes are levied against Landlord or its property and it elects to pay them, or

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if the assessed value of Landlord's property is increased by inclusion of personal property and trade fixtures placed by Tenant in the Demised Premises and Landlord elects to pay the taxes based on the increase, Tenant shall pay to Landlord upon demand that part of the taxes for which Tenant is primarily liable under this lease.

18.2. *Real estate and general tax increases.* Except as provided in Sections 18.1 and 18.3, Landlord shall pay or cause to be paid all general real estate taxes, general and special assessments, parking surcharges, and other governmental charges (collectively "the general taxes") levied against the Shopping Center for each real estate tax year. However, if during any real estate tax year of the primary term (or its renewal or extension) of this lease the general taxes levied against the Shopping Center (or against the Demised Premises, if separately assessed) for that year exceed the general real estate taxes levied against the Shopping Center (or the Demised Premises) for the base real estate tax year, Tenant shall pay to Landlord upon demand, and in addition to the rentals and other charges prescribed in this lease, the entire increase attributable to the Demised Premises. The term "base real estate tax year" means the real estate tax year during which the Demised Premises were originally occupied by Tenant under this lease or any other property. However, if this lease requires Tenant to construct a new building, and Landlord's work on the building is completed more than 60 days after the initial date of a real estate tax year, "base real estate tax year" means the real estate tax year immediately following the one in which Landlord completes its work. The term "increase attributable to the Demised Premises" is defined in Section 18.5, except that if the Demised Premises are separately assessed in either the base real estate tax year or the subsequent year in question, or both, the computations in Section 18.5 shall be modified accordingly. Tenant's payment for the real estate tax year in which this lease terminates shall bear the same ratio to payment which would be required to be made for the full tax year as the number of days of the tax year which elapsed prior to termination of this lease bears to a full tax year.

18.3. *Rent or other taxes.* If at any time during the primary term of this lease or any renewal or extension thereof a tax or excise on rents or other tax however described (except any franchise, estate, inheritance, capital stock, income or excess profits tax imposed upon Landlord) is levied or assessed against Landlord by any lawful taxing authority on account of Landlord's interest in this lease or the rents or other charges reserved hereunder, as a substitute in whole or in part, or in addition to the general taxes described in Section 18.2, Tenant shall pay to Landlord upon demand, and in addition to the rentals and other charges prescribed in this lease, the amount of the tax or excise. If the tax or excise is levied or assessed directly against Tenant, it shall be responsible for and pay the tax or excise whenever and in the manner required by the taxing authority.

18.4. *Increases in insurance premiums.* If at any time during the primary term of this lease or its renewal or extension the premiums for liability insurance, fire and extended coverage insurance, or both, carried by Landlord covering the Shopping Center (the "insurance premiums") exceed the insurance premiums for the base insurance term, Tenant shall pay to Landlord upon demand, and in addition to the rentals and other charges prescribed in this lease, the entire increase attributable to the Demised Premises. The term "base insurance term" means the period commencing with the date the Demised Premises were originally occupied by Tenant under this lease or any prior lease (or, if later the date on which Landlord commenced to carry insurance on the Shopping Center) and ending on the date at which the amount of insurance premiums is increased from the amount at the commencement of the term. The term "increase attributable to the Demised Premises" is defined in Section 18.5 below. Tenant's payment for the insurance term in which this lease terminates shall bear the same ratio to the payment that would be required for the full insurance term as the number of days of the term that elapsed prior to termination of this lease bears to the full term.

18.5. *Formula for increase.* The amount of any increase of general taxes or insurance premiums attributable to the Demised Premises shall be computed in accordance with the following formula:

$$I = (A \times B + C \times D) \times F$$

"I" equals the dollar amount of any increase which is attributable to the Demised Premises; "A" equals the amount of

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general taxes or insurance premiums accruing during the period in question (prorated, if necessary, to provide a period of like duration to the base real estate tax year or base insurance term, as the case may be; "B" equals the total leaseable ground floor area of all buildings in the Shopping Center at the commencement of the period in question; "C" equals the amount of general real estate taxes or insurance premiums which accrued during the base real estate tax year or base insurance term; "D" equals the total leaseable ground floor area of all buildings in the Shopping Center either at the beginning of the base real estate tax year or base insurance term, or, if later, when Tenant originally occupied the Demised Premises; and "F" equals the total square feet included in the Demised Premises.

18.6. *Prepayment.* If at any time during the primary term of this lease or its renewal or existence Landlord has reason to believe that at some time within the immediately succeeding taxable month period, Tenant will owe Landlord a payment pursuant to one or more of the preceding sections of this Article XVIII, Landlord may direct that Tenant prepay monthly a pro rata portion of the prospective future payment (i.e., the prospective future payment divided by the number of months before the prospective future payment will be due). Any prepayment directed by Landlord shall be due and payable monthly on the same day that minimum guaranteed rental is due.

Article XIX Default by Tenant and Remedies

19.1. *Default and remedies.* The following events shall be deemed to be events of default by Tenant under this lease:

- (1) Tenant fails to pay any installment of rent or other obligation hereunder involving the payment of money and the failure continues for ten days after the date due.
- (2) Tenant fails to comply with any term, provision or covenant of this lease, other than as described in subsection (1) above, and does not cure the failure within 15 days after written notice thereof to Tenant.
- (3) Tenant or any guarantor of its obligations under this lease becomes insolvent, makes a transfer in fraud of creditors, or makes an assignment for the benefit of creditors.
- (4) Tenant or any guarantor of its obligations under this lease files a petition under any section or chapter of the National Bankruptcy Act, as amended, or under any similar federal or state law or statute, or Tenant or any guarantor of its obligations under this lease is adjudged bankrupt or insolvent in proceedings filed against Tenant or any guarantor of its obligations under this lease.
- (5) A receiver or Trustee is appointed for the Demised Premises or for all or substantially all of the assets of Tenant or of any guarantor of its obligations under this lease.
- (6) Tenant deserts or vacates, or commences to desert or vacate, all or a substantial portion of the Demised Premises, or removes or attempts to remove, without Landlord's prior written consent, all or a substantial portion of Tenant's goods, wares, equipment, fixtures, furniture, or other personal property.
- (7) Tenant does or permits to be done anything that creates a lien upon the premises.

If any of the above events of default occur, Landlord may pursue either of the following alternative remedies:

A. Without any notice or demand, Landlord may take any action or actions permissible at law to insure performance by Tenant of its covenants and obligations under this lease. If Tenant deserts or vacates the Demised Premises, Landlord may enter upon and take possession in order to protect them from deterioration and continue to demand from Tenant the monthly rentals and other charges provided in this lease, without any obligation to relet. Moreover, if Landlord elects to relet the Demised Premises, that action shall not be deemed an acceptance of Tenant's surrender of them unless

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Landlord expressly notifies Tenant otherwise in writing pursuant to subsection B below. Landlord shall otherwise be reletting as Tenant's agent. Tenant shall pay Landlord on demand any deficiency between the monthly rentals and other charges provided in this lease that are actually collected by Landlord. If there is any default described in subsection (2) of this Section, Landlord may enter upon the Demised Premises, by force if necessary, without being liable for prosecution or any claim for damages, and do whatever Tenant is obligated to do under this lease. Tenant shall reimburse Landlord on demand for all expenses incurred by it in effecting compliance with Tenant's obligations hereunder, and Landlord shall not be liable for resulting damages to Tenant.

B. Landlord may terminate this lease by giving written notice to Tenant. In such event, Tenant shall immediately surrender the Demised Premises to Landlord. If Tenant fails to do so, Landlord may, without prejudice to any other remedy it may have for possession or arrearages in rent (including any accrued interest under Section 4.6), enter upon and take possession of the Demised Premises and expel or remove, by force if necessary, Tenant and any other person who is occupying all or a portion of the premises without being liable for prosecution or any claim for damages. Tenant hereby waives any statutory requirement of prior written notice for filing eviction or damage suits for nonpayment of rent. In addition, Tenant shall pay to Landlord on demand all loss and damage suffered by it by reason of any termination effected under this subsection B. The loss or damage shall be determined by either of the following alternative measures of damages:

(i) Until Landlord is able, through reasonable efforts the nature of which shall be at its sole discretion, to relet the Demised Premises, Tenant shall pay to it, on or before the first day of each calendar month, the monthly rentals and other charges specified in this lease. After Landlord relets the Demised Premises, Tenant shall pay to it, on the 20th day of each calendar month, the difference between the monthly rentals and other charges for the preceding calendar month and the amount actually collected by Landlord for that month. If Landlord is required to bring suit in order to collect a deficiency, it may allow the deficiency to accumulate and bring an action on several or all of the accrued deficiencies at one time. Such suit shall not prejudice in any way Landlord's right to bring a similar action for subsequent deficiencies. If the amount collected by Landlord from subsequent tenants for a calendar month exceeds the monthly rentals and other charges, the excess shall be credited to Tenant in reduction of its liability for any calendar month for which the amount collected is less than the monthly rentals and other charges. However, Tenant's right to the excess is limited to the above described credit.

(ii) Landlord may demand a final settlement at any time. Upon such demand, Tenant shall pay the difference between the monthly rentals and other charges provided in this lease for the remainder of the term and the reasonable rental value of the Demised Premises for that period. The difference shall be discounted to present value at the rate of interest agreed on by the parties, or, if there is no such agreement, at the rate allowed by law in the state designated by Section 28.9 (or, if there is no such law, at the rate of 12 percent per annum).

Landlord's election to exercise the remedy prescribed above in subsection A shall in no way prejudice its right at any later time to cancel the election in favor of the remedy provided in subsection B, if at the time of cancellation Tenant is still in default. Similarly, Landlord's election to compute damages in the manner prescribed above by subsection B(i) shall in no way prejudice its right at any later time to demand a final settlement in accordance with subsection B(ii). Pursuit of any of the above remedies shall not preclude pursuit of any other remedy provided elsewhere in this lease or by law. Landlord's forbearance to enforce any remedy provided herein upon an event of default shall not be deemed to constitute a waiver of the default.

19.2. *Other charges.* In determining "the monthly rentals and other charges provided in this lease," as that term is used in subsections A and B of Section 19.1, the minimum guaranteed rental (as specified in Section 1.1(j)) shall include the following: charges for maintenance of the Common Area (as specified in Section 6.4); charges for taxes and insurance (as specified in Article XVIII); and 1/2 percent of all percentage rentals required to be paid by Tenant (under Sections 4.3 and 4.4) because of gross sales during the two full calendar years immediately preceding the date Landlord initiated action under subsections A and B (or, if two full calendar years have not then elapsed, the minimum guaranteed rental

shall include the corresponding fraction of all percentage rentals required to be paid because of gross sales during the period from the Commencement Date of this lease to the date on which Landlord initiated the action).

19.3. *Landlord expenses.* In addition to the payments required by subsections A and B of Section 19.1, Tenant shall compensate Landlord for the following: all expenses incurred by Landlord in repossession (including any increase in insurance premiums caused by the vacancy of the Demised Premises), and in reletting (including repairs, remodeling, replacements, advertisements, and brokerage fees); all concessions granted to a new tenant upon reletting (including renewal options); all leases incurred by Landlord as a direct or indirect result of Tenant's default (including any adverse reaction by Landlord's mortgagee or by other tenants or potential tenants of the Shopping Center); and a reasonable allowance for Landlord's administrative efforts, salaries, and overhead attributable directly or indirectly to Tenant's default and Landlord's pursuing the rights and remedies provided under this lease and applicable law.

19.4. *Injunction; cumulative remedies.* Landlord may restrain or enjoin any breach or threatened breach of Tenant's covenants, duties, and obligations under this lease without having to prove the inadequacy of any legal remedy or irreparable harm. Landlord's remedies under this lease shall be deemed cumulative and not exclusive.

19.5. *Attorney's fees.* If Landlord is required, on account of a breach or default by Tenant in any obligation under this lease, to hire an attorney to present, enforce, or defend Landlord's rights or remedies under the lease, Tenant shall pay all reasonable attorney's fees incurred by Landlord in that connection.

19.6. *Security deposit.* Landlord hereby acknowledges receipt from Tenant of the sum stated in Section 1.1(m) (prepaid rental), to be applied to the first accruing installments of rent. Landlord further acknowledges receipt from Tenant of the sum stated in Section 1.1(n) (security deposit), to be held without interest as security for Tenant's performance of its covenants and obligations under this lease. The security deposit may be co-mingled with Landlord's other funds; it is not an advance payment of rental or a measure of Landlord's damages in case of Tenant's default. Whenever an event of default by Tenant occurs, Landlord may, without prejudice to any other remedy provided in this lease or by law, use the fund to the extent necessary to make good all arrears of rentals and other damage, injury, expense, or liability caused to it by the event of default. Tenant shall pay to Landlord on demand the amount so applied in order to restore the security deposit to its original amount. If Tenant is not then in default, Landlord shall return to Tenant the remaining balance of the deposit upon termination of this lease (subject to the provisions of Section 17.5).

Article XX Landlord's Contractual Security Interest

20.1. In addition to the statutory Landlord's lien, Landlord shall have at all times a valid security interest to secure payment of all rentals and other sums of money becoming due from Tenant under this lease, as well as all damages or loss which Landlord may suffer by reason of Tenant's breach of any covenant, agreement, or condition. Landlord's security interest shall be upon all of Tenant's goods, wares, equipment, fixtures, furniture, improvements, and other personal property presently or subsequently situated on the Demised Premises. Tenant shall not remove the property without Landlord's consent until it pays and discharges all arrearages in rent and other sums of money then due or to become due to Landlord and fully complies with and performs all of its covenants, agreements, and conditions. Whenever an event of default by Tenant occurs, Landlord may, in addition to any other remedy provided herein, enter upon the Demised Premises and take possession of all of Tenant's goods, wares, equipment, fixtures, furniture, improvements, and other personal property situated on the premises, without liability for trespass or conversion. Landlord may sell the property at public or private sale, regardless of whether it has the property there, after it gives Tenant reasonable notice of the time and place of sale. Landlord or its assigns may, unless otherwise prohibited by law, purchase any property at the sale. Unless otherwise provided by law, and without intending to exclude any other manner of giving Tenant reasonable notice, the requirement of reasonable notice shall be met if notice is given in the manner prescribed in this lease at least seven days before the time of sale. Any sale made under this paragraph shall be deemed to be a public sale conducted in a commercially reasonable manner if held in the above-described premises or where the

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property is located after the time, place, and method of sale and a general description of the types of property to be sold are advertised in a daily newspaper published in the county in which the property is located, for five consecutive days before the date of sale. The proceeds of the sale, less all expenses connected with the taking of possession, holding, and selling of the property (including reasonable attorney's fees and legal expenses), shall be applied as a credit against the indebtedness secured by the security interest granted in this paragraph. Any surplus shall be paid to Tenant or as otherwise required by law, and Tenant shall immediately pay all deficiencies. At Landlord's request, Tenant shall execute and deliver to it a financing statement in form sufficient to perfect Landlord's security interest in the above property and sales proceeds under the applicable provisions of the Uniform Commercial Code (or corresponding state statute) in the state in which the property is located, as well as under any other state law that Landlord considers to be applicable.

Article XXI Holding Over

21.1. If Tenant remains in possession of the Demised Premises after this lease expires and without executing a new lease, it shall be deemed to be occupying them as a tenant from month to month at a rental equal to 150 percent of the rental (including percentage rental) provided herein. Tenant shall also be subject to all the conditions, provisions, and obligations of this lease to the extent they are applicable to a month to month tenancy.

Article XXII Subordination

22.1. *Subordination.* Tenant accepts this lease subject and subordinate to any existing or subsequent mortgage, deed of trust, or other lien, or its renewal or extension, upon the Demised Premises or the Shopping Center as a whole. The mortgagee may at any time subordinate the mortgage, deed of trust, or other lien to this lease. However, notwithstanding that this lease may be (or made to be) superior to the mortgage, deed of trust, or other lien, the provisions of that lien relative to the mortgagee's rights with respect to proceeds arising from an eminent domain taking (including a voluntary conveyance by Landlord) or insurance payable by reason of damage to or destruction of the Demised Premises shall be prior and superior to contrary provisions in this instrument regarding the payment or usage thereof. Landlord shall have full and irrevocable power and authority to subordinate this lease to any future mortgage, deed of trust, or other lien placed upon the Demised Premises or the Shopping Center as a whole, and Tenant shall upon demand execute all further instruments requested by Landlord subordinating this lease. However, Landlord shall, upon Tenant's written request and notice to it, use good faith efforts to obtain the mortgagee's written agreement that Tenant's rights shall remain in full force and effect during the term of this lease so long as Tenant continues to recognize and perform all of its covenants and conditions.

22.2. *Tenant remedies.* Whenever the holder of an indebtedness secured by an outstanding mortgage, deed of trust, or other lien covering Landlord's interest in the Demised Premises gives Tenant written notice of its interest in this lease, Tenant may not exercise any remedies for Landlord's default until the holder receives written notice of the default and a reasonable time for curing the default has elapsed.

Article XXIII Merchants Association

23.1. If Landlord organizes a merchants association composed of tenants in the Shopping Center, Tenant shall join and maintain membership in the association, pay all dues and assessments fixed and determined by it, and comply with all its other bylaws, rules, and regulations.

Article XXIV Radius Restriction

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24.1. Tenant acknowledges that its monetary contribution to Landlord (in the form of rentals) and its general contribution to commerce within the Shopping Center (also important in Landlord's determination to execute this Lease with Tenant) will be substantially reduced if, during the term of this lease, either Tenant or any other person, firm, or corporation directly or indirectly controlling, controlled by, or under common control with it directly or indirectly operates, manages, conducts, or has any interest in any establishment within commercial proximity of the Shopping Center. Accordingly, during the term of this lease, neither Tenant nor any of the above persons (and also, if Tenant is a corporation, any officer or director or shareholder owning more than 10 percent of its outstanding stock, or any parent, subsidiary, related, or affiliated corporation) shall directly or indirectly operate, manage, conduct, or have any interest in any commercial establishment within three miles of the Shopping Center. However, any commercial establishment existing at the date of this lease may continue to be operated, managed, conducted, and owned in the same manner as at that date, if there is no change in its size or trade name.

Article XXV Notices

25.1. *Written notice.* Any notice required or permitted under this lease shall be in writing. The notice, or any other required or permitted document, shall be deemed to be delivered when actually received by the designated addressee, or, if earlier (and regardless of whether actually received), when deposited in the United States Mail, postage prepaid, Certified Mail, Return Receipt Requested. The notice or document shall be addressed to the parties at their respective addresses set forth in Section 1.1 (or, if Landlord so elects, to Tenant at the Demised Premises), or at any other address previously specified by them by written notice.

25.2. *Agent for notice purposes.* Whenever the term "Landlord" or "Tenant" is used in this instrument to include more than one person, firm, or corporation, all such parties shall arrange for the joint execution of the notice and specify an individual and address for the receipt of notices and payments to Landlord or Tenant, as the case may be. All parties included within the terms "Landlord" and "Tenant," respectively, shall be bound by notices and payments given in accordance with the provisions of this Article to the same effect as if each had received the notice or payment.

Article XXVI Commissions

26.1. Landlord shall pay its Agent, Marshall Development Associates ("Agent"), a commission for negotiating this lease. Agent's right to receive the commission (and rentals as provided in Section 4.1 for deduction of applicable commissions before forwarding to Landlord) shall irrevocably vest upon the execution of this lease, notwithstanding any subsequent default by Landlord or Tenant or any amendment, modification, or termination of this lease. Landlord also shall pay Agent additional commissions on all renewals, extensions, holdovers, new leases, or rental agreements (as long as Tenant continues to occupy all or a portion of the Demised Premises), as well as expansions or substitutions of lease space within the Shopping Center, made by Landlord with Tenant or its subtenants or assignees. Landlord shall pay all of the commissions to Agent at its principal office in Dallas, Texas. The commissions shall be six percent of guaranteed minimum and percentage rental, as well as other fees and charges due over the term of this lease. In addition, if Tenant or any assignee or subtenant purchases the Demised Premises (separately or together with all or a portion of the Shopping Center) under a contract entered into at any time before the tenth year of this lease, Landlord shall pay to Agent an additional sales commission of six percent of the gross sales price for the property purchased. Agent shall be granted a lien against Landlord's entire interest in the Shopping Center property to secure payment of the commissions (including not only the original commission payable hereunder, but also all additional commissions that may later become payable by reason of renewals, new leases, rental agreements, sales, or otherwise). Agent's lien shall be subordinate to Tenant's rights under this lease (except for Agent's rights as provided in the preceding sentence), but shall be prior and superior, except as provided in the following sentence, to subsequent liens created against the Shopping Center. Agent's lien shall be subordinate and inferior to all liens in favor of banks, insurance companies, building and loan associations, and similar regulated financial institutions ("institutions") securing indebtedness.

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incurred for the purpose of acquiring the Shopping Center or constructing, repairing, rebuilding, or remodeling buildings and other improvements on it, if the institutions recognize Agent's rights under this lease and acknowledge that the rights will be preserved in any foreclosure or similar proceeding. The above provisions shall be binding upon Landlord and its heirs, personal representatives, assigns, and successors in interest, and inure to the benefit of Agent and its successors in interest. If Landlord makes an assignment of this lease or there is a sale of all or a portion of the Demised Premises, Landlord and the assignee or purchaser, and their respective assigns and successors, shall be jointly and severally liable for all commissions due or to become due under this lease. However, if Landlord causes the assignee or purchaser to assume and agree to perform, in writing delivered to Agent before the transfer, Landlord's covenants, duties, and obligations under this section, Landlord shall be released whenever the assignee or purchaser commences performance under the assumption. If Agent employs an attorney to present, enforce, or defend its rights hereunder, the party against whom the rights are presented, enforced, or defended shall pay all reasonable attorney's fees incurred by Agent in that connection.

Article XXVII Government Regulations

27.1. *Government regulations.* Landlord and Tenant acknowledge that there are in effect federal, state, county, and municipal laws, orders, rules, directives, and regulations (collectively the "Regulations") and that additional Regulations may hereafter be enacted or go into effect, relating to or affecting the Demised Premises or the Shopping Center, and concerning the impact on the environment of construction, land use, maintenance and operation of structures, and conduct of business. Subject to the express rights granted to Tenant under the terms of this lease, Tenant will not cause, or permit to be caused, any act or practice, by negligence, omission, or otherwise, that would adversely affect the environment, or do anything or permit anything to be done that would violate any of the laws, regulations, or guidelines. Moreover, Tenant shall have no claim against Landlord by reason of any changes Landlord may make in the Shopping Center or the Demised Premises or any charges imposed upon customers or other invitees under the Regulations.

27.2. *Rent freeze.* If the payment to, or collection by, Landlord of any rental or other charge (collectively "Lease Payments") payable by Tenant under the provisions of this lease exceeds the amount (the "Maximum Charge") permitted by any federal, state, county or municipal law, order, rule, directive, or regulation (collectively the "Regulations"), then while the Regulations are in force and effect (the "Freeze Period"), Tenant shall not be required to pay, and Landlord shall not be permitted to collect, any sum in excess of the Maximum Charge." Upon the earlier of (i) the expiration of the Freeze Period, or (ii) the issuance of a final order or judgment of a court of competent jurisdiction declaring the Regulations to be invalid or not applicable to the provisions of this lease, Tenant, to the extent not then proscribed by law and commencing with the first day of the next month, shall pay to Landlord as additional rental, in equal monthly installments during the balance of the lease term, an amount equal to the cumulative difference between the Maximum Charges and the Lease Payments during the Freeze Period. If any provision of this lease, or its application, is to any extent declared to be invalid and unenforceable, that shall not be deemed to affect any other provision of this section or lease; the remaining provisions shall be deemed valid and enforceable to the fullest extent permitted by law.

Article XXVIII Miscellaneous

28.1. *Relationship of parties.* Nothing contained in this lease shall be deemed or construed by the parties, or by a third party, to create the relationship of principal and agent, of partnership, or of joint venture between them. No provision contained herein, including the method of computation of rent, and no acts of the parties shall be deemed to create any relationship between them other than the relationship of landlord and tenant.

28.2. *Separate rent obligation.* Tenant shall not for any reason withhold or reduce its required payments of rentals and other charges. Landlord's obligations under this lease are independent of Tenant's obligations, except as expressly

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provided otherwise. In this regard, if Landlord commences proceedings against Tenant for nonpayment of rentals or any other sum due and payable under this lease, Tenant shall not interpose any counterclaim or other claim against Landlord. If Tenant does so, Landlord may, in addition to its other lawful remedies, move to have the counterclaim or other claim severed out of the proceedings. The proceedings may then proceed to final judgment separately and apart from, and without consolidation with or reference to, the status of the counterclaim or other claim.

28.3. *No recourse.* Landlord's liability to Tenant for any default under this lease shall be limited to the sale proceeds on execution of Landlord's interest in the Demised Premises. Landlord shall not be personally liable for any deficiency, except that it shall, subject to the provisions of Section 17.5, remain personally liable to account to Tenant for any security deposited hereunder. This clause shall not be deemed to limit or deny any remedy, which does not involve Landlord's personal liability, that Tenant may have in case of Landlord's default.

28.4. *Consent discretionary.* Except as otherwise provided in this lease, whenever prior consent or permission of Landlord or Tenant ("first party") is required before the other party ("second party") is authorized to take a particular type of action, the decision to do so shall be within the sole discretion of the first party. This decision shall not constitute a breach under the lease, or a defense by the second party to its performance of any covenant, duty, or obligation hereunder that the first party delayed or withheld the granting of consent or permission, whether or not the decision to do so was, in the second party's opinion, prudent, reasonable, or based on good cause.

28.5. *Non-waiver.* A waiver by either party of one or more covenants, terms, or conditions of this lease shall not be construed as a waiver of a subsequent breach of the same covenant, term, or condition. The first party's consent to or approval of any act by the second party shall not be deemed to waive or render unnecessary consent to or approval of any subsequent similar act.

28.6. *Delays beyond Landlord's control.* Whenever a provision of this lease prescribes a time period for Landlord to take action, it shall not be liable or responsible for, and there shall be excluded from the computation of that period, all delays due to strikes, riots, acts of God, shortages of labor or materials, war, governmental laws, regulations, restrictions, or other causes that are beyond Landlord's reasonable control.

28.7. *Estoppel certificate.* Tenant shall, at Landlord's request, execute and deliver to it a statement in recordable form certifying that the lease is unmodified and in full force and effect (or if there have been modifications, that they are in full force and effect).

28.8. *Sublease obligations.* If this lease is in fact a sublease, Tenant accepts it subject to all of the terms and conditions of the underlying lease under which Landlord holds the Shopping Center as lessee. Tenant shall do no act or thing that would constitute a violation by Landlord of its obligation under the underlying lease. However, Tenant's agreement in this regard is premised on Landlord's assurances that the terms of this lease do not violate the underlying lease.

28.9. *Governing law; partial validity; venue.* The interpretation, validity, performance, and enforcement of this lease shall be governed by the laws of the State of Texas. If any provision is held to be invalid or unenforceable, the validity and enforceability of the remaining provisions shall not be affected thereby. Venue for any action under this lease shall be in the county in which rentals are due under Sections 4.1 and 4.4.

28.10. *Headings.* Headings in this lease are for convenience and reference only and shall not be used to limit, amplify, or otherwise construe its provisions.

28.11. *Number; gender.* Whenever used in this lease, the singular number shall include the plural, and words of any gender shall include each other gender.

28.12. *Binding effect.* The terms, provisions, and covenants of this lease shall be binding upon and inure to the benefit

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of both parties and their respective heirs, successors in interest, and legal representatives, except as otherwise expressly provided herein.

28.13. *Modification; entire agreement.* This lease contains the entire agreement between the parties. No other agreements shall be effective to change, modify, or terminate this lease, in whole or in part, unless in writing and duly signed by both parties. Each party acknowledges that it is not relying on any representation or promise of the other, or of the Agent or Cooperating Agent, except as expressly set forth herein.

28.14. *Counterparts.* This lease may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

28.15. *Contents.* This lease consists of 28 Articles and _____ attached pages, including Exhibit A through _____ (any space left blank will be deemed to have been completed with the word "none"). Except for Article VI, if any provision of an exhibit or other attached page is inconsistent with a provision in the body of the lease, the provision in the exhibit shall be deemed to control.

Executed as of December 31, 2001.

Landlord:

Center Associates, a Texas

Limited Partnership

_____ by _____
Attest or Witness Title: General Partner

Tenant:

_____ Big Star Clothes, Inc.
Attest or Witness by _____

Title: President

Agent:

Marshall Real Estate

by _____

Cooperating Agent:

Lone Star Country Real Estate, Inc.

by _____

C.5 Office space lease--building under construction--procedure for tenant work

COMMENT

Although this lease contains special provisions which are specifically applicable to the lease of office space in a building that is under construction, leases generally provide that occupancy of the premises is not to commence until a future date, for a variety of reasons. Thus, the premises may be occupied by an existing tenant who is not required to move until a future date, or the premises may have to be redesigned in order to meet the specific requirements of the new tenant, etc. Accordingly, the comprehensive nature of this lease renders it suitable as a basic model for an office lease which must provide for these common occurrences.

For further information, see Chapter 4.

FORM

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XXX	Notices
XXXI	No Waiver; Entire Agreement
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XXXV	Memorandum of Lease

INDENTURE OF LEASE made June 24, 2001, between Melville Building Company, a New York limited partnership, having its office at 20 Victor Place, New York, New York 10004 ("Landlord"), and Page & Company, Inc., a Delaware corporation duly qualified to do business in the State of New York, and having its principal office at One Trafalgar Plaza, New York, New York 10005 ("Tenant").

Article I Premises; Term

Section 1.01. Landlord leases to Tenant and Tenant hires from Landlord the following space in the building to be constructed substantially in accordance with plans, as modified to this date, on file in Landlord's office and available for inspection by Tenant, in the Borough of Manhattan, City, County and State of New York, known as Melville Plaza (the "Building"):

The 19th, 20th, 21st, and 22nd Floors,

As set forth in the floor plan annexed hereto as "Exhibit A" (the "Demised Premises").

The Demised Premises are leased together with the appurtenances, including the right to use in common with others the lobby, public entrances, public stairways, public elevators (except elevators specifically assigned for the exclusive use of other tenants of the Building), and other public portions of the Building.

To Have and to Hold the Demised Premises unto Tenant for the term of 16 years. If the Commencement Date (defined in Section 2.01) is not the first day of a month, the term shall include the number of days from the Commencement Date to the last day of the month. The term shall commence on the Commencement Date and end, unless terminated sooner, on the last day of the month which includes the 16th anniversary of the Commencement Date. This Lease shall yield and pay the rents and additional rents set forth below, all on the covenants, conditions, and agreements stated therein. Promptly after the Commencement Date, Landlord and Tenant shall execute an agreement in recordable form (the "Commencement Date Agreement"), stating among other things the commencement and termination dates of this Lease.

Article II Commencement of Term

Section 2.01. *Commencement date.* The term of this Lease and the payment of rent hereunder shall commence on the date the Demised Premises are substantially completed ("Commencement Date"). The Demised Premises or any Occupancy Unit (as defined below) shall be deemed substantially completed when the following are done: Landlord procures either a temporary or permanent Certificate of Occupancy permitting occupancy of the Demised Premises or Occupancy Unit for the purposes provided herein; Landlord substantially performs the work and additional work

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required of it in Exhibit "B;" Landlord puts in operating condition for Tenant's permitted use under Article IV the Building's service facilities and systems serving the Demised Premises or the Occupancy Unit, including the elevators, air-conditioning, heating, lighting, water supply, and sewage systems; the exterior of the Building is substantially completed and enclosed; the lobby of the Building is substantially completed and reasonably free of debris and construction materials so as to be reasonably usable for egress and ingress; reasonable access is available to the Demised Premises or Occupancy Unit; and Landlord cleans the Demised Premises or Occupancy Unit and otherwise renders them in new and reasonably unblemished condition, excluding anything caused by Tenant, or its agents, servants, contractors, or employees. This work shall include but not be limited to the following:

- (i) Tile floors wet mopped, waxed, and buffed;
- (ii) Walls and partitions cleaned and all damaged places filled and touched up;
- (iii) All glass cleaned both sides;
- (iv) Toilet fixtures cleaned and polished;
- (v) Trash, dirt, and leftover materials removed from the Demised Premises, excluding anything caused by Tenant. "Operating condition," as applicable to air-conditioning and heating, shall include balancing, but Landlord shall only be required, at such time, to balance the system necessary for the then season.

Section 2.02. *Notice of completion.* Landlord shall give Tenant at least 30 days' prior written notice of the anticipated date of substantial completion of the work to be performed in the Demised Premises in Landlord. Tenant may enter the premises as provided in Exhibit "B," but nothing contained herein shall impose any liability upon Landlord for the care, maintenance, or preservation of Tenant's property. Landlord shall notify Tenant promptly if the substantial completion date is delayed after Landlord gives notice. In that case Landlord shall give Tenant at least five days' prior written notice of the anticipated postponed date of substantial completion. Further postponements shall also require at least five days' prior written notice.

Section 2.03. *Staggered completion.* (a) The parties recognize that the work to be performed by Landlord will be completed in stages. Accordingly, it is the parties' intention that Tenant will take occupancy of various portions of the Demised Premises at different times before the Commencement Date. Tenant shall, on or before March 1, 2002, give notice to Landlord:

(1) Advising it which floor or floors (but not exceeding three full floors in any Occupancy Unit) of the Demised Premises Tenant desires to occupy at or about the same time as the Commencement Date (collectively, an "Occupancy Unit"), and which full floor or floors Tenant does not desire to occupy before that date; and

(2) Setting forth a practicable sequence for the completion of Landlord's work with respect to the various Occupancy Units. The sequence shall be subject to Landlord's approval, which it shall not unreasonably withhold. Nothing in this subsection shall be deemed to obligate Landlord to complete its work with respect to any one or more Occupancy Units by any fixed date before the Commencement Date.

(b) Tenant may use and occupy each Occupancy Unit on a date (the "Earlier Completion Date") fixed by Landlord in a notice to Tenant. This date shall be at least 30 days after the date of Landlord's notice. Landlord's notice shall state that:

(1) The New York City Department of Buildings has or will have issued a temporary or permanent Certificate (or Certificates) covering the Occupancy Unit; and

(2) Landlord has, or before the Earlier Completion Date fixed in the notice will have, substantially completed

Landlord's work with respect to the Occupancy Unit.

Any such use or occupancy shall be deemed to be under all the terms, covenants, and conditions of this Lease, except as provided below in this subsection. Tenant shall pay rent for each Occupancy Unit for the period starting with the Earlier Completion Date for that Unit (or from any earlier date on which Tenant uses or occupies the Occupancy Unit to conduct its business) and ending with the date immediately preceding the Commencement Date. Rent for that period shall be equitably apportioned on the basis of the rentable area of the Occupancy Unit and the rent for the Demised Premises as set forth in Article III, Section 3.01. Rent for each Occupancy Unit shall be payable at the end of each month following the Unit's respective Completion Date (or any earlier date on which Tenant uses or occupies the Occupancy Unit to conduct its business) until the Commencement Date.

Section 2.04. *Possession; substantial completion.* If Tenant takes possession of any Occupancy Unit or of the entire Demised Premises, either fact shall be conclusive evidence, as against Tenant, that, at the time of taking, Landlord substantially completed its work on the Occupancy Unit or the Demised Premises, as the case may be, as required in Exhibit "B." Within 10 business after the Commencement Date, a representative of both parties shall survey the Demised Premises for the purpose of determining which items of Landlord's work remain to be completed, which they shall reduce to an itemized agreed "punch" list. Landlord shall complete these items within a reasonable time thereafter.

Section 2.05. *Site representatives.* Landlord and Tenant will each give full cooperation in having available at the job all persons who are necessary to settle problems arising out of job conditions.

Section 2.06. *Contractor's office, plans.* Landlord or its general contractors shall maintain an office in or near the Building. They shall at all times during the construction of the Building and the finishing of the Demised Premises have available in the office for Tenant's use a complete set of plans, drawings (including shop drawings), specifications pertaining to the work, and construction schedules. Moreover, they shall furnish to Tenant at its request copies of the plans, drawings, specifications, and construction schedules for the Demised Premises.

Section 2.07. *Tenant-caused delay.* If the occurrence of any condition specified in Section 2.01 is delayed due to any act or omission of Tenant, or of its agents, employees, or contractors, the Demised Premises shall be deemed ready for occupancy on the day they would have been ready but for the delay. For this purpose, a delay shall include:

(a) Delay in submission of Tenant's plans or specifications or giving authorizations or approvals required for the preparations for or execution of Landlord's work;

(b) Delay due to:

(1) Changes made by or on behalf of Tenant in its plans or in Landlord's work;

(2) Postponement by Landlord of any work, either at Tenant's request or because Tenant must perform work on a particular item or items before Landlord does so (and Landlord agrees to give Tenant notice of the delay and all additional costs resulting from it before commencing or postponing the work);

(3) Any other interference by Tenant or its agents, servants, or employees, with Landlord's work in the Demised Premises or the building.

Section 2.08. *Delay expenses.* If Landlord sustains additional costs or damages as a result of any delay by Tenant under this Article, Tenant shall pay to Landlord (in addition to the rent payable as a result of the acceleration of the Commencement Date, as provided above) all reasonable costs and damages sustained by Landlord as a result of the delay.

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Section 2.09. *Completion deadline.* If neither the Commencement Date nor any Earlier Completion Date occurs by June 30, 2002, or an extended date as provided in this Section, Tenant may cancel and terminate this Lease and the Demised Term. It shall do so by giving notice of cancellation and termination within 30 days after June 30, 2002, or the extended date. Upon giving of notice, this Lease and the Demised Term shall expire and come to an end, and both parties shall be released and discharged of and from all further liability under the Lease. However, Tenant shall remain liable for the cost of any work performed by Landlord at Tenant's request. Time is expressly declared to be of the essence with respect to any such notice of cancellation and termination. Tenant may not give any notice after expiration of the above 30-day period, and any such notice shall have no force or effect. If Tenant fails to give the required timely notice, or if it uses or occupies any part of the Demised Premises to conduct its business, the Demised Term shall commence in accordance with the provisions of Section 2.01, and Tenant shall have no further right under this Section to cancel and terminate this Lease. Landlord may extend the June 30, 1990 date, set forth in this Section, by a period equal to the total of:

(a) The number of days which have elapsed between the date on which Tenant is required to submit a plan to Landlord under the provisions of Exhibit "B," and the date on which Tenant submits the plan; plus

(b) The number of days of delay (or delays) in substantial completion of Landlord's work due to Tenant's delay (or delays) in submitting any other plans or specifications, in supplying information, in approving plans, specifications, or estimates, or in giving authorizations; by reason of any additional Work, as defined in Exhibit "B," designated by Tenant, or any changes by Tenant in designations previously made by it, under Exhibit "B;" or by reason of any other similar act or omission of Tenant.

Article III Rent

Section 3.01. *Rent payments.* During the term of this Lease, Tenant shall pay to Landlord a fixed annual minimum rent of \$900,000. Rent shall be payable in equal monthly installments, in advance on the first day of each month during this Lease term, at Landlord's office or any other place designated by it, without any set-off or deduction. Tenant shall pay the rent and all other payments deemed under this Lease to be additional rent by check drawn on any bank which is a member of the New York Clearing House. The check shall be payable in lawful money of the United States which, at the time of payment, is legal tender for the payment of public and private debts (Landlord to accept the check subject to collection). If the Commencement Date is not the first day of a calendar month, Tenant shall pay to Landlord, on the Commencement Date, a fraction of the equal monthly installment, the numerator of which is the number of days from the Commencement Date to the end of the calendar month in which that date occurs, and the denominator of which is the total number of days in the calendar month. This payment shall represent the pro rata rent from the Commencement Date to the end of the calendar month.

Section 3.02. *Additional rent.* All costs, charges, and expenses that Tenant assumes, agrees to, or is obligated to Landlord under this Lease and the annexed schedules, shall be deemed additional rent. In the event of nonpayment, Landlord shall have the same rights and remedies with respect to the additional rent as is provided for herein in case of nonpayment of rent. Tenant shall pay Landlord the rent, additional rent, and adjustments of rent provided for in this Lease, when due and without notice or demand, at the time and in the manner specified herein.

Article IV Use

Section 4.01. *Office use; density.* Tenant shall use and occupy the Demised Premises for the general office activities (excluding, however, a cafeteria, computer operations, general records storage, or operations of similar scope) of its executive, administrative, and sales personnel, or those of its assignees or subtenants, permitted under Article XI. The Demised Premises shall not be used for any other purpose. The number of persons per floor shall not exceed one person

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for each 100 square feet.

Section 4.02. *Adverse use.* Tenant shall not suffer or permit the Demised Premises or any part of them to be used in any manner, anything to be done in them, or anything to be brought into or kept in them, that would in any way:

- (i) violate any public law or requirement;
- (ii) cause structural injury to the Building or any part of it;
- (iii) interfere with the normal operations of the Building's heating, air-conditioning, ventilating, plumbing, or other mechanical or electrical systems, or of its elevators;
- (iv) constitute a public or private nuisance; or
- (v) alter the appearance of the Building's exterior or of any portion of its interior other than the Demised Premises.

Section 4.03. *Prohibited uses.* The use of the Demised Premises for the purposes specified in Section 4.01 shall not in any event be deemed to include, and Tenant shall not use, or permit the use of, the Demised Premises or any part thereof for:

- (a) Sale at retail of any products or materials (except for sale of beverages or food to Tenant's employees, only, through vending machines);
- (b) The conduct of a public auction of any kind;
- (c) The conduct of a commercial bank, trust company, savings bank, safe deposit, savings and loan association or bank, or any branches of any of the foregoing or a loan company business (except for the conduct of a credit union or benefit plan for Tenant's employees and except as incident to Tenant's business);
- (d) The issuance and sale of traveler's checks, foreign drafts, letters of credit, foreign exchange or domestic money orders (except as incidental to Tenant's business);
- (e) The receipt of money for transmission (except as incidental to Tenant's business).

Section 4.04. *Continued occupancy.* (a) Tenant acknowledges that the continued occupancy of the Demised Premises by Tenant or its assignees or subtenants permitted under Article XI, and the regular conduct of business therein by Tenant or its assignees or subtenants are of the utmost importance to the Landlord in the renewal of other leases of portions of the Building, in the renting of vacant space in the Building, in the providing of electricity, air-conditioning, steam, and other services to the Building's tenants, and in the maintenance of the character and quality of the Building's tenants. Tenant, therefore, except as otherwise provided in this Section or in Articles VI, X, XI, XIV, and XV, or when prevented by strikes or other labor troubles or generally applicable laws or public regulations, shall occupy the entire Demised Premises and conduct its business therein in the regular and usual manner, throughout the term of this Lease. Tenant acknowledges that Landlord is executing this Lease in reliance upon these covenants, and that they are a material element of consideration in inducing Landlord to execute it. If at any time during this Lease term Tenant vacates the entire Demised Premises, except in the case of constructive eviction or as otherwise permitted by law, or fails to so conduct its business therein, without Landlord's prior written consent, except as permitted by Articles VI, X, XI, XIV, and XV, or when prevented by strikes or other labor troubles or generally applicable laws or public regulations, all rent and additional rent reserved in this Lease from the date of the breach to its expiration date shall become immediately due and payable to Landlord.

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(b) The parties recognize and agree that the damage to Landlord resulting from any breach of the covenants in paragraph (a) of this Section will be extremely substantial, and will be impossible of accurate measurement. The parties therefore agree as follows:

(1) If there is a breach or threatened breach of the above covenants, Landlord shall, in addition to all of its other rights and remedies at law, in equity, or otherwise, have the right of injunction to preserve Tenant's occupancy and use. The words "become vacant or deserted," as used elsewhere in this Lease, shall include Tenant's failure to occupy or use as required by this Section. Cessation of the use or occupancy other than as provided in paragraph (a) of this Section for a period not exceeding 60 days shall not be deemed a breach by Tenant.

(2) If this Lease is terminated because Tenant breaches either covenant in paragraph (a) of this Section, Landlord may, notwithstanding any contrary provision in this Lease, re-enter the Demised Premises to alter, reconstruct, and rent all or any part of them, at any rental agreed to by Landlord, for any portion of or beyond the original Lease term. Any income received by Landlord on such re-rental shall be its property, as compensation for the expenses incurred in preparing and re-renting all or any part of the Demised Premises. This income, together with the above rents and additional rents, shall constitute liquidated damages for Tenant's breach. Tenant shall not receive any portion of the proceeds from the re-letting except for any payment made by or due from it to Landlord under paragraph (a) of this Section.

(c) If any provision of this Section or its application to any person or circumstance is, to any extent, invalid or unenforceable, the remainder of this Section, or the application of the provision to other persons or circumstances, shall not be affected thereby. Each provision of this Section and this Lease shall be valid and enforced to the fullest extent permitted by law.

Article V Construction of Building

Section 5.01. *Building.* Landlord shall, subject to delays by causes beyond its reasonable control, proceed to build the Building as a modern, fully air-conditioned office building on the land herein described in Exhibit "C" (the "Land").

Section 5.02. *Landlord work.* Landlord, prior to the Commencement Date, shall install and furnish in the Demised Premises all of the work, additional work, and installations substantially in accordance with Exhibit "B" annexed hereto.

Article VI Repairs; Alterations; Fixtures

Section 6.01. *Landlord maintenance.* If Landlord knows that structural repairs are needed, it shall, at its expense, make them and maintain the exterior and public areas of the Demised Premises and the public areas of the Building in good order and repair. Landlord shall also maintain in good condition and make (a) all repairs to the structure in the Demised Premises, (b) all repairs to all electric wiring, risers, plumbing, heating and air-conditioning facilities serving the Demised Premises (other than any of the above installed by Tenant), and (c) all other repairs necessary to correct any latent defects for one year after the Commencement Date in the Demised Premises (other than defects connected with, or related to, any alterations made or performed by or on behalf of Tenant by persons other than Landlord or its contractors). However, Landlord shall not be required to make any repairs referred to in subdivisions (a) or (b) if Tenant is obligated to make them under Section 6.02. Tenant shall promptly notify Landlord of the necessity of any repairs of which Tenant has knowledge and for which Landlord may be responsible under this Section.

Section 6.02. *Tenant maintenance.* Tenant shall take good care of the Demised Premises, and the fixtures, equipment and appurtenances therein, except those repairs required to be made by Landlord under Section 6.01. Tenant shall, at its own expense, make all repairs to the Demised Premises when needed to preserve them in good working order and condition. All damage or injury to the Demised Premises and its fixtures, glass, appurtenances, and equipment or to the

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Building or its fixtures, glass, appurtenances, and equipment caused by Tenant moving property in or out of the Building or by installation or removal of furniture, fixtures, or other property, or resulting from fire, explosion, short circuits, flow or leakage of water, steam, illuminating gas, sewer gas, sewerage, or by frost or by bursting or by leaking of pipes or plumbing or from any other cause of any other kind or nature whatsoever, due to carelessness, omission, neglect, improper conduct, or other cause of Tenant, its servants, employees, agents, visitors, or licensees, shall be repaired, restored, or replaced promptly by Tenant to the reasonable satisfaction of Landlord at Tenant's expense except to the extent that the cost and expense is covered by insurance proceeds recovered by Landlord. All repairs and restorations or replacements required in connection therewith shall be of quality and class at least equal to the original work or installations and done in a good and workmanlike manner.

Section 6.03. *Obstructions.* Tenant shall not store or place any materials of whatsoever kind or nature or any obstructions in the lobby, passageways, stairs, on the sidewalks or plaza abutting the Building or in any of its public portions.

Section 6.04. *Additional alterations.* Except as provided for in Exhibit B, Tenant shall make no alterations, decorations, installations, additions, or improvements in or to the Demised Premises, including but not limited to water coolers, air-conditioning or cooling system, unit or part thereof or other apparatus of other or like nature without Landlord's prior written consent and then only by contractors or mechanics approved in writing by Landlord. However, Landlord shall at all times authorize at least three contractors or mechanics in each trade to perform such alterations, decorations, installations, additions, or improvements in and about the Demised Premises. Landlord shall not unreasonably withhold its consent to any nonstructural alterations, decorations, installations, additions, or improvements proposed by Tenant to adapt the Demised Premises for Tenant's business purposes. Landlord hereby consents to all nonstructural alterations, decorations, installations, additions, or improvements proposed by Tenant to adapt the Demised Premises for Tenant's business purposes if they not interfere with furnishing services to other Tenants and if the aggregate estimated cost, in Landlord's reasonable judgment, of all proposed alterations, decorations, installations, additions, or improvements in any successive 12-month period does not exceed \$50,000. However, if the alterations, decorations, installations, or improvements interfere with or affect Landlord's ability to provide the services in the Demised Premises prescribed in Article XXI, Landlord shall be relieved from such obligation to the extent of such interference. All work, alterations, decorations, installations, additions, or improvements shall be done at Tenant's expense and at such times and in such manner as Landlord may from time to time designate and in full compliance with all applicable laws, rules, regulations, and requirements of all governmental bureaus and bodies having jurisdiction thereover. All alterations, decorations, installations, additions, or improvements (other than communications equipment, quotation devices, or equipment leased by Tenant) shall, at Landlord's election (which it shall make by notice as provided in Article XXX not less than 30 days before this Lease expires or is renewed or extended, or, if it is terminated before then, not later than 60 days after termination), become Landlord's property and shall remain upon and be surrendered with the Demised Premises as a part of them at the end of the term or renewal term, or the term's prior expiration, as the case may be. If Landlord elects otherwise, all alterations, decorations, installations, additions or improvements made by Tenant upon the Demised Premises as the Landlord may select (as well as any communications equipment, quotation devices, or equipment leased by Tenant) shall be removed by Tenant and it shall restore the premises to their original condition (except with respect to those items which Landlord has elected to remain) at Tenant's expense at or prior to the expiration of the term. As a condition precedent to Landlord's consent to the making by Tenant of alterations, decorations, installations, additions, or improvements to the Demised Premises in addition to other requirements as provided in this Lease or elsewhere, Tenant shall obtain and deliver to Landlord written and conditional waivers of mechanics' liens upon the property of which the Demised Premises are a part for all work, labor and services to be performed and materials to be furnished in connection with such work in the form approved by Landlord's attorneys, signed by all contractors, subcontractors, material-men, laborers, and workmen to become involved in such work. Notwithstanding the above, if any mechanic's lien is filed against the Demised Premises or the Building for work claimed to have been done for, or materials claimed to have been furnished to Tenant, it shall be discharged by Tenant within ten days thereafter, at Tenant's expense, by filing the bond required by law or payment or otherwise. Landlord shall not be liable for any failure or any Building facilities or services including but not limited to the air-conditioning and ventilating equipment in the Demised Premises installed

by Landlord caused by alterations, installations, and/or additions by Tenant, and Tenant shall correct any faulty installation. Upon Tenant's failure to correct same, Landlord may make the correction and charge Tenant for its cost. The sum due Landlord shall be deemed additional rent and shall be paid by Tenant promptly upon being billed therefor. Tenant shall keep full and accurate records of the cost of all alterations, installations, and improvements in and to the Demised Premises made by it and shall, if requested by Landlord, make them available to Landlord for use in connection with any proceeding to review the Assessed Valuation of the Building or to acquire the Land and Building for public or quasi public use. If any of Tenant's property remains in the Demised Premises after expiration of the term (or the earlier termination of this Lease) and Tenant's removal, the property may be deemed by Landlord to have been abandoned. In that case, Landlord may either retain the property or dispose of it at Tenant's expense and without accountability in whatever manner Landlord may see fit. If Landlord causes the property to be removed, any damage caused by the removal and any other damage to the Demised Premises caused by Tenant's removal may be repaired at Tenant's expense and Tenant shall pay to Landlord upon demand all such expenses. The above provisions shall survive the expiration or termination of this Lease.

Section 6.05. *Permits; insurance.* With the exception of Tenant's work performed under Exhibit "B," prior to commencing any work under the provisions of Section 6.04, Tenant shall furnish to Landlord:

- (a) Copies of all governmental permits and authorizations which may be required in connection with the work.
- (b) A certificate evidencing that Tenant (or its contractors) has (have) procured workmen's compensation insurance covering all persons employed in connection with the work who might assert claims for death or bodily injury against any Over-Landlord, Tenant, or the Building.
- (c) All additional personal injury and property damage insurance (over and above the insurance required to be carried by Tenant under Section 9.03) that Landlord may require because of the nature of the work to be done by Tenant.

Article VII Floor Load; Noise

Section 7.01. Tenant shall not place a load upon any floor of the Demised Premises which exceeds the load per square foot which the floor is then designed to carry and which is then allowed by law. All business machines and equipment and all other mechanical equipment installed and used by Tenant in the Demised Premises shall be properly shielded and be so placed, equipped, installed, and maintained by Tenant at its expense in settings of cork, rubber, or spring-type vibration-eliminators or in such other manner as Landlord may reasonably direct so as to be sufficient to eliminate the transmission of noise, vibration or electrical, or other interference from the Demised Premises to any other area of the Building. Landlord shall include a sentence of equivalent purport to the preceding sentence in other leases of space for adjacent floors in the Building, and shall exercise reasonable efforts to require compliance therewith with respect to such transmissions affecting the Demised Premises.

Tenant shall not move any safe, heavy equipment or bulky matter in or out of the Building without Landlord's written consent, which it shall not unreasonably withhold or delay. If the movement of such items requires special handling, Tenant shall employ only persons holding a Master Rigger's License to do the work and all such work shall be done in full compliance with the Administrative Code of the City of New York and other municipal requirements. All such movements shall be made during hours which will least interfere with the normal operations of the Building, and all damage caused by such movement shall be promptly repaired by Tenant at its expense.

Article VIII Laws, Ordinances, Requirements of Public Authorities

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Section 8.01. *Tenant compliance.* Tenant shall, at its expense, comply with all federal, state, county, and municipal laws, orders, ordinances and regulations and with any lawful direction of any public officer or officers which shall, with respect to the occupancy, use or manner of use of the Demised Premises or to any abatement of nuisance caused by Tenant, impose any violation, order, or duty upon Landlord or Tenant arising from Tenant's occupancy, use, or manner of use of the Demised Premises or any installations made therein by or at Tenant's request or required by reason of a breach of any of Tenant's covenants or agreements hereunder.

Section 8.02. *Notice of violations.* Tenant shall promptly notify Landlord if it receives notice of any violation of law, ordinance, rule, order, or regulation applicable to the Demised Premises. Landlord shall promptly notify Tenant if it receives notice of any violation of any such law, order, ordinance, or regulation applicable to the Demised Premises or services, access or other appurtenances to the Demised Premises, especially, but not limited to, any creating an obligation of Tenant under Section 8.01.

Section 8.03. *Landlord compliance.* Except as provided above, Landlord shall, at its expense, comply with or cause to be complied with, all federal, state, county, and municipal laws, orders, ordinances, and regulations and any direction made pursuant to law of any public officer or officers which shall, with respect to the public portions of the Building, or which affect Tenant's access to the Demised Premises, impose any violation, order or duty upon Landlord or Tenant and with respect to which Tenant is not obligated by Section 8.01 to comply. Landlord may at its expense contest the validity of any such law, ordinance, rule, order, or regulation.

Section 8.04. *Window cleaning.* Tenant shall not clean, nor require, permit, suffer or allow any window in the Demised Premises to be cleaned, from the outside in violation of Section 202 of the Labor Law or of the rules of the Board of Standards and Appeals or of any other board or body having or asserting jurisdiction.

Section 8.05. *Rent control laws.* Landlord may cancel this Lease and its term, by giving Tenant 30 days' notice, if at any time hereafter a law or ordinance which is of a nature commonly referred to as "rent control laws" is enacted. For this purpose, a rent control law is any law or ordinance which limits, reduces, or suspends in whole or in part or otherwise affects the rents or revenues from the Demised Premises or the Building or which makes it illegal to pay or prohibit or restrict the payment to, or receipt by, Landlord of the minimum fixed rent, additional rent, or adjustment of rent or any part or portion of any thereof or as a result of which the Landlord may not, or may not be entitled to receive when due, the full and entire fixed minimum rent, additional rent, and adjustments of rent, or which permits Tenant to seek the return of all or any part of the rent, additional rent, or adjustments of rent. If Landlord elects to terminate and serves upon Tenant a 30-day notice of cancellation of this Lease, upon the expiration of the 30-day period this Lease and its term shall end and expire as fully and completely as if the date of expiration of the 30-day period were the day herein definitely fixed for the end and expiration of this Lease and its term and Tenant shall then quit and surrender the Demised Premises to Landlord.

Article IX Insurance

Section 9.01. *Compliance with insurance regulations.* Tenant shall not do or permit to be done any act or thing in or upon the Demised Premises which will invalidate or be in conflict with the Certificate of Occupancy or the terms of the New York State standard form of fire, boiler, sprinkler, water damage, or other insurance policies covering the Building and/or the fixtures, equipment, and property therein. Tenant shall, at its expense, comply with all rules, orders, regulations, or requirements of the New York Board of Fire Underwriters or any other similar body having jurisdiction, that relate to its use or occupancy of the Demised Premises, and shall not knowingly do or permit anything to be done in or upon the Demised Premises or bring or keep anything therein or use them in a manner which increases the rate of insurance upon the Building or on any property or equipment located therein over the rate in effect at the commencement of the term of this Lease.

Section 9.02. *Tenant caused increases.* If, because of anything done, caused, or permitted to be done, permitted, or omitted by Tenant, the rate of liability, fire, boiler, sprinkler, water damage or other insurance (with all extended coverage) on the Building or on the property and equipment of Landlord or any other tenant or subtenant in the Building is higher than it otherwise would be, Tenant shall reimburse Landlord and the other tenants and subtenants in the Building for the additional insurance premiums thereafter paid by any of them. Tenant shall make the reimbursement on the first day of the month following the payment by Landlord or the other tenants or subtenants. In any action or proceeding in which Landlord and Tenant are parties, a schedule or "make up" of any insurance rate for the Building or Demised Premises issued by the New York Fire Insurance Exchange, or other body establishing fire insurance rates for the Building, shall be conclusive evidence of the facts therein stated and of the several items and charges in the insurance rates then applicable to the Building or Demised Premises.

Section 9.03. *Liability insurance.* Tenant, at its expense, shall maintain insurance protecting and indemnifying Landlord, Tenant and any Overlandlord against all claims for injury or damage to persons or property or for the loss of life or of property occurring upon, in or about the Demised Premises, the public portions of the Building used by Tenant, its employees, agents, contractors, customers, and invitees. The insurance shall afford minimum protection during the term of this Lease, of not less than \$1,000,000 for bodily injury or death to any one person and not less than \$3,000,000 for any one occurrence or accident, and not less than \$100,000 for property damage.

All such insurance shall be effected under valid and enforceable policies (which may cover the Demised Premises and other locations), shall be issued by insurers of recognized responsibility acceptable by Landlord, and shall contain a provision under which the insurer agrees not to cancel the insurance without 20-days' prior written notice to Landlord.

On or before the Commencement Date, Tenant shall furnish Landlord with a certificate evidencing the aforesaid insurance coverage. Renewal certificates shall be furnished to Landlord at least 30 days prior to the expiration date of each policy for which a certificate was furnished.

Section 9.04. *Waiver of subrogation.* Landlord's insurance policies shall insure the Building and its property therein against loss, damage, or destruction by fire or other casualty and the rental value thereof. Tenant's policies shall insure its property in the Demised Premises against loss, damage, or destruction by fire or other casualty. Both parties shall use their best efforts to include in their respective insurance policies: (a) a waiver of the insurer's right of subrogation against the other party; (b) an express agreement that the policy will not be invalidated if the assured waives the right of recovery against any party responsible for a casualty covered by the policy before the casualty; or (c) any other form of permission for the other party's release. If the waiver or permission is not, or ceases to be, obtainable, with or without additional charge, the insured party shall, upon learning that, promptly so notify the other party. In that case, if the other party so elects and pays the insurer's additional charge therefor, the waiver or permission shall be included in the policy. Each party hereby releases the other party with respect to any claim (including a claim for negligence) which it might otherwise have against the other party for loss, damages, or destruction with respect to its property by fire or other casualty (including rental value or business interest, as the case may be) occurring during the term of this Lease and with respect and to the extent to which it is not prohibited under a policy or policies containing a waiver of subrogation or permission to release liability or naming the other party as an additional assured, as provided above. If such waiver is not obtainable for any reason there shall be no release of the other party. The waiver of subrogation or permission for release referred to herein shall extend to the agents of each party and its and their employees and shall be coextensive therewith, and, in the case of Tenant, shall also extend to all other persons and entities occupying or using the Demised Premises in accordance with the terms of this Lease, but only if and to the extent that such waiver or permission can be obtained without additional charge (unless such party pays the charge). If Tenant does not carry insurance, Landlord shall be released co-extensively and to the same extent as though Tenant's property were insured for fire insurance with extended coverage.

Article X Damage by Fire or Other Cause

Section 10.01. *Damage.* If the Demised Premises are partially damaged by fire or other cause without the fault or neglect of Tenant, or of its servants, employees, agents, visitors, or licensees, the damage shall be repaired by and at Landlord's expense and the fixed minimum rent until the repairs are made shall be apportioned according to the part of the Demised Premises which is usable by Tenant. But if such partial damage is due to the fault or neglect of Tenant, or of its servants, employees, agents, visitors, or licensees, without prejudice to any other rights and remedies of Landlord and, except as provided in Section 9.04, without prejudice to the rights of subrogation of Landlord's insurer, the damage shall be repaired by Landlord but there shall be no apportionment or abatement of rent. No penalty shall accrue for any delay which may arise by reason of adjustment of insurance by Landlord and for any delay on account of "labor troubles," or any other similar or dissimilar cause, beyond Landlord's control. Tenant shall give immediate notice to Landlord in case of fire in the Demised Premises. If the Demised Premises are totally or substantially damaged or are rendered wholly or substantially untenantable by fire or other cause, and Landlord decides not to restore or rebuild them, or if the Building is substantially damaged and Landlord decides to demolish, rebuild, or remodel it (regardless of whether the Demised Premises have been damaged), Landlord may, within 90 days after the fire or other cause, give Tenant written notice (as provided in Article XXX) of its decision. Thereupon, the term of this Lease shall expire by lapse of time on the third day after notice is given, and Tenant shall vacate the Demised Premises and surrender them to Landlord. If Tenant is not in default under this Lease, upon its termination under the conditions provided for in the immediately preceding sentence, Tenant's liability for rent shall cease as of the day following the casualty. Tenant hereby expressly waives the provisions of Section 227 of the Real Property Law or any like law which may hereafter be enacted and agrees that the foregoing provisions of this Article shall govern and control in lieu thereof, this Article being an express agreement.

Section 10.02. *Limitation.* No damages, compensation, or claims shall be payable by Landlord for inconvenience, loss of business or annoyance arising from any repair or restoration of any portion of the Demised Premises or of the Building, except for rent abatement as provided in Section 10.01.

Article XI Assignment, Subletting, Mortgaging

Section 11.01. *Conditions, requirements.* Tenant shall not, by operation of law or otherwise, assign, mortgage, or encumber this Lease, or sublet or permit the Demised Premises or any part thereof to be used by others, without Landlord's prior written consent. Landlord's consent to any assignment or subletting shall not in any manner be construed to relieve Tenant from obtaining Landlord's express written consent to any other or further assignment or subletting. Tenant may permit portions of the Demised Premises to be used by, or sublet portions of the Demised Premises without profit to any wholly owned subsidiaries or affiliates of Tenant (*i.e.*, corporations at least 50% of whose stock is owned by Tenant), if, and so long as, Tenant's ownership of them continue to be not less than 20% of their stock. Tenant shall give prompt notice to Landlord of any such use or subletting by or to the subsidiaries or affiliates. Tenant may, without Landlord's consent, assign its interest in this Lease to any corporation which succeeds to the assets, business, and goodwill of Tenant (either by merger or consolidation) or of any wholly owned subsidiary or affiliate (*i.e.*, corporations of which Tenant owns at least 50 percent of the stock), if, and for so long as, the subsidiaries or affiliates continue to be owned by Tenant. However, the assignment shall not be valid unless, within 10 days after its execution, Tenant delivers to Landlord (i) a duplicate original instrument of assignment, in form and substance satisfactory to Landlord, duly executed by Tenant, and (ii) an instrument, in form and substance satisfactory to Landlord, duly executed by the assignee, in which such assignee shall assume observance and performances of, and agree to be personally bound by, all of the terms, covenants, and conditions of this Lease on Tenant's part to be observed and performed. Tenant shall, in no event, be released from liability under this Lease.

With the express exceptions set forth in the preceding paragraph, if Tenant desires to assign or sublet all or any portion of the Demised Premises, it shall use Landlord as its exclusive rental agent for such purpose and notify Landlord of its desire to assign this Lease or sublet the premises. Before obtaining a proposed assignee or sublessee, upon terms

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satisfactory to Tenant, Tenant shall submit to Landlord in writing the terms and conditions of the proposed assignment or subletting and any other information reasonably requested by Landlord.

Landlord shall have the following options, to be exercised within 90 business days from submission of Tenant's request:

(a) If the proposed assignment or subletting is for all or substantially all of the Demised Premises, Landlord may, within the above 90-day period, cancel and terminate this Lease as of the date proposed by Tenant for the assignment or subletting.

(b) If the proposed sublease is for less than all or substantially all of the Demised Premises or for less than the balance of the term granted hereunder, Landlord may, within the above 90-day period, cancel and terminate this Lease only as to the portion of the premises and of the term of the proposed sublease that takes effect as of the effective date thereof. If Landlord exercises its option under this paragraph (b), the rent and all other charges payable hereunder shall be equitably apportioned.

If Landlord does not exercise either option within the time set forth above, Tenant may list the proposed space with any other brokers. Landlord shall not unreasonably withhold consent to any proposed assignment or subletting if it is upon the same or better terms than those submitted to Landlord. Landlord shall give Tenant notice as to giving or withholding such consent within 30 days after Tenant furnishes Landlord, in writing, in addition to the information set forth above, (1) the name of the proposed assignee or sublessee and (2) the nature and character of the business of the proposed assignee or sublessee. However, if Landlord does not exercise either of the above options and Tenant assigns this Lease or sublets all or any portion of the Demised Premises, other than a sublease in lieu of temporary condemnation as provided in Article XIV, Section 14.03, Tenant shall pay to Landlord, as additional rent, any difference between the fixed minimum rent plus additional rent allocable to that part of the Demised Premises affected by such assignment or sublease under the provisions of this Lease, and the fixed minimum rent and additional rent payable by the assignee or sublessee to Tenant, less a single brokerage commission payable by Tenant with respect to such assignment or sublease. The additional payments shall be made monthly within five days after their receipt by Tenant.

Section 11.02. *Rent collection.* If this Lease is assigned, or all or a part of the Demised Premises is sublet or occupied by any person or persons other than Tenant, Landlord may, after default by Tenant, collect rent from the assignee, subtenant or occupant and apply the net amount collected to the rent herein reserved. However, no such assignment, subletting, occupancy or collection of rent shall be deemed a waiver of the covenants in this Article, nor shall it be deemed acceptable of the assignee subtenant or occupant as a tenant, or a release of Tenant from the full performance by Tenant of all the terms, conditions and covenants of this Lease.

Section 11.03. *Lease obligations.* Each permitted assignee or transferee shall assume and be deemed to have assumed this Lease and shall be and remain liable jointly and severally with Tenant for the payment of the rent, additional rent, and adjustments of rent, and for the due performance of all of Tenant's terms, covenants, conditions, and agreements for the term of this Lease. No assignment shall be binding on Landlord unless the assignee or Tenant delivers to Landlord a duplicate original of the instrument of assignment which contains a covenant of assumption by the assignee of all of the above obligations and obtains from Landlord the above written consent prior thereto.

Article XII No Liability on Landlord's Part

Section 12.01. Landlord and its agents shall not be liable for any damage to property of Tenant or of others entrusted to employees of the Building, or for the loss of or damage to any property of Tenant by theft or otherwise. Landlord and its agents shall not be liable for any injury or damage to persons or property resulting from fire, explosion, falling plaster, steam, gas, electricity, water, rain or snow, or leaks from any part of the Building, from the pipes, appliances or plumbing works, from the roof, street or sub-surface, or from any other place or by dampness or by any other cause of

whatsoever nature, unless caused by or due to the negligence of Landlord, its agents, servants, or employees. Moreover, Landlord and its agents shall not be liable for any such damage caused by other tenants or persons in the Building or caused by operations in construction of any private, public, or quasi-public work. Landlord shall not be liable for damages for injury to the person or property of Tenant or others, except to the extent of its obligation, if any, under Section 6.01 for any latent defect in the Demised Premises or in the Building. If at any time any windows of the Demised Premises are temporarily closed, darkened, or bricked up for any reason including, but not limited to, Landlord's own acts, Landlord shall not be liable for any resulting damage to Tenant, and Tenant shall not be entitled to any compensation therefor or abatement of rent; moreover, such actions shall not release Tenant from its obligations hereunder or constitute an eviction. (Reference above to Landlord shall for all purposes be deemed to include any Overlandlord.) Tenant shall reimburse and compensate Landlord as additional rent within five days after rendition of a statement for all expenditures made by or damages or fines sustained or incurred by Landlord due to nonperformance or noncompliance with or breach or failure to observe any term, covenant, or condition of this Lease upon Tenant's part to be kept, observed, performed, or complied with. Tenant shall give immediate notice to Landlord in case of accidents in the Demised Premises or in the Building or of defects therein or in any fixtures or equipment. Landlord shall give immediate notice to Tenant of its knowledge of accidents in the Demised Premises or accidents affecting services, access or other appurtenances to the Demised Premises, or (to the extent caused or claimed to arise from or be related to, Tenant's use or occupancy under this Lease) in the Building or of defects therein or in any fixtures or equipment.

Article XIII Name of Building

Section 13.01. The Building will be known as "Melville Plaza," but Landlord may from time to time change the name or designation, without Tenant's consent. So long as Tenant occupies the Demised Premises, Landlord shall not designate, as the name by which the Building is commonly known, the name of any firm whose principal line of business is the same as or related to Tenant's business, except as provided above.

Article XIV Condemnation

Section 14.01. *Condemnation.* If all or a material part of the Building is condemned or taken in any manner for any public or quasi-public use, this Lease shall cease and terminate as of the date of vesting of title. If only a part of the Demised Premises is so condemned or taken, then, effective thereafter as of the date Tenant vacates and removes from the part of the Demised Premises so taken, the fixed minimum rent and the Tenant's Proportionate Share shall be proportionately reduced, and this Lease shall continue as to the remaining part. If only a nonmaterial part of the Building is so condemned or taken, then (a) if substantial structural alteration or reconstruction of the Building is, in Landlord's opinion, necessary or appropriate as a result of the condemnation or taking (regardless of whether the Demised Premises are affected), Landlord may terminate this Lease as of the date of vesting of title by giving Tenant, within 60 days after it receives notice thereof, written notification of termination, or (b) if Landlord does not elect to terminate this Lease, this Lease shall be and remain unaffected by such condemnation or taking, except that the rent shall be abated to the extent, if any, hereinbefore provided. If only a part of the Demised Premises is so condemned or taken and this Lease and the term and estate hereby granted are not terminated as provided above, Landlord shall, at its expense, restore with reasonable diligence the remaining structural portions of the Demised Premises as nearly as practicable to their same condition as prior to the condemnation or taking. In the event of termination in any of the cases provided above this Lease and the term and estate hereby granted shall expire as of the date of the termination with the same effect as if that were the date hereinbefore set for the expiration of the term of this Lease, and the rent hereunder shall be apportioned as of that date.

Section 14.02. *Condemnation award.* If there is any condemnation or taking, as provided above, of all or part of the Building (regardless of whether the Demised Premises are affected), Landlord shall receive the entire award in the condemnation proceeding, including any award made for the value of the estate vested by this Lease in Tenant. Tenant

hereby expressly assigns to Landlord all of its right, title and interest now or hereafter arising in or to any such award or any part thereof, and Tenant shall not be entitled to receive any part of the award. Notwithstanding the above, Tenant shall be entitled to any award for loss or taking of its fixtures, or its relocation expenses.

Section 14.03. *Temporary condemnation.* (a) If the whole or any part of the Demised Premises is acquired or condemned for any temporary public or quasi-public use or purpose, for any period ending prior to the end of the term, then, except as otherwise provided in this Section, this Lease and the Demised Term shall continue in force and effect and Tenant shall continue to pay in full the rent, additional rent, and other charges herein reserved without deduction or abatement. Tenant shall be entitled, subject to the provisions of this Section, to all awards or payments made for such temporary use, except that they shall be paid to and held by Landlord as a fund which Landlord shall apply, from time to time, to the extent that such fund avails, to the payment of rent, additional rent and other charges due to Landlord from Tenant under the terms of this Lease provided Tenant is not otherwise in default hereunder beyond any applicable grace period for the curing of such default (if such use is for only a part of the Demised Premises, the awards or payments shall only be applied in payment of the rent, additional rent, and other charges allocable to such part of the Demised Premises). If required by Landlord, Tenant shall restore the Demised Premises to its condition prior to the temporary taking.

(b) If all of the Demised Premises are acquired or condemned for any temporary public or quasi-public use or purpose for a period extending beyond the end of the term, this Lease and the Demised Term shall end as of the Date of such taking with the same effect as if that Date were the end of the term.

(c) If any part, rather than all, of the Demised Premises is acquired or condemned for any temporary public or quasi-public use or purpose for a period extending beyond the end of the term, that part of the Demised Premises (the "Eliminated Condemnation Space") shall be eliminated from the Demises Premises from and after the date (the "Elimination Condemnation Date") immediately prior to the commencement of such temporary use, and

(1) From and after that date, the Eliminated Condemnation Space shall be eliminated from the Demised Premises for all purposes;

(2) Tenant shall surrender the Eliminated Condemnation Space on or before the Elimination Condemnation Date in the same manner as if that date were the end of the term but Tenant shall not be required to remove its property or restore the Demised Premises as required by Section 6.04;

(3) From and after the Elimination Condemnation Date,

(A) The rent, and any electric charge, escalation, or additional rent computed on a Floor area basis shall be equitably reduced on the basis of the area of the Eliminated Condemnation Space, and any pre-paid portion of rent or additional rent for any period after that Date allocable to the Space shall be refunded by Landlord to Tenant; and

(B) The Demised Premises Area shall be reduced in the proportion which the area of the Eliminated Condemnation Space bears to the total area of the Demised Premises immediately before the Elimination Condemnation Date.

Article XV Entry, Right to Change Public Portions of the Building

Section 15.01. *Access.* Landlord may erect, use, and maintain pipes and conduits in and through the Demised Premises, which shall be, to the extent possible, concealed. Landlord and its agents and designees may enter the Demised Premises for the purpose of making any repairs or alterations that it desires, is required, or has the right, to make under this Lease. Subject to the above, Landlord may enter the Demised Premises for the purpose of inspecting them or

exhibiting them to prospective purchasers or lessees of the Building, to prospective mortgagees, or to the mortgagees' prospective assignees. Except in cases of emergency, Tenant may require Landlord or its representative, agent, or employee to be accompanied, while in the Demised Premises, by Tenant's representative, agent, or employee if Tenant furnishes such person promptly after Landlord gives notice to Tenant that it is exercising its right of entry. Landlord may take all material into and upon the Demised Premises that is required for the above repairs or alterations, and such act shall not constitute an eviction or partial eviction of Tenant. Moreover, the rent reserved shall not abate, except as otherwise provided in this Lease, while the repairs or alterations are being made. However, the repairs shall be made as expeditiously as reasonably possible, and be conducted in such a manner, and on such notice, as to minimize as far as reasonably possible any unreasonable interference with Tenant's use and occupancy of the Demised Premises for the purposes specified in Article IV, Section 4.01.

Section 15.02. *Changes to public areas.* Landlord may at any time without thereby creating any actual or constructive eviction or incurring any liability to Tenant therefor, and without abatement in rent, change the arrangement or location of entrances, passageways, doors, doorways, corridors, stairs, toilets, and other like portions of the Building, as well as the designated express or local stops of elevators servicing the Demised Premises. However, such changes shall be designed to avoid any material obstruction or reduction in Tenant's access to the Demised Premises, and other appurtenances. Landlord may, if necessary to comply with laws, rules, or requirements of any governmental bureau or agency, move any wall or partition in or dividing the Demised Premises.

Article XVI Bankruptcy

16.01. *Prior to term.* This Lease shall *ipso facto* be cancelled and terminated if at any time before the date fixed above as the Commencement Date a petition in bankruptcy or insolvency, for reorganization, or for the appointment of a receiver or trustee of all or a portion of Tenant's property is filed by or against it in any court under any federal or state statute, and within 90 days thereafter Tenant fails to secure a discharge thereof, or if Tenant makes an assignment for the benefit of creditors, or petitions for or enters into an arrangement. In any such event, neither Tenant nor any person claiming through or under it or by virtue of any statute or court order shall be entitled to possession of the Demised Premises and Landlord, in addition to the other rights and remedies given by Section 16.03 and by virtue of any other provision contained in this Lease or any statute or rule of law, may retain as liquidated damages any rent, security, deposit or moneys received by it from Tenant or others in Tenant's behalf upon the execution thereof.

16.02. *During term.* Landlord may cancel and terminate this Lease if at the date fixed as the Commencement Date or any time during the term hereby demised a petition in bankruptcy or insolvency, for reorganization, or for the appointment of a receiver or trustee of all or a portion of Tenant's property is filed by or against Tenant in any court under any federal or state statute, and within 90 days thereafter Tenant fails to secure a discharge thereof, or if Tenant makes an assignment for the benefit of creditors or petitions for or enters into an arrangement. Landlord shall exercise its right to cancel and terminate within a reasonable time after it receives notice that any of the above events have occurred. If Landlord exercises such right, neither Tenant nor any person claiming through or under it by virtue of any statute or court order shall be entitled to possession or to remain in possession of the Demised Premises but shall forthwith quit and surrender the premises, and Landlord, in addition to the other rights and remedies it has by virtue of any other provision contained in in this Lease or any statute or rule of law, may retain as liquidated damages any rent, security, deposit or monies received by it from Tenant or others in Tenant's behalf.

16.03. *Landlord's damages.* In the event of the termination of this Lease under Sections 16.01 and 16.02, Landlord may immediately, notwithstanding any contrary provision of this Lease, recover from Tenant as and for liquidated damages the difference between the rent reserved hereunder for the unexpired portion of the term demised and the then fair and reasonable rental value of the Demised Premises for the same period. In computing such damages the differences between any installment of rent becoming due hereunder after the date of termination and the fair and reasonable rental value of the Demised Premises for the period for which such installment was payable shall be discounted to the date of

termination at the rate of 10% per annum. If all or any part of the premises are re-let by Landlord for the unexpired term of this Lease or any part thereof, before proof of such liquidated damages is presented to any court, commission or tribunal, the amount of rent reserved upon such reletting shall be deemed prima facie to be the fair and reasonable rental value for the part or the whole of the premises so re-let during the term of the re-letting. Nothing contained herein shall limit or prejudice Landlord's right to prove for and obtain as liquidated damages by reason of such termination, an amount equal to the maximum allowed by any statute or rule of law in effect at the time, and governing the proceedings in which, such damages are to be proved, regardless of whether that amount is greater than, equal to, or less than the amount of the difference referred to above.

Article XVII Defaults, Remedies and Waiver of Redemption

Section 17.01. *Default and remedies.* (a) If Tenant (1) defaults in fulfilling any covenant of this Lease, requiring the payment of fixed minimum rent or additional rent, (2) defaults in complying with any other term, condition, or provision of this Lease, or (3) except as provided in Articles VI, X, XI, XIV, or XV, or where prevented by strikes or other labor troubles, or generally applicable laws or public regulations, ceases to conduct its business in the Demised Premises or leaves them completely vacant, then, in the case of the nonpayment of fixed minimum rent or additional rent which continues for ten days after Landlord serves a written notice upon Tenant specifying such default, or if Tenant defaults in any one or more of the events referred to in (2) or (3) above, then upon Landlord serving a written 15-days' notice upon Tenant specifying the nature of the default and upon the expiration of said 15 days, if Tenant has failed to comply with or remedy such default, or if the default or omission complained of is of such a nature that it cannot be completely cured or remedied within the 15-day period, and if Tenant has not diligently commenced curing the default within such 15-day period, and does not thereafter with reasonable diligence and in good faith proceed to remedy or cure default, then Landlord may serve a written 15-days' notice of cancellation of this Lease upon Tenant, and upon the expiration of the 15 days, this Lease and the term hereunder shall end and expire as fully and completely as if the date of expiration of the 15-day period were the day herein definitely fixed for the end and expiration of this Lease and the term thereof. Tenant shall then quit and surrender the Demised Premises to Landlord but Tenant shall remain liable as provided below.

(b) If the 15-day notice of cancellation provided for in subparagraph (a) above is not given, and the term expires as provided above; or (1) if Tenant defaults after ten-days' notice in the payment of the fixed minimum rent reserved herein or any item of additional rent herein mentioned or any part of either or in making any other payment herein provided; or (2) if any execution or attachment is issued against Tenant or any of its property whereupon the Demised Premises are taken or occupied by someone other than Tenant, Landlord may, without notice, re-enter the Demised Premises by force or otherwise and dispossess Tenant, its legal representative, or other occupant by summary proceedings or otherwise, remove their effects, and hold the premises as if this Lease had not been made. However, Tenant shall remain liable hereunder as hereinafter provided, and it hereby waives the service of notice of intention to re-enter or to institute legal proceedings to that end.

Section 17.02. *Rent deficiency.* In case of any such default, re-entry, expiration and/or dispossession by summary proceedings or otherwise, (a) the fixed minimum rent and additional rent shall become due thereupon and be paid up to the time of re-entry, dispossession and/or expiration, together with all expenses incurred by Landlord for legal expenses, attorneys' fees, brokerage, and/or putting the Demised Premises in good order, or for preparing them for re-rental; (b) Landlord may re-let all or part of the premises, either in its name or otherwise, for a term or terms, which may be less than or exceed the period which would otherwise have constituted the balance of the term of this Lease, and may grant concessions or free rent; and/or (c) Tenant or its legal representatives shall also pay Landlord as liquidated damages for Tenant's failure to observe and perform its covenants contained herein, any deficiency between the rents and additional rents hereby reserved and/or covenanted to be paid and the net amount, if any, of the rents collected or to be collected on account of the lease or leases of the Demised Premises for each month of the period which would otherwise have constituted the balance of this Lease term. Landlord's failure or refusal to re-let all or part of the premises shall not

release or affect Tenant's liability for damages. In computing such damages there shall be added to the deficiency all expenses incurred by Landlord in connection with re-letting, such as legal expenses, attorneys' fees, brokerage, and for keeping the Demised Premises in good order or for preparing them for re-letting. Any such damages shall be paid in monthly installments by Tenant on the rent days specified in this Lease. Any suit brought to collect the deficiency for any month or months shall not prejudice in any way Landlord's rights to collect the deficiency for any subsequent month or months by a similar proceeding. Landlord may make all alterations, repairs, replacements and/or decorations in the Demised Premises that it considers advisable and necessary for the purpose of re-letting them. The making of such alterations and/or decorations shall not operate or be construed to release Tenant from its above liability. Landlord shall in no event be liable in any way for failure to re-let the Demised Premises, or if the Demised Premises are re-let, for failure to collect the rent thereof under such reletting. Any such action may be for the full amounts of all rents and damages suffered or to be suffered by Landlord. If Tenant breaches or threatens to breach any covenant or provision of this Lease, Landlord shall have the right of injunction and the right to invoke any remedy allowed at law or in equity as if re-entry, summary proceedings and other remedies were not provided for herein. Mention in this Lease of any particular remedy shall not preclude Landlord from any other remedy, in law or in equity. Landlord's above remedies and rights are cumulative. Tenant hereby expressly waives all rights of redemption granted by or under any present or future laws if it is evicted or dispossessed for any cause, or if Landlord obtains possession of the Demised Premises, by reason of Tenant's violation of any covenant or condition of this Lease, or otherwise.

Article XVIII Landlord's Right to Perform Tenant's Obligations

Section 18.01. *Tenant obligations.* If Tenant defaults in the observance or performance of any term or covenant under this Lease, Landlord may, without thereby waiving the default, remedy the default for Tenant's account and at Tenant's expense. If in connection therewith Landlord makes any expenditures or incurs any obligations for the payment of money or in instituting, prosecuting, or defending any action or proceedings commenced before or during the term of this Lease or after the expiration or termination of the term, including but not limited to legal expenses and attorneys' fees, Tenant shall pay to Landlord on demand the sums paid or obligations incurred, together with legal interest and costs. If not paid, Landlord, in addition to any other remedy, may deem the due payments to be additional rent.

Section 18.02. *Additional rent.* All amounts over the fixed minimum rent payable by Tenant to Landlord under the terms of this Lease shall be deemed additional rent hereunder. Tenant shall pay these amounts in the same manner as an installment of the fixed minimum rent within a reasonable time after they become payable unless provision is made in this Lease for their payment on a specific date or within a specified time and, in default of payment may, if the Landlord desires, be added to the next or any other installment of fixed minimum rent subsequently becoming due. Landlord shall have all the rights and remedies in the event of their nonpayment as it would have had in the event of the nonpayment of any installment of fixed minimum rent. Tenant's obligation to pay any additional rent which has theretofore become due and payable shall survive the expiration or earlier termination of this Lease.

Article XIX Covenant of Quiet Enjoyment

Section 19.01. Landlord warrants and represents that it has full authority to execute this Lease for the above term. Landlord covenants that upon Tenant's paying the rent and additional rent and performing its covenants, Tenant may peaceably and quietly have, hold, and enjoy the Demised Premises, subject, nevertheless, to the terms and conditions of this Lease. This covenant shall bind Landlord only so long as it is the owner of the premises.

Article XX Excavation

Section 20.01. If any excavation or construction is made or authorized for building or other purposes upon land adjacent

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to the Building, Tenant shall, if necessary, afford to the person or persons causing or authorizing the work a license to enter upon the Demised Premises for the purpose of doing all work that is reasonably necessary to protect or preserve the Building or its walls from injury or damage and to support them by proper foundations, pinning and/or underpinning, or otherwise.

Article XXI Services and Equipment

Section 21.01. *Landlord services.* So long as Tenant is not in default under any provision of this Lease, Landlord, at its expense, shall:

(a) Provide elevator service in accordance with Building Plans from 8:00 a.m. to 6:00 p.m., Mondays through Fridays, holidays excepted, and at least one elevator serving the Demised Premises on Saturdays, Sundays, and holidays and after regular hours on other days. Landlord intends to install operatorless elevators in the Building. Landlord may designate local and express stops for elevators and change the designation of express and local stops from time to time, as provided in Article XV, Section 15.02.

(b) Landlord, at its expense, shall supply heat during the heating seasons, air-conditioning during the cooling seasons, and ventilation from the system installed by it from 8 a.m. to 6 p.m. on Mondays through Fridays, holidays excepted, which the parties agree are the hours of normal occupancy. Landlord shall have no responsibility or liability for the ventilating conditions and/or temperature of the Demised Premises during the hours or days it is not required to furnish heat, ventilation, or air-conditioning under this paragraph. Landlord has informed Tenant that the windows of the Demised Premises and the Building may be sealed, and that the Demised Premises may become uninhabitable and the air therein may become unbreathable during the hours or days when Landlord is not required to furnish heat, ventilation, or air-conditioning except as provided in this Section 21.01(e). Any use or occupancy of the Demised Premises authorized by Tenant, other than by Landlord's employees, agents, or contractors, acting under this Lease, during the hours or days Landlord is not so required to furnish heat, ventilation, or air-conditioning to the Demised Premises shall be at Tenant's sole risk, responsibility and hazard. Such condition of the Demised Premises shall not constitute nor be deemed to be a breach or a violation of this Lease or of any provision thereof, nor shall it be deemed any eviction, nor shall Tenant claim or be entitled to claim any abatement of rent nor make any claim for any damages or compensation by reason of such condition.

The heating seasons shall be the periods between September 15th and the following May 15th and the cooling seasons shall be the periods between May 15th and the following September 15th. Tenant shall in any event cause and keep entirely unobstructed all of the vents, intakes, outlets, and grilles, at all times and shall comply with and observe all regulations and requirements prescribed by Landlord for the proper functioning of the heating, ventilating, and air-conditioning system.

(c) Provide Building standard cleaning services in the Demised Premises and public portions of the Building except on Saturdays, Sundays, and holidays, similar to first-class office buildings in the area.

(d) Furnish hot and cold water for lavatory and drinking and office cleaning purposes. If Tenant requires, uses, or consumes water for any other purposes, Landlord may install a meter or meters or other means to measure Tenant's water consumption. Tenant shall reimburse Landlord for the cost of all meters and their installation, and pay for the maintenance of the meter equipment and/or pay Landlord's cost of other means of measuring the water consumption by Tenant. Tenant shall reimburse Landlord for the cost of all water consumed as measured by the meter or meters or as otherwise measured, including sewer rents, and all other charges imposed by any authority, on, or measured by, the use of water.

(e) Landlord also shall furnish air-conditioning (heating, ventilating, and cooling) beyond the above stated hours if it is

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given notice of the need for such service before noon on a business day when required for use in the evening, and by noon of the preceding business day when such service is to be provided for Saturday, Sunday, or holiday use. Tenant shall pay Landlord's charge, as agreed upon from time to time, for supplying additional services under this Section 21.01.

Section 21.02. *Holidays.* Holidays shall be deemed to mean all those dates designated as holidays by the Board of Governors of the New York Stock Exchange, in addition to dates designated as holidays by the City of New York, State of New York and/or the United States, other than Columbus Day and Lincoln's Birthday, unless the Board of Governors designates them as holidays.

Section 21.03. *Interruptions.* Landlord may interrupt, curtail, or suspend its services under this Article when such action is necessary because of accident, emergency, or mechanical breakdown, or is required by any federal, state, county, or municipal law, order, or regulation, or for any other cause beyond Landlord's reasonable control. Landlord shall use reasonable diligence to complete all required repairs or other necessary work as quickly as reasonably possible so that Tenant's inconvenience resulting therefrom may be for as short a period as circumstances will reasonably permit. Tenant shall not claim any diminution or abatement of rent or other compensation as a result of such interruptions, curtailment, or suspension, nor shall this Lease or any of Tenant's obligations be affected or reduced by reason of them.

Section 21.04. *Reimbursement.* Tenant shall reimburse Landlord for its cost of removing from the Demised Premises and the Building any of Tenant's refuse and rubbish in excess of normal office waste and Tenant shall pay all bills therefor when rendered.

Section 21.05. *Lobby directory.* Tenant shall be entitled to its proportionate share of listing spaces on a directory to be maintained by Landlord in the lobby of the Building for the listing of the names of Tenant, its officers and employees and of all other permitted occupants of the Demised Premises, their officers and employees. Tenant shall pay all charges for such listings.

Article XXII Adjustment of Rent

Section 22.01. *Wage adjustments.* In addition to the fixed minimum rent reserved above, Tenant shall pay to Landlord, as additional rental, sums computed in accordance with the following provisions:

(a) "Wage Rate" shall mean one-half of the combined total of the minimum regular hourly wage rate plus all other sums required to be paid to or for the benefit of (1) porters, and (2) female cleaners engaged in the general maintenance and operation of office buildings of the type and in the vicinity of the Building under a collective bargaining agreement between Realty Labor Relations, Inc. (or any of its successors) and Local 45 of the Employees International Union (or any of its successors). The Wage Rate shall include but not be limited to sums paid for pensions, welfare funds, vacations, bonuses, social security, unemployment, disability benefits, health, life, accident, and other type of insurance. If any such agreement is not entered into or the parties or their successors cease to bargain collectively, the Wage Rate shall be one-half the combined total of the minimum regular hourly wage rate and above other sums payable to or for the benefit of porters and female cleaners engaged in the maintenance and operation of the Building and payable by either Landlord or the contractor furnishing such services. However, the Wage Rate shall not exceed the hourly minimum rate of wages and other sums for porters and female cleaners engaged in the general maintenance and operation of buildings of the same type as the Building.

(b) "Base Wage Rate" shall mean the Wage Rate in effect on December 30, 1983.

(c) For purposes of this article, the number of square feet of rentable area contained in the Demised Premises is hereby fixed at 89,428 square feet.

If the Wage Rate is changed at any time during the term of this Lease and is greater than the Base Wage Rate, Tenant shall pay to Landlord as additional rent an annual sum equal to 1.50 times the product obtained by multiplying (i) the number of cents (including any fraction of a cent), by which the Wage Rate exceeds the Base Wage Rate by (ii) the number of square feet of rentable area in the Demised Premises. Such amounts shall be payable in equal monthly installments commencing with the first monthly installment of fixed rent falling due hereunder after the effective date of such change in the Wage Rate and continuing thereafter until a new adjustment in the additional rent is established and become effective in accordance with the provisions of this paragraph, except that notwithstanding any change in the Wage Rate downwards the fixed minimum annual rental shall not be reduced. If any change in the Wage Rate is made retroactive, Tenant shall pay Landlord the amount of the retroactive adjustment within ten days after being billed for it.

Section 22.02. *Tax adjustments.* Tenant further shall pay to Landlord, as additional rent, sums computed as follows:

(a) "Taxes" shall mean all real estate taxes, assessments, governmental levies, county taxes or any other governmental charge, whether general or special, ordinary or extraordinary, foreseen or unforeseen, or of any kind or nature, which are or may be assessed or imposed upon the Land, any leasehold of air rights or Landlord's share thereof, the Building and the sidewalks, plazas or streets in front of or adjacent thereto, including any tax, excise or fee measured by or payable with respect to any rent, and levied against Landlord and/or the Land and/or Building, under the laws of the United States, the State of New York or any political subdivision thereof or by the City of New York, as a substitute or addition in whole or in part for taxes presently or hereafter imposed on the Land and Building or resulting from or due to any change in the method of taxation, provided that the substitute tax on rent is considered as if the rent were Landlord's only income, but excluding any income, franchise, corporate, estate, inheritance, succession, capital stock, or transfer tax levied on Landlord. The term "Land," when used in this Lease, shall, unless the context otherwise indicates, include air rights, by lease or deed over adjoining property.

(b) "Tax Year" shall mean every 12-month consecutive period commencing each July 1 during the term of this Lease.

(c) "First Tax Year" shall mean that period of 12 months commencing July 1 for which the Building is first assessed for tax purposes, as a completed building.

(d) "Tenant's Proportionate Share" shall be deemed to be 13.625%.

(e) "Basic Tax" shall mean the agreed amount of \$762,500.

If the taxes for any Tax Year including the First Tax Year are greater than the Basic Tax, Tenant shall pay to Landlord as additional rent an amount equal to Tenant's Proportionate Share of the increase over the Basic Tax. If the Commencement Date of this Lease occurs during any Tax Year, or if the term of this Lease expires or is terminated during any Tax Year, the amount shall be prorated.

After the applicable governmental authority issues tax bills for real estate taxes assessed, levied and/or imposed upon the Land and Building, Landlord shall submit to Tenant a copy of the bill or bills. Thereafter, on or about each respective anniversary date, Landlord shall submit a copy of the tax bill or bills for the Taxes assessed, levied or imposed upon the Land and Building for Tax Year, together with a statement which indicates any amount required to be paid by Tenant as additional rent as under this Section.

Within 30 days after the issuance of the statement, Tenant shall pay any additional rent set forth on the statement.

If Landlord receives a reduction of taxes for any Tax Year for which Tenant has paid any additional rent under this

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Section, the proceeds of such reduction less legal fees and other expenses incurred in collecting them, shall be applied and allocated to the period for which the reduction was obtained and proper adjustment shall be made between Landlord and Tenant.

All payments or refunds due hereunder for any period of less than a full Tax Year at the commencement or end of the term of this Lease, or because of any change in the area of the Demised Premises, shall be equitably pro-rated to reflect such event.

Section 22.03. *Rent tax.* Tenant shall pay to Landlord all present and future occupancy and rent taxes payable by Landlord. The tax shall be paid to Landlord as additional rent upon demand.

Article XXIII Electric Inclusion

Section 23.01. *Electric service.* Landlord shall furnish the electric energy required by Tenant in the Demised Premises on a rent inclusion basis. That is, there shall be no charge to Tenant for the electric energy by way of measuring it on any meter or otherwise, but it shall be included in Landlord's services which are covered by the fixed minimum rent. The amount included in the fixed minimum rent was based upon the normal use of electrical energy between the hours of 8:00 a.m. to 6:00 p.m. on Mondays through Fridays, except holidays, for lighting and for the operation of the machinery, appliances and equipment normally used in Tenant's business. Landlord shall not be liable in any way to Tenant for any failure or defect in the supply or character of electric energy furnished to the Demised Premises by reason of any requirement, act or omission of the public utility serving the Building with electricity or for any other reason not attributable to Landlord. Tenant shall furnish and install all lighting tubes, lamps, bulbs, and ballasts required in the Demised Premises, at its expense, or shall pay Landlord's reasonable charges therefor on demand.

Section 23.02. *Tenant electric use.* Subject to the provisions of Section 23.05, Tenant's use of electric energy in the Demised Premises shall not at any time exceed the capacity of any of the electrical conductors, machinery, and equipment in or otherwise serving the Demised Premises. In order to insure that such capacity is not exceeded and to avert possible adverse effect upon the Building electric service, Tenant shall not, without Landlord's prior written consent in each instance, connect any additional fixtures, machinery, appliances, or equipment to the Building electric distribution system or make any alteration or addition to Tenant's machinery, appliances, or equipment (other than an insubstantial number of electric typewriters, small computers, calculators, electric office equipment, or equipment of equivalent nature and immaterial consumption of electric energy), or the electric system of the Demised Premises existing on the Commencement Date. If Landlord grants consent, it shall provide all additional risers or other equipment required therefor and Tenant shall pay the cost thereof upon Landlord's demand. As a condition to granting consent, Landlord may require Tenant to agree to an increase in the fixed minimum rent by an amount that will reflect the values to Tenant of the additional service to be furnished by Landlord, that is, the potential additional electrical energy to be made available to Tenant based upon the estimated additional capacity of the additional risers or other equipment. If Landlord and Tenant cannot agree thereon, the amount shall be determined by an independent electrical engineer, based on standard practices, to be selected by Landlord and paid by Tenant. When the amount of the increase is so determined, the parties shall execute a supplementary agreement to reflect the increase in the amount of fixed minimum rent stated in this Lease and in the amount set forth in Section 23.04, effective from the date the additional service is made available to Tenant; but the increase shall be effective from such date even if the supplementary agreement is not executed.

Section 23.03. *Utility rate adjustment.* A utility rate adjustment shall be made (as provided below) if any one or more of the following events occur: the public utility rate schedule for the supply of electric current to the Building is increased or decreased during the term of this Lease; there is a change in taxes; additional taxes are imposed upon the sale or furnishing of the electric current; there is a change in the space constituting the Demised Premises; if Tenant's failure to maintain its machinery and equipment in good order and repair causes greater consumption of electrical current; if

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Tenant uses electricity on days or hours other than those specified in the third sentence of Section 23.01; or if Tenant adds any machinery, appliances or equipment. In any such event, the fixed minimum rent herein reserved shall be equitably adjusted to reflect the resulting increase in use, and the amount set forth in Section 23.04 shall also be adjusted accordingly. If Landlord and Tenant cannot agree thereon, the amounts of the adjustments shall be determined, based on standard practices, by an independent electrical engineer, to be selected by Landlord and paid by Tenant. When the amounts are so determined, the parties shall execute a supplementary agreement to reflect such adjustments in the amount of the fixed minimum rent stated in this Lease and in the amount set forth in Section 23.04. The adjustments shall be effective from the date of the increase or decrease of such usage as determined by the electrical engineer, or, if applicable, from the effective date of such increase or decrease in the public utility rate schedule. However, the adjustments shall be effective from such date regardless of whether a supplementary agreement is executed.

Section 23.04. *Discontinued service.* If required by law or public regulation or the tariff of the applicable public utility, or if Landlord wishes to discontinue service to the balance of the Building, Landlord may discontinue furnishing electric energy to Tenant in the Demised Premises at any time by giving it not less than 90 days' notice. If Landlord exercises such right to termination, this Lease shall continue in full force and effect and shall be unaffected thereby. However, from and after the effective date of termination, Landlord shall not be obligated to furnish electric energy to Tenant and the fixed minimum rent payable under this Lease shall be reduced by \$44,714 per annum, plus or minus the amount of any change under Sections 23.02 and 23.03. If Landlord so discontinues furnishing electric energy to Tenant, Tenant shall arrange to obtain electric energy directly from the public utility company furnishing electric service to the Building. Such electric energy may be furnished to Tenant by means of the then existing building system feeders, risers, and wiring to the extent that they are available, suitable and safe for such purposes. Tenant shall install and maintain, at its expense, all meters and additional panel boards, feeders, risers, wiring, and other conductors and equipment which may be required to obtain electric energy directly from the public utility company.

Section 23.05. *Electric load limitation.* At no time will the average connected electrical load in each floor of the Demised Premises exceed 5 watts per square foot. Subject only to any limiting requirement, act or omission of the public utility serving the Building with electricity referred to in Section 23.01, as well as the provisions of Section 23.04, Landlord shall furnish sufficient electric energy to each floor of the Demised Premises to supply an average connected electrical load of 5 watts per square foot.

Section 23.06. *Electric tax.* If any tax is imposed upon Landlord with respect to electrical energy furnished as a service to Tenant by any federal, state, or municipal authority, Tenant shall, if permitted by law or applicable regulations, reimburse its pro rata share of the taxes to Landlord.

Section 23.07. *Electrical survey.* Although the charge for the service of redistributing and furnishing electrical energy is included in the fixed minimum rent on a so-called "rent inclusion" basis, Landlord shall, at tenant's expense, select an independent electrical engineer or electrical consulting firm doing solely such work to make a determination within one year next following the commencement of Tenant's normal business activities in all of the Demised Premises, of the charge for the electrical service supplied by the Landlord and used by Tenant annually in the Demised Premises. If Tenant disputes the determination of such engineer or consultant, Tenant may have a survey made by an independent electrical engineer or electrical consulting firm doing solely such work. If the two consultants so chosen do not agree upon the rent inclusion charges, they shall pick a third similar consultant, and the opinion of two of them shall be binding upon the parties. If it is finally determined that the charge exceeds or is less than \$44,714, the parties shall enter into a written supplementary agreement, in form satisfactory to Landlord, modifying this Lease by adjusting the fixed minimum rent by an amount equal to the difference. In that event, the \$44,714 figure set forth in Section 23.04 shall be changed in a like amount.

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Section 24.01. The sole broker who negotiated and brought about this transaction was Stanley & Drake, Inc. Landlord shall pay it a broker's commission as per separate agreement.

Article XXV Subordination

Section 25.01. *Subordination.* This Lease is and shall be subject and subordinate to any ground or underlying lease and any lease of air rights which may now or hereafter affect the Building, the Land, or both, and to any amendment, modification, renewal, or extension of the ground or underlying lease or lease of air rights. This Lease is also subject and subordinate to all mortgages which may now or hereafter affect any lease of air rights or ground or underlying lease or the Land and/or Building and to all renewals, modifications, amendments, consolidations, replacements, or extensions thereof. The Landlord or Lessor under any ground or underlying lease is referred to in this Lease as "Overlandlord." This clause shall be self-operative and no further instrument of subordination shall be required by any Overlandlord or Mortgagee. In confirmation of such subordination, Tenant without cost or charge to Landlord, shall execute promptly any certificate or instrument of subordination requested by Landlord. If Tenant fails upon reasonable request to execute the certificate or instrument, Tenant hereby constitutes and appoints Landlord its attorney-in-fact to execute all such certificates or instruments for and on behalf of Tenant.

Section 25.02. *Notice of mortgagees.* If there is any act or omission by Landlord which would or may give Tenant the right to terminate this Lease or to claim a partial or total eviction, Tenant will not exercise the right until:

- (a) It has given written notice of any such act or omission to the holder of any leasehold mortgage or of any fee mortgage and to the Landlord or Landlords of any ground or underlying lease or leases whose names and addresses previously have been furnished to Tenant by giving such notice, addressed to the holders and the Landlord or Landlords at the last addresses so furnished; and
- (b) A reasonable period of time for remedying such act or omission has elapsed following the giving of notice, during which any of the parties to whom notice was given has not commenced with reasonable diligence to remedy, or cause to be remedied, the act or omission.

Section 25.03. *Mortgage modification.* If, in connection with obtaining temporary or permanent financing for the Land and/or Building or of any ground or underlying lease, any lender requests reasonable modifications of this Lease as a condition to such financing, Tenant shall not unreasonably withhold, delay, or defer the execution of an agreement of modification of this Lease if such modifications do not increase Tenant's financial obligations hereunder or materially adversely affect the leasehold interest hereby created or Tenant's reasonable use and enjoyment of the premises. If Tenant refuses to execute and deliver any such modification agreement within ten days after its request by Landlord, Landlord may cancel and terminate this Lease. Upon such cancellation and termination neither party shall have any further right or obligation to the other arising out of the execution and delivery of this Lease.

Section 25.04. *Nondisturbance of Tenant.* Notwithstanding the provisions of Section 25.01, the subordination of this Lease to any later executed superior lease or superior mortgage or to any later renewal, modification, replacement, or any extension of superior lease or superior mortgage, or to any existing or future consolidation or spreader of any superior mortgage, is subject to the express conditions that, so long as this Lease is in full force and effect and Tenant is not in default of the terms and provisions of this Lease beyond any applicable grace periods:

- (a) Tenant shall not be joined as a party defendant (1) in any action or proceeding which may be instituted or taken by the lessor of the superior lease for the purpose of terminating it by reason of any default thereunder, or (2) in any foreclosure action or proceeding which may be instituted or taken by the holder of the superior mortgage; and
- (b) Tenant shall not be evicted from the Demised Premises, Tenant's leasehold estate under this Lease shall not be

terminated or disturbed, nor shall any of Tenant's rights under this Lease be affected in any way, by reason of any default under the superior leasehold or superior mortgage.

Section 25.05. *Attornment.* If the lessor of a superior lease or the holder of a superior mortgage succeeds to Landlord's rights under this Lease, whether through possession or foreclosure action or delivery of a new lease or deed, then at the request of the successor party ("successor landlord") and upon such successor landlord's written agreement to accept Tenant's attornment, Tenant shall attorn to and recognize the successor landlord as Tenant's landlord under this Lease, and shall promptly execute and deliver any instrument requested by the successor landlord to evidence such attornment. If Tenant refuses or fails promptly upon reasonable request to execute such instrument, Tenant hereby irrevocable appoints Landlord or the successor landlord its attorney-in-fact to execute and deliver the instrument on its behalf. Upon such attornment this Lease shall continue in full force and effect as if it were a direct lease between the successor landlord and Tenant upon all of the terms, conditions, and covenants set forth in it and shall be applicable after such attornment. However, the successor landlord shall not:

- (a) Have any liability for refusal or failure to perform or complete Landlord's work or otherwise to prepare the Demised Premises for occupancy in accordance with the provisions of Exhibit "B" of this Lease;
- (b) Be obligated under Article X to repair, restore, replace, or rebuild the Building or the Demised Premises, in case of total or substantially total damage or destruction, beyond any repair, restoration, or rebuilding that can reasonably be accomplished with the net proceeds of insurance actually received by, or made available to, the successor landlord;
- (c) Be liable for any of Landlord's previous acts or omissions under this Lease;
- (d) Be subject to any offset, not expressly provided for in this Lease, which has previously accrued to Tenant against Landlord;
- (e) Be bound by any previous modification of this Lease, except as expressly provided for in it, or in Article XIV, Section 14.03, by any previous prepayment of more than one month's rent, unless the modification or prepayment has been expressly approved in writing by the lessor of the superior lease or the holder of the superior mortgage through or by reason of which the successor landlord has succeeded to Landlord's rights under this Lease.

Article XXVI Legal Proceedings

Section 26.01. *Waiver of jury trial.* Landlord and Tenant hereby waive, to the extent not prohibited by law, the right to a jury trial in any action, summary proceeding, or legal proceeding between or among the parties or their successors arising out of this Lease, Tenant's occupancy of the Demised Premises, or Tenant's right to occupy the Demised Premises.

Section 26.02. *Tenant counterclaims.* Tenant hereby waives the right to interpose a counterclaim in any summary proceeding instituted by Landlord against Tenant or in any action instituted by Landlord for unpaid rent or additional rent under this Lease.

Section 26.03. *Tenant's equitable remedies.* If Tenant claims or asserts that Landlord has violated or failed to perform a covenant not to unreasonably withhold or delay Landlord's consent or approval, or whenever Landlord's reasonableness in exercising its judgment is in issue, Tenant's sole remedy shall be an action for specific performance, declaratory judgment, or injunction. Tenant shall not be entitled to any money damages for a breach of such covenant or to claim or assert any claims in any money damages in any action or by way of set off, defense, or counterclaim. Tenant hereby specifically waives the right to any money damages or other remedies.

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Article XXVII Surrender of Premises

Section 27.01. Upon the expiration or other termination of the term of this Lease, Tenant shall quit and surrender the Demised Premises in good order and condition, ordinary wear and tear and damage by fire or other casualty, or the elements excepted, and shall remove all its property therefrom, except as otherwise provided in this Lease. Tenant's obligation to observe or perform this covenant shall survive the expiration or other termination of this Lease term.

Article XXVIII Rules and Regulations

Section 28.01. *Rules and regulations.* Tenant, its servants, employees, agents, visitors, and licensees shall observe faithfully and comply strictly with the rules and regulations set forth in Exhibit "D" attached hereto and made a part hereof. Landlord may from time to time during the term of this Lease make reasonable changes in and additions to the rules thus set forth if such changes and additions are applicable to all other office tenants in the Building.

Section 28.02. *Enforcement.* Landlord's failure to enforce any existing or future rules and regulations, either against Tenant or any other tenant in the Building, shall not constitute a breach hereunder or waiver of any such rules and regulations. However, any rule or regulation not generally enforced against other Tenants in the Building will not be discriminatorily enforced against Tenant.

Article XXIX Successors and Assigns

Section 29.01. *Binding effect.* The covenants, conditions, and agreements contained in this Lease shall bind and inure to the benefit of the parties and their respective heirs, legal representatives, successors and, except as otherwise provided herein, assigns.

Section 29.02. *Landlord defined.* The term "Landlord" whenever used in this Lease shall be limited to mean only the owner or owners at the time in question of the Building or the tenant under a ground or underlying lease affecting the Land and/or the Building, to whom this Lease may be assigned, or an overlandlord who enters into possession, or a mortgagee in possession, so that in the event of any sale, assignment or transfer of the Landlord and/or Building, or of the ground or underlying lease, such owner, tenant under the ground or underlying lease or overlandlord or mortgagee in possession shall thereupon be released and discharged from all of Landlord's covenants, conditions and agreements thereafter accruing. However, such covenants, conditions and agreements shall be binding upon each new owner, tenant under the ground or underlying lease, overlandlord or mortgagee in possession for the time being of the Building, until sold, assigned, or transferred.

Article XXX Notices

Section 30.01. Any notice, request, demand, or communication permitted or required to be given by this Lease, or by any law or governmental regulation, by one party to the other, shall be in writing. Unless otherwise required by law or regulation, the notice, request, or demand shall be given, and shall be deemed to have been served and given, by Landlord and received by Tenant when Landlord deposits it by certified or registered mail, return receipt requested, enclosed in a securely closed postpaid wrapper, in a United States Government general or branch post office, addressed to Tenant (1) at the Demised Premises, or (2) until Tenant shall have moved its offices to the Demised Premises, addressed to Tenant at its address as stated on the first page of this Lease. Such notice, request, or demand shall be given, and shall be deemed to have been served and given by Tenant and received by Landlord, when Tenant deposits it, by certified or registered mail, return receipt requested, enclosed in a securely closed postpaid wrapper in such post

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office addressed to Landlord at its address stated on the first page of this Lease. Either party may, by notice sent in the above manner, designate a different address or addresses for notices, requests, demands, or communications to it.

Article XXXI No Waiver; Entire Agreement

Section 31.01. *Non-waiver.* The failure of either party to seek redress for violation of, or to insist upon the strict performance of, any covenant or condition of this Lease, or of Landlord to enforce any Rule or Regulation set forth or hereafter adopted by it, shall not prevent a subsequent act, which would have originally constituted a violation, from having all the force and effect of an original violation. The receipt by Landlord of rent or payment of rent by Tenant with knowledge of the breach of any covenant of this Lease shall not be deemed a waiver of the breach. No provision of this Lease shall be deemed to have been waived by either party, unless it is in writing signed by such party. No payment by Tenant or receipt by Landlord of a lesser amount than the monthly rent herein stipulated shall be deemed to be other than on account of the earliest stipulated rent, nor shall any endorsement or statement on any check or any letter accompanying any check or payment as rent be deemed an accord and satisfaction. Landlord may accept the check or payment without prejudice to its right to recover the balance of the rent or pursue any other remedy provided in this Lease.

Section 31.02. *Entire agreement.* This Lease together with the annexed Exhibits contains the entire agreement between the parties. Any executory agreement hereafter made between them shall be ineffective to change, modify, waive, release, discharge, terminate, or effect an abandonment of this Lease, in whole or in part, unless the executory agreement is in writing and signed by the party against whom enforcement of the change, modification, waiver, release, discharge, termination, or effecting of the abandonment is sought.

Section 31.03. *Severability.* If any term or provision of this Lease is to any extent invalid or unenforceable, the remainder of this Lease shall not be affected thereby and the remaining terms and provisions shall be valid and enforceable to the fullest extent either hereunder or as permitted by law.

Article XXXII Index and Captions; Estoppel Certificate

Section 32.01. *Headings.* The index preceding this Lease and the headings of Articles in this Lease are inserted only as a matter of convenience and for reference. They in no way define, limit, or describe the scope of this Lease or of the intent of any provision thereof.

Section 32.02. *Estoppel certificates.* Each party shall, at any one or more times, upon not less than 10 days' prior notice by the other party, execute, acknowledge, and deliver to it a written statement. The statement shall certify that this Lease is unmodified and in full force and effect (or, if there have been modifications, that the same is in full force and effect as modified and stating the modifications), state the dates to which the fixed minimum rent, additional rent, and other charges have been paid, and state whether to the best knowledge of the signer of the certificate, there exists any default in the performance of any covenant, agreement, term, provision, or condition contained in this Lease, and, if so, specify each such default. The parties intend that any such statement may be relied upon by the other party, by any mortgagee or prospective mortgagee of any mortgage affecting the Building or the Building and the Land or Tenant's interest in this Lease, by any Landlord under a ground or underlying lease affecting the Land or Building, and by any subtenant or assignee of Tenant's interest in this Lease.

Article XXXIII Inability to Perform

Section 33.01. *Landlord performance.* This Lease and Tenant's obligation to pay rent or additional rent hereunder and

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perform and comply with all of its other covenants and agreements hereunder shall in no way be affected, impaired, or excused because of Landlord's delay or failure to perform or comply with any of its covenants or provisions hereunder; or because Landlord is unable to fulfill any of its obligations under this Lease or to supply or is delayed in supplying any service expressly or impliedly to be supplied or is unable to make; or is delayed in making any repair, additions, alterations or decorations; or is unable to supply or is delayed in supplying any equipment or fixtures if Landlord is prevented or delayed from so doing by reason of strike or labor troubles or any other cause including, but not limited to, governmental preemption in connection with a National Emergency or by reason of any rule, order or regulation of any governmental department, agency, or subdivision thereof or the conditions of supply and demand which have been or are affected by war or other emergency. The time given to Landlord to comply with any obligation under this Lease shall be extended for a period equal to any period of delay resulting from any of the above causes.

Section 33.02. *Tenant performance.* This Lease and Landlord's obligation to perform and comply with its covenants and agreements hereunder shall in no way be affected, impaired, or excused because of Tenant's delay or failure to perform or comply with any of its covenants or provisions hereunder; nor because Tenant is unable to fulfill any of its obligations under this Lease or to supply or is delayed in supplying any service expressly or impliedly to be supplied; or is unable to make, or is delayed in making any repair, additions, alterations, or decorations; or is unable to supply or is delayed in supplying any equipment or fixtures, if Tenant is prevented or delayed from so doing by reason of strike or labor troubles or any other cause including, but not limited to, governmental preemption in connection with a National Emergency or by reason of any rule, order or regulation of any governmental department or subdivision or the conditions of supply and demand which have been or are affected by war or other emergency. The time given to Tenant to comply with any obligation under this Lease shall be extended for a period equal to any period of delay resulting from any of the above causes.

Article XXXIV No Representations by Landlord

Section 34.01. Neither Landlord nor its agents have made any representations or promises with respect to the Building, the Land, or the Demised Premises except as expressly set forth herein. No rights, easements, or licenses are acquired by Tenant by implication or otherwise except as expressly set forth in the provisions of this Lease. The taking possession of the Demised Premises by Tenant shall be conclusive evidence as against it, that Tenant accepts the premises and the Building and that they were in good and satisfactory condition when possession was so taken.

Article XXXV Memorandum of Lease

Section 35.01. This Lease shall not be recorded. The parties shall, if Tenant requires, execute and deliver a memorandum of this Lease in proper form for the purpose of recording. However, the memorandum shall not in any circumstances be deemed to modify or change any provision of this Lease. The Lease provisions shall in all instances prevail.

In witness whereof Landlord and Tenant have respectively signed and sealed this Lease as of the day and year first above written.

Melville Building Company

(a New York Limited Partnership) by _____

General Partner

Landlord

Page & Company Inc. by _____

Senior Vice President

Tenant

(Corporate Seal)

(Acknowledgments)

Exhibit "A" (Floor Plan)

Exhibit "B" Procedure for Tenant Work

1. Tenant's work

Tenant, at its expense, shall prepare a set of plans, which shall contain complete information and dimensions necessary for the construction and finishing of the premises. Tenant shall submit the plans to Landlord on or before the following dates:

(a) Partition layouts for A/C design: November 1, 2002.

(b) Final detail drawings: April 1, 2003.

In accordance with these plans, Landlord, at its expense, except as otherwise expressly specified in this Exhibit B and in the foregoing Lease, shall make and complete in and to the premises the following work and installations, all of which shall be of material, manufacture, design, capacity, finish, and color of the building-standard adopted by Landlord for the Building:

I. Partitions:

A. Furnish and install 2 1/2" metal stud drywall partitions with one layer of 5/8" sheetrock each side, spackled, taped and painted. One side of partitions shall extend to slab above hung ceiling.

B. At all points that any partition intersects the perimeter airconditioning enclosures, furnish and install sound baffles within these enclosures.

II. Doors, Bucks & Hardware:

A. Furnish and install ceiling high hollow metal doors in hollow metal bucks. Doors shall be a 3/4" thick. All doors shall be installed in bucks in locations as specified on Tenant's plans.

B. Closets. Each closet, 5'-0' (nominal) in length, ceiling high, and flush bi-fold doors; two wood hat shelves (paint grade) and one metal chrome coat rod. One closet for up to each 3,000 square feet of net rentable area.

C. Furnish and install 1 1/2 pairs of ball bearing butts, a heavy duty latch set, and door stop on each door as designated on the Tenant's plans. All hardware shall be Schlage D-Line or equal in satin chrome finish. Locksets and door closers

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shall be furnished and installed on the basis of a maximum of two doors per floor. All locksets shall be masterkeyed to building system.

III. Ceilings:

Furnish and install a building standard mechanically suspended acoustic ceiling, concealed spline, mineral fissured.

IV. Floor Covering:

A. Furnish and install building standard 1/8" vinyl asbestos tile in all noncarpeted areas including 4" rubber or vinyl base (cove or straight edge) in accordance with Tenant's plans. Colors to be selected by Tenant from Landlord's building standards. (The expression "noncarpeted areas" shall not be deemed to include those areas in which rugs and/or carpets are used or initially planned to be used by the Tenant.)

V. Venetian Blinds:

Furnish and install building standard venetian blinds on all windows of office floors in color and type as selected by Landlord. (No substitutions)

VI. Lighting:

A. Furnish and install one fluorescent lighting fixture per every 90 square feet of rentable area in the demised premises. These fixtures shall be 2' x 4' recessed, designed to contain four 40-watt fluorescent lamps with rapid start ballasts and acrylic plastic lens (without lamps).

B. Furnish and install all miscellaneous fixtures, either fluorescent or incandescent, for such areas as mechanical spaces, toilets, stairwells, exits, etc., in quantities to conform with the Building Code.

C. Furnish and install all quiet type single pole switches and associated wiring facilities required to service the aforementioned lighting fixtures, as required by municipal authorities, but in no event less than one per room.

VII. Electrical:

A. Furnish and install a cellular floor with active cells approximately 6'0" on center and a header duct system for power receptacles and telephone wiring system. Furnish and install, in locations designated on Tenant's plans, standard electrical duplex receptacles with the required associated wiring facilities in the quantity of one outlet per 100 square feet of rentable area in the demised area of which 25% can be floor outlets.

All floor outlets must be located directly above active floor cells.

B. Landlord shall provide adequate electrical power feeders to each floor not to exceed 6-watts per square foot rentable area for Tenant power and lighting requirements, exclusive of air conditioning and elevator power requirements.

C. Furnish and install one telephone outlet per 150 square feet of rentable area in the demised area of which 25% may be floor outlets. All floor outlets must be located directly above active floor cells.

VIII. Heating, Ventilating & Air Conditioning:

Year round air conditioning system except as otherwise provided in this lease, combining the use of periphery units and interior duct air distribution system. The periphery air conditioning system shall service that portion of the demised

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premises being approximately 15 ft. distant from the glass line of the Building. For periphery rooms, Landlord will furnish one thermostat for every two peripheral column bays. Interior duct distribution, including building standard ducts, grilles, etc., to accommodate Tenant's layout. The air conditioning system will maintain interior conditions of 78 degrees dry bulb and 50% relative humidity when outside conditions are 95 degrees dry bulb and 75 degrees wet bulb, and will provide fresh air in a quantity not less than 0.30 cu. ft. per minute per square foot of floor area provided that in any given room or area of the demised premises--the occupancy does not exceed one person for each 100 square feet of the Demised Premises and total connected electric load does not exceed 5 watts per sq. ft. of all purposes, including lighting and power. Duct distribution to accommodate Tenant's layout shall be designed only by Engineer in Landlord's employ.

IX. Plumbing:

Furnish and install rough plumbing for a reasonable amount of Tenant's electric water coolers but not to exceed an average of two per floor and said rough plumbing shall be located at a wet column. Connections and water coolers shall be at Tenant's expense.

X. Painting & Wall Coverings:

A. Paint all walls, vertical furring, nonacoustically treated ceilings, metal or wood doors and door bucks, convactor enclosures and all other masonry or metal surfaces. This painting shall consist of one prime coat and two coats of paint, flat or semi-gloss, stippled finish. Colors for this initial painting of all surfaces shall be selected by Tenant from 12 building standard colors, with no more than one color in any one room or open area.

B. Complete one coat repainting after the fifth and tenth years of the term of the Lease. Only those areas which were originally painted by Landlord at its expense are to be repainted, as called for above.

XI. Miscellaneous:

A. All work performed by the Landlord shall be performed in good and workmanlike manner and the quality of materials, equipment and fixtures shall be of good quality throughout the Building.

2. Substitutions and Credits

Tenant may select different new materials (except venetian blinds) in place of Building standard materials which would otherwise be initially furnished and installed by Landlord under the provisions of this Exhibit. If Tenant makes any such selection, or if different new materials are required because of any situation created by Tenant (by reason of subleasing or any other similar or dissimilar cause) wherein the Building Code prohibits the use of Landlord's Building standard materials, and if the Work Cost of the different new materials exceed Landlord's cost of its Building standard material thereby replaced, Tenant shall pay to Landlord, as provided below, the difference between the Work Cost and Landlord's Cost. Tenant may also indicate on its plans additional Building standard work and materials to be furnished and installed at its expense, and Tenant shall pay to Landlord, as provided below, the Work Cost of the additional work and materials. No different new materials shall be furnished and installed in replacement for any of Landlord's Building standard materials nor shall any additional work or additional materials be furnished and installed until Landlord has received Tenant's agreement to pay the difference between the Cost of the different new materials and Landlord's Cost of the replaced Landlord's Building standard materials, of the Cost of the additional work or additional materials, as the case may be. If within ten days after Landlord's notice to Tenant of such Costs Tenant fails to deliver to Landlord its agreement to pay them, Landlord may proceed with the installation of the Building standard materials which would otherwise have been initially furnished and installed by it under the provisions hereof. All amounts payable by Tenant to Landlord under this exhibit shall be paid as additional rent promptly after Landlord submits bills for them to Tenant. Landlord may submit bills while the work is being performed or while the materials for it are furnished and installed.

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Tenant shall be allowed credit equal to Landlord's unit costs for the omission of Landlord's Building standard materials, but only within each trade.

The term "Work Cost," as used in this Exhibit, shall mean the actual cost (including the cost of applicable insurance premiums and the cost of additional engineering, if any, required by reason of the next preceding paragraph) to Landlord's contractor of furnishing and installing the different new materials or the additional work or additional materials including 21% of the actual costs for the contractor's overhead and profit. The term "Landlord's Cost," as used in this Exhibit, shall mean the estimated or actual cost to Landlord of furnishing and installing its Building standard materials thereby replaced.

3. *Tenant's Installations*

(a) Tenant may employ directly any finishing trades, such as carpeting, curtains, and interior furnishings. Landlord shall provide access to the Demised Premises for such trades and also for the purpose of permitting Tenant to install its furniture, furnishings, business machines, and other like movable property when, in Landlord's opinion, the basic work in the Building and Demised Premises has been completed to the point that the installations or the work of such trades can be made and installed without delaying or interfering with the performance of the work of Landlord's contractors or subcontractors in the Demised Premises or elsewhere in the Building.

(b) All employees of the above finishing trades and those who are employed in Tenant's Installations shall be of union affiliation acceptable to Landlord's contractors and subcontractors. Tenant shall cooperate fully in the maintenance of harmony between all trades. If at any time any entry in the Building causes disharmony, or in Landlord's opinion, interferes with or tends to delay completion of the work of Landlord's contractors or subcontractors in the Demised Premises or elsewhere in the Building, Landlord may immediately withdraw this license by giving Tenant oral or written notice. As soon as such notice is given all employees engaged in the finishing trades or installations shall immediately withdraw from the Building and thereafter have no further right of access in or to the Building.

(c) All work and installations to be done in the Demised Premises by Tenant shall be performed whenever, in the judgment of Landlord and its contractor, the work will not interfere with the performance of other work of Landlord's contractors or subcontractors in the Demised Premises or elsewhere in the Building. Tenant shall pay Landlord for all loss of rent under the Lease caused by delays in the substantial completion of any part of the Demised Premises or the Building resulting from any interference with or delay of other work of Landlord's contractors or subcontractors in the Demised Premises or the Building.

(d) Any installation or work by Tenant shall be at its sole risk and any loss or damage to any work or installations by or for Tenant shall be borne solely by it. Neither Landlord nor its contractors shall be responsible for the care or safety of Tenant's work or installations. Tenant shall promptly repair any damage resulting from its acts or those of its contractors, subcontractors, agents, or employees in the Demised Premises in advance of or subsequent to the Commencement Date.

(e) Any entry upon the Demised Premises or in the Building by Tenant or its agents, employees, contractors, and workmen shall be deemed to be under all of the terms, covenants and provisions of the Lease, except as to the covenant to pay rent.

(f) Tenant shall enter into a written contract or contracts with Landlord's contractor covering the installation of Tenant's Work if the contractor agrees to perform the work and installations at a cost to Tenant not exceeding the contractor's cost plus 21% for its overhead and profits.

4. Miscellaneous

(a) Tenant, at its expense, shall file all required Tenant plans with the Department of Buildings and obtain approvals of other applicable governmental authorities.

(b) The Building, and all facilities and equipment installed by Landlord as part of Landlord's Work, whether in the Demised Premises or elsewhere in the Building, shall be constructed, installed, and operated in such a manner that noise and vibration levels in the Demised Premises resulting from operation of the facilities and equipment shall not exceed the noise and vibration levels in buildings of similar nature, where good construction and operating practices prevail. Landlord shall not be liable for noise or vibrations, however caused, emanating from sources outside the Building.

(c) Landlord at its expense, shall cause the Demised Premises, including the exterior and interior of the peripheral windows, to be cleaned on completion of construction immediately prior to Tenant's occupancy.

(d) All plans, drawings, and specifications for the Demised Premises and required to be submitted by Tenant to Landlord, shall comply and conform with the Building plans filed with the Department of Buildings of the City of New York, and with all the rules, regulations, and other requirements of any governmental department having jurisdiction over the construction of the Building or the Demised Premises. In completing the Building and the Demised Premises, Landlord may make all changes required by any governmental department and all changes and variations in construction due to or in order to meet job conditions affecting their construction. The changes or variations shall not be deemed to be a violation of Tenant's plans or any provision of this Exhibit, and shall be accepted by Tenant.

(e) Notwithstanding any contrary provision herein, if Tenant fails to comply with the Submission Dates as set forth in this Exhibit, Landlord may proceed with all its work in accordance with plans and drawings last submitted by either party to the other and with the standard of the Building. The completion shall be deemed to be substantial completion of the Premises in accordance with the provisions of the Lease.

If, within 30 days after the Submission Dates, Tenant submits no plans, Landlord may complete the Demised Premises only in accordance with the minimum legal requirements necessary for occupancy as "open space." Completion in such manner shall be deemed full compliance with this Exhibit and Landlord shall be released of all further obligations under it.

(f) If substantial completion of the Demised Premises or substantial performance of Landlord's work under this Schedule or further agreements between the parties pertaining to the work is delayed by Tenant's failure to comply with its obligations under this Schedule or by Tenant's changes, the term of this Lease and the payment of rent under it shall commence on the date such term and payment would have commenced had Tenant not so delayed completion of the work. In addition, Tenant shall pay the costs and damages sustained by Landlord by reason of the changes or delay in submitting the layouts.

(g) All of Tenant's plans and drawings shall be subject to Landlord's approval, which it shall not unreasonably withhold. Except as otherwise permitted or required herein, each party shall give the other its required approval or disapproval within 10 days after written request therefor. Submissions of shop drawings, plans, layouts, etc., and requests for authorization to proceed with work at Tenant's expense that are not disapproved or corrected within ten days shall be deemed approved.

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(h) The initial air conditioning duct distribution for the premises other than for special areas will be designed at Landlord's expense. If any engineering services are required for any other purposes or as a result of changes in any of Tenant's layout or its requirements for occupancy, Tenant shall reimburse Landlord for their cost. The engineering services shall be performed by Landlord's engineer only.

Exhibit "C" (Description of Land)

Exhibit "D" Rules and Regulations

1. The rights of tenants in the entrances, corridors, elevators, and escalators of the Building are limited to ingress to and egress from the tenants' premises for the tenants and their employees, licensees, and invitees. No tenant shall use, or permit the use of, the entrances, corridors, escalators, or elevators for any other purpose. No tenant shall invite to its premises, or permit the visit of, persons in such numbers or under such conditions as to interfere with the use and enjoyment of any plaza, entrance, corridor, escalator, elevator or other facility of the Building by other tenants. Tenant shall not use or permit its employees to use the elevators before 10:00 a.m. in a "Down" direction for purposes of taking a coffee break or similar activities. Fire exits and stairways are for emergency use only, and shall not be used for any other purposes by the tenants, their employees, licensees or invitees. No tenant shall encumber or obstruct, or permit the encumbrance or obstruction of any sidewalk, plaza, entrance, corridor, escalator, elevator, fire exit, or stairway of the Building. Landlord reserves the right to control and operate the public portions of the Building and the public facilities, as well as facilities, furnished for the common use of the tenants, in any manner it deems best for the benefit of the tenants generally.

2. The cost of repairing any damage to the public portions of the Building or the public facilities or to any facilities used in common with other tenants, caused by a tenant or its employees, licensees, or invitees, shall be paid by the tenant.

3. Landlord may refuse admission to the Building outside of ordinary business hours to any person not known to the watchman in charge or not having a pass issued by the Landlord or not properly identified, and may require all persons admitted to or leaving the Building outside of ordinary business hours to register. Tenant's employees, agents, and visitors shall be permitted to enter and leave the building whenever appropriate arrangements have been previously made between the Landlord and the Tenant with respect thereto. Each tenant shall be responsible for all persons for whom permission is requested and shall be liable to the Landlord for all acts of such persons. Any person whose presence in the Building at any time shall, in Landlord's judgment, be prejudicial to the safety, character, reputation, and interests of the Building or its tenants may be denied access to the Building or may be ejected from it. For the safety of the tenants and protection of property in the Building, Landlord may prevent all access to the Building, by closing the doors or otherwise, during any invasion, riot, public excitement, or other commotion. Landlord may require any person leaving the Building with any package or other object to exhibit a pass from the tenant from whose premises the package or object is being removed, but the establishment and enforcement of such requirement shall not impose any responsibility on Landlord for the protection of the tenant against the removal of such property. Landlord shall, in no way, be liable to any tenant for damages or loss arising from the admission, exclusion, or ejection of any person to or from the tenant's premises or the Building under this rule.

4. No tenant shall obtain or accept for use in its premises ice, drinking water, food, vending machines, beverage, towel, barbering, boot blacking, floor polishing, lighting maintenance, cleaning, or other similar services from any persons not authorized by the Landlord in writing to furnish such services, if Landlord authorizes a person or persons to provide services desired by Tenant, and the charges for services are not excessive. The services shall be furnished only at the hours, in the places within the tenant's premises, and under the regulations fixed by Landlord.

5. No tenant shall install any awnings or other projections over or around the windows. Only window blinds supplied or

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permitted by Landlord shall be used in a tenant's premises.

6. No hand trucks, except those equipped with rubber tires and side guards, shall be used by Tenant, jobbers, or others in delivering or receiving merchandise in any space or the public halls of the Building.

7. All entrance doors in each tenant's premises shall be left locked when the premises are not in use. Entrance doors shall not be left open at any time. All windows in each tenant's premises shall be kept closed at all times and all blinds therein above the ground floor shall be lowered when and as reasonably required because of the position of the sun, during the operation of the Building air conditioning system to cool or ventilate the tenants' premises.

8. No noise, including the playing of any musical instruments, radio, or television, which, in Landlord's judgment, might disturb other tenants in the Building shall be made or permitted by any tenant. No cooking shall be done in the tenant's premises, except as expressly approved by Landlord. Nothing shall be done or permitted in any tenant's premises, and nothing shall be brought into or kept in any tenant's premises, which would impair or interfere with any of the Building services, the proper and economic hearing, cleaning or other servicing of the Building or the premises, or the use or enjoyment by any other tenant of any other premises. No tenant shall install any ventilating air conditioning, electrical, or other equipment of any kind which might cause any such impairment or interference.

9. Tenant shall not permit any cooking or food odors emanating within the Demised Premises to seep into other portions of the Building.

10. No acids, vapors, or other materials shall be discharged or permitted to be discharged into the waste lines, vents, or flues of the Building which may damage them. The water and wash closets and other plumbing fixtures in or serving any tenant's premises shall not be used for any purpose other than that for which they were designed or constructed, and no sanitary napkins, paper towels, sweepings, rubbish, rags, acids, or other foreign substances shall be deposited therein. Each tenant shall be responsible for all damages resulting from any misuse of the fixtures by it or by its servants, employees, agents, visitors, or licensees.

11. No signs, advertisement, notice, or other lettering shall be exhibited, inscribed, painted, or affixed by any tenant on any part of the outside or inside the premises or the Building without Landlord's prior written consent. If any tenant violates the preceding rule, Landlord may remove the sign or other lettering without any liability and charge the tenant for the resulting expense. Interior signs and lettering on doors and elevators shall be inscribed, painted, or affixed for each tenant by Landlord at the Tenant's expense, and shall be of a size, color and style acceptable to Landlord. Landlord may prohibit any advertising by any tenant which impairs the reputation of the building or its desirability as a building for offices, and upon written notice from Landlord, Tenant shall refrain from or discontinue such advertising.

12. No additional locks or bolts of any kind shall be placed upon any door or window in any tenant's premises and no lock on any door therein shall be changed or altered in any respect. Duplicate keys for a tenant's premises and toilet rooms shall be procured only from Landlord, which may make a reasonable charge therefor. Upon the termination of a tenant's lease, all keys of the tenant's premises and toilet rooms shall be delivered to Landlord.

13. No tenant shall mark, paint, drill into, or in any way deface any part of the Building or the premises demised to him. No boring, cutting or stringing of wires shall be permitted, except with Landlord's prior written consent and as directed by Landlord. No tenant shall install any resilient tile or similar floor covering in the demised premises except in a matter approved by Landlord.

14. No tenant shall use or occupy, or permit any portion of the demised premises to be used or occupied, as an office for a public stenographer or typist, as a barber or manicure shop, or as an employment bureau. No tenant or occupant shall engage or pay any employees in the Building, except those actually working for such tenant or occupant in the Building, nor advertise for laborers giving an address at the Building.

15. No premises shall be used, or permitted to be used, at any time, as a store for the sale or display of goods, wares, or merchandise of any kind, as a restaurant, shop, booth, bootblack, or other stand, for the conduct of any business or occupation which predominantly involves direct patronage of the general public in the premises demised to such tenant, or for manufacturing or other similar purposes. However, nothing in the preceding sentence shall prohibit the conduct of the business and services of securities and commodities brokerage and investment banking.

16. The requirements of tenants will be attended to only upon application at the building office. Landlord's employees shall not perform any work or do anything outside of the regular duties, unless under special instructions from Landlord's office.

17. If Landlord is required to discontinue providing electric current to the premises demised to Tenant, each tenant shall, at its expense, provide artificial light in its demised premises for Landlord's agents, contractors, and employees while performing janitorial or other cleaning services and making repairs or alterations in such premises.

18. The tenant's employees shall not loiter around the hallways, stairways, elevators, front, roof, or any other part of the building used in common by the occupants thereof.

19. If the premises demised to any tenant become infested with vermin, such tenant, at its expense, shall cause its premises to be exterminated, from time to time, to Landlord's satisfaction, and shall employ only those exterminators approved by Landlord.

20. Tenant shall, at its expense, care for and clean all cuspidors or similar containers or receptacles used in any tenant's premises. C.6 Amendment to office space lease providing for expansion of space--rent increase for added space--option for additional expansion space--right of first offer--renewal option

COMMENT

Lease amendments:

As with any contract, a lease may be amended in accordance with applicable requirements of law and the original requirement. Most leases provide that they can be amended, but only in a writing signed by both parties. Such a writing, the lease amendment, changes and becomes a part of the original lease. This lease amendment form specifically refers to, changes and deletes the various affected sections of the original lease.

Lease amendments are commonly needed to adjust the agreement of the parties to account for unanticipated changes in the premises or the business needs of one or both of the parties. This form amends a number of sections of the original lease in response to the unanticipated growth of the tenant. Among other things, the amendment provides for three separate office space expansions (including changes in rent to account for the additional space), an option to expand more in the future, a right of first refusal for certain nearby office space, and a renewal option.

Option to expand space:

If a tenant anticipates future growth, the tenant may want the option to expand the area of its premises in the landlord's facility. Expansion options may be achieved by giving the tenant the right of first refusal or the right of first offer for the desired space as it becomes available. Such a provision will give the tenant a right to lease the desired space that is superior to the right of any third party. Under such an arrangement, the tenant has no obligation to lease the additional space if and when it becomes available. Alternatively, surrounding tenants may be restricted to short-term leases of adjoining space, which are

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expressly subject to the right of the landlord to relocate them if the principal tenant seeks to expand.

Right of first offer:

This form accommodates the tenant's concerns about future expansion by granting the tenant a right of first offer. The landlord who gives a tenant a right of first offer is obligated to offer to lease the desired premises to the tenant before offering to lease the premises to any third parties. The tenant's right to lease is activated when the landlord offers the property to the tenant at a rental price and upon terms chosen by the landlord. The tenant may accept the landlord's terms for the lease, or, if not, the landlord may offer the premises to third parties at the same rental price and upon the same terms.

For further information, see Chapter 4.

FORM

AMENDMENT TO LEASE

THIS AMENDMENT TO LEASE ("Amendment") is made _____, 20_____,
between _____ Associates, a limited partnership in the State of _____ (Landlord),
and _____ Corp., a corporation incorporated under the laws of the State of _____
(Tenant).

RECITALS:

A. Landlord and Tenant entered into a certain Lease dated _____, 20_____, as amended by an Amendment to Lease dated _____, 20_____ (collectively the "Lease"), for the lease of certain premises now containing approximately _____ useable square feet (the "Existing Premises"), as more particularly described in the Lease, which space is known as Suite _____ and is located on the eighth floor of the building known as The _____ Building, in the City of _____, State of _____.

B. Tenant desires to lease additional space on the eighth floor of The _____ Building, shown within the area outlined in red on Exhibit B, attached hereto and by this reference made a part hereof, containing approximately _____ useable square feet (the "First Expansion Space").

C. Tenant desires to lease additional space on the seventh floor of The _____ Building, shown within the area outlined in red on Exhibit C, attached hereto and by this reference made a part hereof, containing approximately _____ useable square feet (the "Second Expansion Space").

D. Tenant desires to lease additional space on the ninth floor of The _____ Building, shown within the area outlined in red on Exhibit D, attached hereto and by this reference made a part hereof, containing approximately _____ useable square feet (the "Third Expansion Space").

E. Landlord and Tenant desire to amend the Lease in order to provide for the terms of leasing the First Expansion Space, the Second Expansion Space and the Third Expansion Space and to memorialize other changes they have agreed to concerning the Lease by entering into this Third Amendment.

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NOW, THEREFORE, in consideration of the premises, the terms, covenants and conditions set forth below and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Landlord and Tenant agree as follows:

1. *Certain Definitions.* Unless specifically defined herein or the context clearly requires a different meaning, the words and phrases used herein that are defined in the Lease and not otherwise defined in this Amendment shall have the meanings ascribed to them in the Lease. The term "First Effective Date" as used herein means the date that Landlord substantially completes and delivers the First Expansion Space to Tenant. The term "Second Effective Date" as used herein means the date that Landlord substantially completes and delivers the Second Expansion Space to Tenant. The term "Third Effective Date" as used herein means the date that Landlord substantially completes and delivers the Third Expansion Space to Tenant.

2. *Term.* The term of the Lease is hereby extended for a period of approximately seven (7) years beginning on the First Effective Date and ending seven (7) years after the last day of the month in which the First Effective Date occurs (the "Extended Term").

3. *First expansion space.* Effective as of the First Effective Date, Landlord leases to Tenant and Tenant hereby leases from Landlord the First Expansion Space. As of the First Effective Date, the Premises and all references thereto throughout the Lease shall include the First Expansion Space and the total square footage of the Premises shall contain _____ useable square feet and _____ rentable square feet.

As of the First Effective Date, the second sentence of Section _____ of the Lease is hereby deleted in its entirety and the following is substituted in lieu thereof:

"Tenant acknowledges, understands and agrees that the rentable square footage of the Premises (_____ square feet) rather than the usable square footage of the Premises (_____ square feet) is the basis for calculating rental increases for Real Estate Taxes and Building Operating Costs."

4. *Second expansion space.* Effective as of the Second Effective Date, Landlord leases to Tenant and Tenant hereby leases from Landlord the Second Expansion Space. As of the Second Effective Date, the Premises and all references thereto throughout the Lease shall include the Second Expansion Space and the total square footage of the Premises shall contain _____ useable square feet and _____ rentable square feet.

As of the Second Effective Date, the second sentence of Section _____ of the Lease is hereby deleted in its entirety and the following is substituted in lieu thereof:

"Tenant acknowledges, understands and agrees that the rentable square footage of the Premises (_____ square feet) rather than the usable square footage of the Premises (_____ square feet) is the basis for calculating rental increases for Real Estate Taxes and Building Operating Costs."

5. *Third expansion space.* Effective as of the Third Effective Date, Landlord leases to Tenant and Tenant hereby leases from Landlord the Third Expansion Space. As of the Third Effective Date, the Premises and all references thereto throughout the Lease shall include the Third Expansion Space and the total square footage of the Premises shall contain _____ useable square feet and _____ rentable square feet.

As of the Third Effective Date, the second sentence of Section _____ of the Lease is hereby deleted in its entirety and the following is substituted in lieu thereof:

"Tenant acknowledges, understands and agrees that the rentable square footage of the Premises (_____ square feet) rather than the usable square footage of the Premises (_____ square feet) is the basis for

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calculating rental increases for Real Estate Taxes and Building Operating Costs."

6. *New Exhibit A.* The Lease Data Sheet attached to the Lease as Exhibit A is deleted in its entirety and Exhibit A attached hereto is substituted as the new Lease Data Sheet.

7. *Rent.* During the Extended Term, Tenant covenants and agrees to pay to Landlord, at such place as Landlord may designate, without deduction or setoff, except as otherwise expressly provided in the Lease, rent for the Premises as follows:

(a) During the period beginning on the First Effective Date and ending on the date preceding the Second Effective Date, the sum of \$_____ per annum, in equal monthly installments of \$_____ each, in advance on the first day of each and every calendar month during said period;

(b) During the period beginning on the Second Effective Date and ending on the date preceding the Third Effective Date, the sum of \$_____ per annum, in equal monthly installments of \$_____ each, in advance on the first day of each and every calendar month during said period;

(c) During the period beginning on the Third Effective Date and ending _____, 20_____, the sum of \$_____ per annum, in equal monthly installments of \$_____ each, in advance on the first day of each and every calendar month during said period;

(d) During the period beginning _____, 20_____ and ending _____, 20_____, the sum of \$_____ per annum, in equal monthly installments of \$_____ each, in advance on the first day of each and every calendar month during said period; and

(e) During the period beginning _____, 20_____ and ending on the expiration date of the Extended Term, the sum of \$_____ per annum, in equal monthly installments of \$_____ each, in advance on the first day of each and every calendar month during said period.

8. *Rent abatement.* Effective as of the First Effective Date, Section _____ of the Lease, captioned "Rent Abatement," is hereby deleted in its entirety and the following is substituted in lieu thereof:

"Notwithstanding anything to the contrary contained in Section _____ of the Lease or the Lease Data Sheet, Tenant shall be entitled to a rent abatement at the rates and at the time set forth in the following schedule (collectively the "Rental Abatement"):

TIME PERIOD	RATE PER MONTH

Beginning on the Second Effective Date and ending _____ months thereafter.	\$_____ per month.

Beginning on the Third Effective Date and ending _____ months thereafter.	\$_____ per month.

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The Rental Abatement provided for in this Section is applicable only during the Extended Term and is totally inoperable and without effect during any renewal period of the Lease.

9. *Increases for taxes and building costs.*

(a) Effective as of the First Effective Date, Second Effective Date and Third Effective Date, Tenant's pro rata share of Building Operating Costs and Real Estate Taxes shall be respectively increased as shown in Sections _____, _____, _____, and _____ of the Lease Data Sheet attached as Exhibit A.

(b) Notwithstanding anything to the contrary contained in Section _____ of the Lease, Tenant's pro rata share of any increase for any comparison year in Building Operating Costs shall not exceed _____ percent of Tenant's pro rata share of those expenses for the preceding comparison year, or a _____ percent increase on a cumulative basis for the Extended Term.

10. *Improvements.* Landlord, at Landlord's expense, agrees to make the improvements to the First Expansion Space and the Existing Premises in accordance with the work letter and floor plan attached hereto as Exhibit E. Notwithstanding the foregoing, Tenant shall pay the sum of \$ _____ toward the cost of the improvements for the First Expansion Space, which sum shall be paid by Tenant to Landlord on or before the First Effective Date. Landlord, at Landlord's expense, agrees to make the improvements to the Second Expansion Space in accordance with the work letter attached hereto as Exhibit F. Landlord, at Landlord's expense, agrees to remodel the Third Expansion Space in the same manner and style and on the same terms as provided for in the Existing Premises.

11. *Storage area.* Landlord shall relocate Tenant's storage area to another location of comparable size in The _____ Building.

12. *Additional expansion space options.*

(a) The first paragraph of Section _____ of the Lease is hereby deleted in its entirety and the following is substituted in lieu thereof:

"Tenant shall have options to lease the respective additional amounts of rentable square feet shown at Sections _____ and _____ on the Lease Data Sheet located on the tenth floor of the Building by giving written notice to Landlord on or before the respective dates shown at Sections _____ and _____ on the Lease Data Sheet. Such options are given upon the following terms and conditions:"

(b) The term "Expansion Space Effective Date" as used in Section _____ of the Lease shall mean the dates appearing in Section _____ and Section _____ of the Lease Data Sheet, whichever may be applicable at the time in question.

(c) The following is added to the end of Section _____ of the Lease as Subsection _____ :

"If the spaces identified in Sections _____ and _____ of the Lease Data Sheet become available prior to the respective times specified, then Landlord will notify Tenant of such availability and Tenant may elect to lease such space(s) on the same terms as provided above. Tenant must exercise such election within fifteen (15) business days after receipt of Landlord's notice. If Tenant fails to exercise such option(s), Landlord may lease that space to another tenant; however, Tenant shall again have the right to elect to lease such space(s) at the times originally

stated."

(d) Section _____ of the Lease is deleted in its entirety and the following is substituted in lieu thereof:

"The annual rent for the additional space shall be at the same rate per rentable square foot, including all applicable escalations, then being paid by Tenant for the Existing Premises as of the Expansion Space Effective Date, but subject to the rental increases for the Existing Premises in effect from time to time as provided in Sections 7 and 17 of this Amendment."

(e) Notwithstanding anything to the contrary contained in this Amendment, the Lease Data Sheet or the Lease, Tenant's Second Expansion Option more fully described in Section _____ of the Lease Data Sheet, shall be null and void unless Tenant simultaneously exercises its renewal option in accordance with the provisions of Section 17 of this Amendment.

13. *Right of first offer.*

(a) During the Extended Term, Tenant shall have the right of first offer (the "Right of First Offer"), to lease space located on the tenth and eleventh floors of The _____ Building (the "Offer Space"), subject to Sections 13(b) through 13(f) of this Amendment, inclusive.

(b) At the time Tenant exercises a Right of First Offer:

(i) The Lease must be in full force and effect;

(ii) Tenant shall not be in Default; and

(iii) The commencement date of the lease for any Available First Offer Space must be at least three (3) years prior to the expiration date of the Extended Term unless Tenant simultaneously exercises its option to renew in accordance with the provisions of Section 17 of this Amendment.

(c)(i) Subject to the other terms of this Section 13, after any part of the Offer Space has or will "become available" (defined below), Landlord shall not, during the Extended Term, offer on the market or lease to another tenant that space within the Offer Space that has or will become available without first offering Tenant the right to lease that space.

(ii) Space shall be deemed to become available when the lease for the current occupant of the space expires or is otherwise terminated.

(iii) Notwithstanding Section 13(c)(ii) of this Amendment, Offer Space shall not be deemed to become available if the space is:

(1) Assigned or subleased by the current tenant of the space;

(2) Released by the current tenant of the space by renewal, extension, or renegotiation;

(3) Subject to a specific expansion right of another tenant in the Building existing as of the date of this Amendment unless and until such tenant(s) has (have) failed to timely exercise its (their) option(s) or right(s); or

(4) Not leased to a tenant as of the date of this Lease (until that space is leased, and then subsequently "becomes available").

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(iv) Consistent with Section 13(c)(i) of this Amendment, Landlord shall not offer any such Offer Space on the open market unless and until Landlord has first notified Tenant in writing (the "First Offer Leasing Notice") that Landlord intends to offer the designated Offer Space to third parties, and until a period of fifteen (15) days has elapsed from the date that Landlord has delivered to Tenant the First Offer Leasing Notice without Tenant having notified Landlord in writing of Tenant's desire to lease all of the Available First Offer Space (defined below). The First Offer Leasing Notice shall:

(1) Advise Tenant that Landlord intends to offer on the market the Available First Offer Space;

(2) Describe the amount and location of the First Offer Space that has or will become available (the "Available First Offer Space") and attach a floor plan showing the Available First Offer Space crosshatched; and

(3) Set forth the date on which the Available First Offer Space will be available for leasing by Tenant (which shall not be more than twelve (12) months and not less than three (3) months after the date of the First Offer Leasing Notice).

(v) Subject to Section 13(b) of this Amendment, if Tenant delivers to Landlord written notice of Tenant's desire to lease all of the Available First Offer Space within the fifteen-day period, the Available First Offer Space shall be leased by Tenant on the terms and conditions set forth in this Section 13.

(vi) If Tenant declines or fails to effectively exercise the Right of First Offer as provided herein or fails to meet the conditions set forth in Section 13(b) of this Amendment, Landlord shall thereafter be free to offer the particular Available First Offer Space previously identified in a First Offer Leasing Notice on the open market and to lease some or all of that Available First Offer Space previously offered to Tenant at any time without regard to the restrictions in this Section 13 and on whatever terms Landlord may decide in its sole discretion.

(vii) If Landlord rejects Tenant's acceptance of any Offer Space because Tenant fails to meet the conditions in Section 13(b) or (c) of this Amendment, Landlord must provide to Tenant a written notice within ten (10) days after receiving Tenant's acceptance, which Landlord notice shall specify in detail how Tenant failed to meet the cited conditions.

(d) If Tenant leases Available First Offer Space under this Section 13, all of the terms and conditions of the Lease shall apply to the Available First Offer Space except that:

(i) The commencement date of the Lease for each particular Available First Offer Space shall be seven (7) days after the Available First Offer Space is delivered to Tenant broom clean, free of tenants or other occupants, and otherwise in the condition required by Section 13(d)(ii), and the termination date shall be the same as for the Existing Premises, including any extension or renewal terms (exercised or to be exercised).

(ii) Landlord shall build-out the Available First Offer Space in the same manner and style as for the Existing Premises or if the Available First Offer Space is already built out, then Landlord shall adapt the Available First Offer Space to conform with the style and layout of the Existing Premises.

(iii) The annual rent for the Available First Offer Space shall be at the same rate per rentable square foot, including all escalations, then being paid by Tenant for the Existing Premises as of the commencement of the lease for the Available First Offer Space, but subject to rental increases for the Existing Premises in effect from time-to-time as provided in Sections 7 and 17 of this Amendment.

(iv) As of the commencement date for the Available First Offer Space, Tenant's pro rata share shall be increased to an amount computed by dividing the total of the rentable square footage of the Existing Premises plus all Available First Offer Space leased by Tenant plus all other space becoming part of the Existing Premises after the date of this Amendment (the numerator) by the rentable square footage of The _____ Building (the denominator),

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and expressing the fraction as a percentage.

(v) Any Available First Offer Space taken by Tenant shall be deemed part of the Premises as of the commencement of the lease term for such Available First Offer Space taken by Tenant.

(e) Landlord shall use commercially reasonable efforts to remove any holdover tenants or other occupants from the Available First Offer Space Tenant leases under this Section 13. Although Landlord shall not be liable for any damages for any holdover Tenant or other occupant (unless Landlord is not using commercially reasonable efforts to remove the holdover tenant or other occupant), all of Tenant's obligations regarding the Available First Offer Space shall be abated until the holdover tenant or other occupant is removed, and the commencement date for the Available First Offer Space shall be delayed until the holdover tenant or other occupant is removed.

(f) The parties shall, within thirty (30) days after each time Tenant adds any Available First Offer Space, confirm in writing:

(i) The Commencement date for the Available First Offer Space;

(ii) The Available First Offer Space that was leased showing that space cross-hatched;

(iii) The additional rent to be paid for the Available First Offer Space;

(iv) The increased pro rata share allocated to the Available First Offer Space; and

(v) Any other terms related to the Available First Offer Space or this lease that either party reasonably requests to be confirmed.

14. *Rental escalations--operating expenses.* Tenant shall have the right to audit Building Operating Costs payable as provided in Section _____ of the Lease upon thirty (30) days prior written notice to Landlord. Tenant's right to dispute any item pursuant to Section _____ of the Lease is subject to the condition that Tenant shall have paid to Landlord all amounts due from Tenant to Landlord on or before the time required therefor under the provisions of the Lease. In no event shall Tenant be entitled to withhold, deduct, or offset any monetary obligation of Tenant to Landlord under the Lease (including, without limitation, Tenant's obligation to make all rental payments and all payments for its pro rata share of real estate taxes and Building Operating Costs) pending the resolution of any disputed item. Tenant acknowledges that Landlord maintains its records for this property at its offices at _____ Street, City of _____, State of _____, and Tenant therefore agrees that any review of records under this Subsection shall occur at that location.

Tenant acknowledges and agrees that any records reviewed under Section _____ of the Lease constitute confidential information of Landlord, which shall not be disclosed to anyone other than the accountants performing the review, the principals of Tenant who receive the results of the review and Tenant's attorneys. Any dispute arising from any audit as provided in this Section 14 shall be subject to arbitration as provided in Section _____ of the Lease.

15. *Right to relocate.* Landlord reserves the right at any time to relocate Tenant from the Second Expansion Space to other space within the Building. Landlord shall give Tenant at least sixty (60) days' prior written notice of its intention to relocate Tenant from the Second Expansion Space to other space within the Building. Landlord shall make reasonable efforts to assure that the relocated premises are comparable in size and tenant finish with the Second Expansion Space; however, the relocated premises shall contain at least _____ percent of the number of useable square feet that are contained in the Second Expansion Space. The rent for the relocated premises will be calculated at the rate per rentable square foot of floor area as the rate from time to time in effect for the Second

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Expansion Space, but will not exceed the rent for the Second Expansion Space regardless of whether the relocated premises are larger than the Second Expansion Space. Landlord agrees to pay the reasonable costs of moving Tenant from the Second Expansion Space to the relocated premises and the cost of replacing Tenant's then existing stock of stationary and business cards bearing the Second Expansion Space suite number.

16. *Minimum space guaranty.*

(a) During calendar year 20_____, Landlord shall afford Tenant the opportunity to lease at least_____ square feet of additional space in the Building for a term commencing on or about_____, 20_____ and ending on the same termination date as for the Existing Premises including any extension or renewal term (exercised or to be exercised). Any additional space offered to Tenant during calendar year 20_____ as provided in Section_____ of the Lease and Section 13 of this Amendment shall be credited against that_____ square feet. Any additional space offered to Tenant other than pursuant to the provisions of Section_____ of the Lease or Section 13 of this Amendment shall be offered by Landlord to Tenant on the same terms and conditions as provided in Sections 13(b), (c)(iv)-(vii), (d), (e) and (f) of this Amendment. The additional space contemplated by this paragraph need not be a single block of space, but rather may comprise multiple areas of The_____ Building that together aggregate approximately_____ square feet.

(b) If Tenant exercises its renewal option in accordance with the provisions of Section 17 of this Amendment, then during calendar year 20_____, Landlord shall afford Tenant the opportunity to lease at least_____ square feet of additional space in The_____ Building for a term commencing on or about_____, 20_____ and ending on the expiration date of the renewal option described in Section 17 of this Amendment. Any additional space offered to Tenant during calendar year 19_____, as provided in Section_____ of the Lease and Section 13 of this Amendment, shall be credited against the_____ square feet. Any additional space offered to Tenant, other than pursuant to the provisions of Section_____ of the Lease or Section 13 of this Amendment, shall be offered by Landlord to Tenant on the same terms and conditions as provided in Section 13(b), (c)(iv)-(vii), (d), (e) and (f) of this Amendment. The additional space contemplated by this paragraph need not be a single block of space, but rather may comprise multiple areas of The_____ Building that together aggregate approximately_____ square feet.

17. *Renewal option.* Section_____ of the Lease is deleted in its entirety and the following is substituted in lieu thereof:

"(a) The Tenant shall, if it is not in default, have the option to extend this Lease for one (1) period (renewal period) as shown at Item_____ on the Lease Data Sheet for the number of years shown at Item_____ on the Lease Data Sheet by giving written notice of such renewal to Landlord no later than the date shown at Item_____ on the Lease Data Sheet.

"(b) If such option to extend is exercised, all provisions and covenants of this Lease shall be in full force and effect during such extended term, except that the annual rental during the renewal period shall be the higher of (i) the annual rental payable by Tenant during the last year of the Extended Term of this Lease, or (ii) the product of the annual rental payable by Tenant during the last year of the Extended Term of this Lease multiplied by a fraction, the numerator of which shall be the Department of Labor, Bureau of Labor Statistics Consumer Price Index for "All Urban Consumers" (CPI-U, 1982-84 Base = 100, the "Index") as of the first day of the renewal period and the denominator of which shall be the Index as of the Effective Date (i.e.,_____, 20_____).

"References to the Consumer Price Index applicable to any date means the Consumer Price Index published most recently prior to that date. If the Department of Labor, Bureau of Labor Statistics, ceases to publish the Index, the index

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that would most nearly accomplish the purpose and use thereof by the parties hereto with respect to the adjustment in rent herein contemplated shall be used in lieu of the Index. As soon as Landlord obtains the necessary data, it shall determine the annual rent payable during the renewal period and notify the Tenant of the adjustment in writing. Pending that determination, Tenant shall continue to pay the same monthly rent it was paying during the last year of the Extended Term. Should the monthly rent for the period following that adjustment date exceed the monthly rent previously paid by Tenant for such period, Tenant shall forthwith pay the difference to Landlord.

(c) If (i) Tenant shall fail to exercise the renewal option during the period in which it is available and in the manner required hereby, or (ii) this Lease is no longer in full force and effect for any reason, or (iii) Tenant is in default under this Lease, at the time of such exercise, said renewal option shall terminate, be void and of no further force or effect.

"(d) Unless otherwise herein expressly provided, any reference in this Lease to the "term of this Lease" shall mean the original term hereof, the Extended Term and the renewal period, if exercised by Tenant pursuant to its option to renew set forth in this Section, except to the extent that the original term, the Extended Term or renewal period may be sooner terminated or canceled under any provisions of this Lease.

"(e) The base year for rental escalation during the renewal period shall be the escalation base year as set out at Item _____ on the Lease Data Sheet."

18. *Reaffirmation and conflicts.* All of the terms, covenants and conditions of the Lease shall continue in full force and effect, and the same are hereby reaffirmed, remade and rewritten, except to the extent that any such terms, covenants or conditions have been nullified hereby or conflict or are inconsistent with the terms of this Amendment, in which event the terms of this Amendment shall, in all respects, govern and prevail. Tenant acknowledges that to the best of its knowledge, it has no claims, defenses, or offsets regarding the performance of any of its obligations under the Lease, nor any claims against Landlord or its agents.

19. *Binding effect.* This Amendment shall be binding upon and shall inure to the benefit of the parties hereto and their respective successors and assigns. No reference in the preceding sentence to assigns shall be deemed to authorize any assignment or other transfer, in whole or in part, of the interest of Tenant in violation of any of the provisions of the Lease.

IN WITNESS WHEREOF, Landlord and Tenant have executed this Amendment as of the date first above written.

SIGNED IN THE PRESENCE OF: LANDLORD:

_____ By: _____

(Witnesses as to Landlord)

TENANT:

_____ By: _____

(Witnesses as to Tenant)

Acknowledgments

C.7 Sublease--simultaneous termination with underlying lease

COMMENT

There is a distinction between a true sublease and an assignment of a lease. An assignment is deemed to be a complete transfer of all of one's interest in a lease in some jurisdictions.

Sublease vs. assignment:

An assignment transfers the entire unexpired term in the whole or some part of the leased and/or demised premises, leaving no reversionary interest in the transferor. It is a transfer of the prime lessee's whole interest in the lease in the whole or some part of the demised premises.

A transfer of a portion of the lessee's interest, however, is a sublease. A transfer creating new conditions with a right of reentry or new causes of forfeiture is also a sublease, since the transferee in such case holds by different tenure than his transferor. A transferor who reserves the right of reentry for breach of conditions has a contingent reversionary interest which prevents his transfer from operating as an assignment of the whole of the unexpired term; instead, a sublease is created. If a subtenant makes rental payments directly to the owner rather than to his transferor, that does not affect the status of the transfer, even though such payment is by mutual agreement.

Whether a given transaction constitutes an assignment or a sublease will depend upon its legal effect rather than on what the parties denominate it or what sort of instrument they may employ to give it effect.

Remedies of lessor against lessee's assignees:

Whatever remedies the lessor of any real property has against his immediate lessee for the breach of any agreement in the lease, or for recovery of the possession, he also has against the assignees of the lessee for any cause of action accruing while they are the assignees, except where the assignment is made as security for a loan, and is not accompanied by possession of the premises.

In some jurisdictions an occupant of real property holding possession by bare assignment of the lessee assumes, vis-a-vis the lessor, only such obligations as arise out of privity of estate, as distinguished from those arising on privity of contract and therefore is bound to perform only those covenants running with the land.

Effect of lease provisions on sublease:

Leases frequently contain a prohibition against the lessee's assigning or subletting the leased premises without the prior consent of the lessor. Generally, these provisions prohibit only voluntary and not involuntary assignments. Thus, transfer by execution sale and assignment by lessee's estate may be permissible. If the lessor desires to avoid an involuntary transfer of the leasehold interest of the tenant, it should be expressly provided in the lease.

A clause prohibiting the assignment of a lease does not necessarily foreclose every voluntary transfer of the lessee's rights. If a transfer results merely from a change in the legal form of a business and does not affect the interests of the party protected by the nonassignment provisions of the lease, there may be no breach of that provision. Accordingly, a lessee might be permitted to transfer the lease to a corporation formed and wholly owned by the lessee.

The incorporation of the lessee does not of itself operate as an assignment of the lease to the corporation. For example, the incorporation of an existing partnership does not operate to transfer to the corporation the title to the real or personal property of the partnership or association in the absence of a statutory provision to such effect. But there generally must be a conveyance, contract of sale, or assignment. (The corporation may, however, acquire an equitable title without a conveyance.)

Transfer by lessee in violation of lease prohibition:

Since a violation of the covenant or condition against assignment or subletting may result in forfeiture, the condition generally is strictly construed against the lessor. In such a case, assignment without consent may not of itself terminate the lease or render the assignment void. However, the making of the assignment may give the lessor certain rights to be exercised in the manner provided by law, i.e., the assignment is not void, but only voidable. The leasehold passes to the assignee, subject only to forfeiture by the lessor and the right to declare a forfeiture may be waived.

If the lessor desires to rely on the restriction against assignment, he may give notice of his election to declare a forfeiture of the lease and sue for breach of the lease. He may also pursue his remedy in unlawful detainer in some jurisdictions if possession is thereafter withheld following proper notice. But he does not have the option of merely giving notice of the invalidity of the assignment without declaring a forfeiture. The restriction as to the condition of assignment is generally considered to be a personal covenant for the benefit of the lessor and until the lessor elects to take advantage of the breach, the assignment remains a valid and binding conveyance of the leasehold interest as to all other parties.

Rent payments:

Absent a provision in the lease otherwise expressly providing, if the lessor accepts payments of rent from the assignee, even under a stipulation reserving the right to declare a forfeiture, the lessor's right is deemed waived. But, since a waiver is the relinquishment of a known right, there must be actual knowledge of the existence of the fact on which such right can be predicated. There is no waiver on the part of the lessor due to an acceptance of rent without actual knowledge of the assignment or sublease. Such knowledge must be actual, not constructive. However, there is a presumption of an assignment which follows occupancy of the leased premises by one other than the lessee, especially when the occupancy pays the rent and cost of maintenance.

For further information, see Chapter 4.

FORM

SUBLEASE, dated October 29, 2001, between Albany Metal Works, a New York Corporation, with its principal place of business at Houghton Park, Albany, New York 14830 (the "Lessor"), and Retailers Alliance Limited--U.S.A. ("RAL, U.S.A."), a Delaware Corporation, with a place of business at 57 East Road, Chicago, Illinois 60631 (the "Lessee").

The Lessor lets to the Lessee and Lessee hires from the Lessor the following described premises: Approximately 990 sq. ft. of office space located in the Fifth Floor, known as Suite No. 525, of the office building designated as Building 100 in the complex of buildings known as PHASE III, O'Hare Plaza, located at 57 East Road, Chicago, Illinois to be used only for a district sales office for the term commencing November 1, 2001 and expiring March 31, 2002 at the monthly rent provided in Section 20.

The Lessee agrees to each of the following:

1. *Payment of rent.* Pay the rent set forth herein to Albany Metal Works.
2. *Repairs.* At its expense keep the premises in good repair, ordinary wear and tear, repairs to the roof, exterior of the building, and structural repairs excepted, unless such repairs are made necessary by the Lessee's act or negligence. At the expiration of the term the Lessee shall remove its goods and effects and peaceably yield up the premises to the

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Lessor in as good condition as when delivered to the Lessee, ordinary wear and tear, damage by fire, the elements, act of the public enemy, or casualty excepted. All notices to quit or vacate are expressly waived, any law, usage or custom to the contrary notwithstanding.

3. *Compliance with regulations.* Comply promptly with all laws, ordinances, requirements, and regulations of the federal, state, county, municipal and other authorities, the fire insurance underwriters, and insurance organizations or associations. However, the Lessee shall not be required to make alterations to the exterior of the building, or alterations of a structural nature.

4. *Viewing premises.* Use the premises exclusively for the purpose set forth herein and during the last three months of this lease, or any extension thereof, and permit the Lessor to display the usual "To Let" signs and show the premises to prospective tenants. At any time during the term the Lessor, its landlord, or either's agents, may enter the premises for the purpose of examining their condition or making repairs in any part of the building. However, the Lessor does not assume any liability for the care or supervision of the premises or appurtenances.

5. *Assignment.* The Lessee shall not make or permit to be made any alterations or additions to the premises, assign, mortgage, or pledge this lease, or sublet the whole or any part of the premises without the Lessor's written consent. Such consent shall apply solely to the particular transaction consented to and shall not constitute the Lessor's waiver of the provisions of this lease.

6. *Insurance.* The Lessee shall not leave the premises unoccupied during the term, or by any act of commission or omission cause an increase in the rate of insurance or the cancellation of any insurance policy. If any increase in the rate of insurance is caused by the Lessee's occupancy, the Lessee shall pay on demand the amount of the increase, and in default of such payment, the amount may be added to the next installment of rent as additional rent. The Lessee shall furnish the Lessor with public liability insurance policies issued by companies and in amounts satisfactory to the Lessor.

7. *Signs.* The Lessee shall not install awnings, advertisements, or signs on any part of the premises without the Lessor's written consent and shall keep the sidewalks free from ice, snow, and all obstructions.

8. *Utilities.* The Lessee shall make its own arrangements for the supply of gas, electricity, water, fuel, and the like, and pay for all such services.

9. *Indemnification.* The Lessor shall not be responsible for any defect or change of condition in the premises, or for any damage thereto, or to any person, or to goods or things contained therein due to any cause except the Lessor's act or negligence. The Lessee shall indemnify the Lessor from all claims, demands, and actions arising in connection with the Lessee's use of the property, or the use by any person occupying the premises during the term hereof, or by reason of any breach or nonperformance of any covenant herein, or the Lessee's violation of any law or regulation.

10. *Fire damage.* If the premises are so damaged by fire, other casualty, or act of the public enemy so as to be substantially destroyed, this lease shall terminate and any unearned rent paid in advance by the Lessee shall be apportioned and refunded to it. However, if the premises are not substantially destroyed, the Lessor will endeavor to have the Lessee restore them, and a just proportion of the rent shall abate according to the extent to which the premises have been rendered untenable until they have been restored. The Lessee shall give the Lessor immediate notice of any damage to the premises.

11. *Default and remedies.* If the Lessee fails to perform or observe any of its covenants under this lease within 10 days after the Lessor gives it notice of default, the Lessor may immediately: (a) terminate or cancel this lease by notifying the Lessee as provided above, and upon such termination or cancellation the Lessee shall be liable to the Lessor for all damages sustained by it by reason of the Lessee's breach of covenant and of the termination or cancellation; or (b) re-enter the premises without notice and upon reentry let all or any part thereof as agent for the Lessee. If the premises

are let in accordance with the provisions of (b), the Lessor may receive the rent, applying it first to the payment of any expense the Lessor incurs in entering and letting the premises, and then to the payment of the rent and the fulfillment of the Lessee's covenants hereunder. If the Lessee defaults, it shall pay and be liable for the several installments of rent that would under this lease become due had no default occurred, regardless of whether the demised premises are re-let or remain vacant, and whether the vacancy is in whole or in part or for a period less than the whole or remainder of the term. The Lessee shall be credited at the end of each month with any net amounts actually received by the Lessor during that month for the use or occupancy of all or part of the demised premises provided that the Lessor has been fully reimbursed for all sums and liabilities it has paid or incurred for any of the above purposes (which the Lessee also shall pay and be liable for). Such payments shall be made either directly by the Lessee or out of moneys actually received for renting the demised premises after the Lessor has received undisputed possession. The Lessor's maintenance of any action or proceeding to recover possession of the premises or any installment or installments of rent or other moneys that may be due or become due from the Lessee shall not preclude the Lessor from also instituting and maintaining subsequent actions or proceedings to recover possession of the premises or of any subsequent payment or payments of rent or other moneys that may be due or become due from the Lessee. A waiver by the Lessor of the Lessee's breach of any one or more covenants or conditions contained herein shall not bar any of the Lessor's rights or remedies for a subsequent breach of the same covenant or condition.

12. *Additional rent.* If the Lessor makes any expenditure for which the Lessee is responsible, or if the Lessee fails to make any required payment under this lease, the Lessor may add such amount to any current or future installment of rent.

13. *Condemnation.* If all or any part of the premises are taken or condemned for a temporary or permanent public or quasi-public use, the Lessor may terminate this lease. In that case it shall return to the Lessee all unearned rent paid in advance.

14. *Demolition.* If any competent governmental authority decides that the building or buildings should be demolished and removed, the Lessee shall immediately vacate the premises, this lease shall terminate, and all unearned rent paid in advance by the Lessee shall be apportioned and refunded to it.

15. *Notices.* All notices or other documents under this lease shall be in writing and delivered personally to the party to be notified or sent by telegram or by registered or certified mail addressed to such party at its last known address.

16. *Termination.* The Lessor may terminate this lease if any one or more of the following events occur: proceedings in bankruptcy, or under any other act for the relief of debtors, are instituted by or against the Lessee; the Lessee compounds its debts, or assigns over its estate or effects for payment thereof; any execution issues against the Lessee or any of its effects; a receiver or trustee is appointed for the Lessee's property; or this lease by operation of law devolves upon or passes to any person or persons other than the Lessee personally. In any such event, the Lessor may immediately terminate this lease by notifying the Lessee as provided in paragraph 15. Upon such termination all present and future sums due from the Lessee shall immediately become due and payable.

17. *Sublease.* This is a sublease. The Lessor's interest in the premises is as Lessee under an underlying sublease made by General Products Corporation dated February 2, 1997, a copy of which, initialed for identification, is attached hereto. Except as provided in paragraph 20, this sublease is expressly made subject to all the terms and conditions of the underlying lease. The Lessee shall use the premises in accordance with the terms of the underlying lease and not do or omit to do anything which will breach any of its terms. If the underlying lease is terminated, this sublease shall terminate simultaneously and any unearned rent paid in advance shall be refunded to the Lessee, if such termination is not the result of a breach by the Lessee of the within sublease. The Lessee shall assume the obligation for performance of all of the Lessor's obligations under the underlying lease.

18. *Quiet possession.* The Lessor covenants that the Lessee, upon paying the rent reserved herein and performing all its

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covenants and agreements contained herein, may quietly enjoy the premises, except as otherwise provided herein. However, this covenant shall be subject to the terms of the underlying lease and of any mortgages which may now or later affect the premises.

19. *Waiver.* Both parties waives their respective rights against the other for damages caused by fire or other perils covered by insurance when the damages are sustained in connection with the occupancy of the leased premises.

20. *Rent payments.* Commencing November 1, 2001 through March 31, 2002, the monthly rental shall be \$763.13. No term of the underlying lease referred to in Section 17 shall be effective under any circumstances to increase or escalate this monthly rental during the term of this sublease. Rental shall be payable in advance on the first business day of each month during the term of the sublease.

21. *Binding effect.* The provisions of this instrument shall be binding upon and inure to the benefit of both parties and their respective legal representatives, successors, and assigns.

22. *Non-waiver.* No delay or failure by either party to exercise any right under this instrument, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

23. *Headings.* Headings in this Sublease are for reference and convenience only and shall not be used to interpret or construe its provisions.

24. *Counterparts.* This Sublease may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

25. *Entire agreement.* This instrument supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them, except as otherwise provided herein.

In witness whereof the Lessor has signed and sealed this instrument, November 3, 2001 and the Lessee has signed and sealed this instrument, October 29, 2001.

Attest:

Albany Metal Works

Assistant Secretary

Senior Vice President--Staff

Attest:

Retailers Alliance Limited--

U.S.A.

Secretary

Chairman of the Board

Consent of Lessor in Primary Lease

The undersigned, as Managing Agent for National Bank and Trust Company of Chicago, consents to the within Sublease whereby Albany Metal Works has subleased premises located at 57 East Road, Chicago, Illinois to RAL, U.S.A.

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Dated _____ Chambers & Company, Managing

Agent for National Bank and Trust

Company of Chicago as Trustee

The undersigned, General Products Corporation, hereby consents to the within Sublease whereby Albany Metal Works has subleased premises located at 57 East Road, Chicago, Illinois, to RAL, U.S.A.

Dated: October 29, 2001 General Products

Corporation

by _____

by _____

C.8 Assignment and assumption of lease--landlord consent--assignor remains liable for assignee's performance

COMMENT

Assignment and assumption agreement:

The agreement set forth in this form is a three-way agreement between an assignor, an assignee, and the landlord. Such an agreement is a convenient method to delineate the rights and obligations of all three parties interested in the transaction in one document. Each party then has full knowledge of the agreement between the other two parties. In this single agreement, the assignor assigns the lease to the assignee, the assignee assumes the assignor's obligations under the lease, and the landlord consents to the assignment. Alternatively, the assignment can be accomplished in one agreement between the assignor and the assignee, and the landlord's consent can be accomplished in a separate document.

Assignor's continued liability:

Where the original lease provides that it cannot be assigned without the landlord's consent, the landlord may refuse to consent to an assignment unless certain conditions are met. A common condition to the landlord's consent is that the assignor remain liable for the assignee-tenant's performance under the lease. In essence, the landlord requires the assignor to guarantee the assignee's performance. As with a lease guaranty, this protects the landlord from the consequences of a default by an assignee-tenant whose financial situation is uncertain.

For further information, see Chapter 4.

FORM

ASSIGNMENT AND ASSUMPTION OF LEASE

THIS ASSIGNMENT AND ASSUMPTION OF LEASE ("Assignment") is made as of the _____ day of _____, 20_____, by and among: (1) _____, Assignor, having a notice address of _____ Street, City of _____, State of _____; (2) _____ Corp., Assignee, a corporation incorporated under the laws of the State

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of _____, having a notice address of _____ Avenue, City of _____, State of _____; and (3) _____ Associates, Landlord, a limited partnership in the State of _____, having a notice address of _____ Road, City of _____, State of _____.

WITNESSETH:

WHEREAS, Assignor (as "Tenant"), and Landlord made and entered into a certain Lease Agreement dated _____, 20_____, as amended by a First Amendment to Lease dated _____, 20_____ (collectively the "Lease"), demising certain leased premises located at _____ Road, City of _____, State of _____, containing approximately _____ square feet of floor area, all as in the Lease more particularly described (the "Premises");

WHEREAS, Assignor desires to assign the Lease to Assignee;

WHEREAS, the Lease provides, among other things, that the Lease shall not be assigned without the Landlord's consent in writing;

NOW, THEREFORE, in consideration of the mutual covenants and agreements herein set forth, and of other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties covenant and agree as follows:

1. Effective as of _____, 20_____, Assignor assigns to Assignee all its right, title and interest in and to the Lease.
2. Assignor covenants, warrants and represents that: (a) the Lease is in full force and effect; (b) Assignor has performed all of its obligations up to the effective date of this Assignment; (c) Assignor has full right and power to execute this Assignment; and (d) the Lease has not been modified, supplemented or amended.
3. Assignor hereby surrenders and assigns to Assignee, and Assignee hereby accepts the surrender and assignment from Assignor of, all of Assignor's right, title and interest in, to and under the Lease, a copy of which is attached as Exhibit A and incorporated herein by reference.
4. Assignee hereby assumes and agrees to be bound by and pay and perform all of the obligations, terms, covenants and conditions which, pursuant to the Lease, are to be observed, kept and/or performed by the Assignor, effective as of _____, 20_____.
5. Assignor agrees to remain liable for the performance of all terms, covenants and conditions of the Lease to be performed by Assignee and by Assignee's successors and assigns thereunder.
6. Landlord consents to the aforesaid Assignment of the Lease by Assignor to Assignee upon the express conditions that: (a) the Assignor remains liable for the full and due performance by the Assignee, and by Assignee's successors and assigns, of all terms, obligations, covenants and agreements under the Lease; and (b) no further assignment of the Lease shall hereafter be made without the prior written consent of the Landlord.
7. Nothing in this Assignment shall be deemed to authorize any assignment or other transfer in whole or in part of the interest of Assignee in violation of any provisions of the Lease.

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8. This Assignment shall be binding upon and shall inure to the benefit of the parties hereto and their successors and permitted assigns.

IN WITNESS WHEREOF, the parties have executed this Assignment and Assumption of Lease as of the date first written.

SIGNED IN THE PRESENCE OF: ASSIGNOR:

_____ By: _____

(Witnesses as to Assignor)

ASSIGNEE:

_____ By: _____

(Witnesses as to Assignee)

LANDLORD:

_____ By: _____

(Witnesses as to Landlord)

C.9 Third party lease guaranty agreement

COMMENT

Lease guaranties:

A lease guaranty agreement is an agreement by a third-party to be liable for rent payments and the performance of the tenant's obligations under a lease agreement. The landlord may require such a guaranty before signing a lease with a tenant whose financial situation is uncertain. Such assurances might be necessary if the tenant is starting a new business, engages in a highly speculative business, has insufficient capital to provide a security deposit, or has a poor credit record. The guaranty protects the landlord from the consequences of a tenant default, and enables such a tenant to enter into a lease. Additionally, the guarantor may benefit from the tenant's ability to lease the premises if the guarantor is a partner in a tenant partnership, an officer or director of a tenant corporation, a franchisor of a tenant franchisee, or otherwise related to the tenant's business.

Conditional or absolute guaranty:

This form is an example of an absolute guaranty. Under the agreement, upon the tenant's default, the landlord may proceed directly against the guarantor without being obligated to proceed against the tenant first. In a conditional guaranty, the landlord is required to exhaust its remedies against the tenant before the landlord can proceed against the guarantor. Sometimes, the agreement provides that the guaranty is subject to certain conditions other than the tenant's default, and those conditions must be met before the landlord may proceed against the guarantor.

Scope and duration of guaranty:

A guaranty agreement may limit the scope of the guaranty, usually to a specified dollar amount. The agreement also may limit the duration of the guaranty to a specified period of time. The agreement set forth in this form is not limited as to its scope or duration.

For further information, see Chapter 4.

FORM

GUARANTY AGREEMENT

This Guaranty is made as of this _____ day of _____, 20_____,
by _____ ("Guarantor"), to _____ Associates, a State of _____
limited partnership ("Landlord").

WITNESSETH:

Guarantor has requested Landlord to enter into a certain Lease Agreement dated _____,
20_____, (hereinafter, together with any modifications, amendments, extensions, riders, and
renewals, referred to as the "Lease") with _____, Inc., a corporation incorporated under the laws of the
State of _____, as the Tenant ("Tenant"), covering the space as set forth in
Section _____ of the Lease, and defined as the "premises" in the Lease.

To induce Landlord to enter into the Lease, the Guarantor hereby agrees to guarantee, as hereinafter provided, the
performance by Tenant of all of the terms, covenants, conditions, obligations, and agreements (collectively the
"Covenants") contained in the Lease on the part of Tenant to be performed thereunder.

NOW THEREFORE, in consideration of the making of the Lease and other good and valuable consideration, including
the undertakings herein contained, the Guarantor hereby agrees as follows, intending to be legally bound hereby:

1. *Definitions.* Unless specifically defined in this Guaranty Agreement or the context clearly requires a different
meaning, the capitalized words and phrases used in this Guaranty Agreement have the same meanings ascribed to them
in the Lease.

2. *Guaranty of Lease.* Guarantor unconditionally and absolutely, jointly and severally, guarantees to Landlord the
prompt payment, when due, of the rents and any and all other charges payable under the Lease and the full and faithful
performance and observance of any and all Covenants contained in the Lease, including, without limitation, the rules
and regulations as therein provided, on the part of Tenant to be performed and observed. Guarantor unconditionally and
absolutely covenants to Landlord that, if Tenant shall default at any time in the Covenants to pay rent or any other
charge stipulated in the Lease or in the performance of any of the other Covenants contained in the Lease on Tenant's
part to be performed, Guarantor will well and truly perform such Covenants, and pay the rent or other charges or arrears
thereof that may remain due thereon to Landlord, and also all damages stipulated in the Lease. Guarantor shall pay to
Landlord, on demand, all expenses (including reasonable expenses for attorneys' fees and reasonable charges of every
kind) incidental to, or relating to, the enforcement of this Guaranty Agreement. If the Lease is renewed or its term
extended, for any period beyond the original expiration date specified in the Lease, either pursuant to any option to
renew granted under the Lease or otherwise at any time, or if the Tenant holds over beyond the term of the Lease, or if
the Lease is modified in any way, the obligations hereunder of Guarantor shall extend and apply with respect to the full
performance and observance of all of the covenants, terms, and conditions of the Lease, as existing, extended, renewed
or modified and of any such amendment thereof.

3. *No Discharge of Guaranty.* The liability of any Guarantor hereunder shall not be impaired, released, terminated or
discharged, in whole or in part, by any of the following, notwithstanding that the same are made with or without notice

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to the Guarantor:

- (a) any amendment or modification of the provisions of the Lease; or
- (b) any extensions of time for performance, whether in whole or in part, of the covenants of Tenant under the Lease given prior to or after default thereunder; or
- (c) any other Guaranty now or hereafter executed by any Guarantor or any other person; or
- (d) any waiver of, assertion or enforcement of, or failure or refusal to assert or enforce, in whole or in part, any covenants, claims, causes of action, or remedies that Landlord may, at any time, have under the Lease or with respect to any guaranty or any security that Landlord may hold, at any time, for or under the Lease or with respect to Tenant; or
- (e) any act, thing, omission or delay to do any act or thing that may, in any manner, or to any extent, vary the risk of Guarantor or that would otherwise operate as a discharge of any Guarantor as a matter of law; or
- (f) the failure to give any Guarantor any notice whatsoever; or
- (g) the release of any security, Guaranty, or any rights, power, or privileges Landlord may now or hereafter have against any persons, entity, or collateral; or
- (h) any transfer by Tenant or any assignment of Tenant's interest under the Lease, whether or not with Landlord's consent; or
- (i) the invalidity of the Lease for any reason whatsoever.

In the event that any agreement or stipulation between Landlord and Tenant shall extend the time of performance or modify any covenants of the Lease on the part of Tenant to be performed, Guarantor shall continue to be liable upon this Guaranty.

4. Demand Not Required. To charge any Guarantor under this Guaranty, no demand shall be required nor shall there be required any notice of any default in any of the covenants of the Lease on the part of Tenant to be performed or of the same as affected by any agreement or stipulation extending the time of performance or modifying the covenants of the Lease. Guarantor hereby expressly waives any such demand or notice. Landlord shall have the unlimited right to enforce this Guaranty without pursuing any rights or remedies of Landlord against Tenant, or any other party, of any security Landlord may hold, it being intended that immediately upon any breach or default by Tenant in the performance or observance of any covenant of the Lease, Landlord may enforce its rights directly against any Guarantor under this Guaranty. Landlord may commence any action or proceeding based upon this Guaranty directly against Guarantor for the full performance of the Lease without making Tenant, any other guarantors, or any other person a party defendant in such action or proceeding. Any one or more successive or concurrent actions may be brought on this Guaranty against any Guarantor either by the same action, if any, brought against Tenant and/or any other party or in separate actions, as often as Landlord, in its sole discretion, may deem advisable.

5. Waivers. The Guarantor hereby expressly waives and releases the following: (i) notice of the acceptance of this Guaranty and notice of any change in Tenant's financial condition; (ii) the right to interpose all substantive and procedural defenses of the law of guaranty, indemnification, and suretyship, except the defenses of prior payment or prior performance by Tenant (of the obligations which Guarantor is called upon to pay or perform under this Guaranty) or that there is no obligation on the part of Tenant with respect to the matter or matters claimed to be in default; (iii) all rights and remedies afforded by applicable law to Guarantor or sureties, including, without limitation, any extensions of time conferred by any law now or hereafter in effect; (iv) the right to interpose any defense (except as allowed under (ii)

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above), set-off, or counterclaim of any nature or description in any action or proceeding; (v) any right or claim of rights to cause a marshaling of Tenant's assets or to cause Landlord to proceed against Tenant or any collateral held by Tenant at any time or in any particular order; (vi) any right against Tenant for reimbursement or contribution because of any payment made by Guarantor under this Guaranty Agreement; and (vii) any defense based upon the invalidity of the Lease.

6. *No Impairment of Obligation.* Neither Guarantor's obligations to make payment in accordance with the term of this Guaranty nor any remedy for the enforcement thereof, shall be impaired, modified, changed, stayed, released, or limited in any manner whatsoever by impairment, modification, change, release, limitation or stay of the liability of Tenant or its estate in bankruptcy or any remedy for the enforcement thereof, resulting from the operation of any present or future provision of the Bankruptcy Act of the United States or other statutes, or from the decision of any court interpreting any of the same, and each Guarantor shall be obligated under this Guaranty as if no such impairment, stay, modification, change, release, or limitation had occurred.

7. *Subrogation Rights.* Whenever at any time or from time to time Guarantor makes any payment to Landlord or performs or fulfills any Covenant, Guarantor will notify Landlord in writing that such payment or performance, as the case may be, is for such purpose. No such payment or performance by Guarantor pursuant to any provision hereof shall entitle Guarantor, by subrogation or otherwise to the rights of Landlord to any payment by Tenant or out of the property of Tenant, except after payment of all sums or fulfillment of all covenants, terms, conditions, provisions or agreements to be paid or performed by Tenant.

8. *Estoppel Certificate.* Guarantor will, at any time and from time to time, within ten (10) business days following written request by Landlord, execute, acknowledge and deliver to Landlord a statement certifying that this Guaranty is unmodified and in full force and effect (or if there have been modifications, that the same is in full force and effect as modified and stating such modifications). Such certificate may be relied on by anyone holding or proposing to acquire any interest in the premises from or through Landlord or by any mortgagee or prospective mortgagee of the premises or of any interest therein.

9. *Binding Effect.* All of Landlord's rights and remedies under this Guaranty are intended to be distinct, separate and cumulative and no right or remedy mentioned herein is intended to be an exclusion of or a waiver of any of the others. This Guaranty shall be binding upon Guarantor and Guarantor's heirs, personal representatives and assigns.

10. *Confessions of Judgment.* Guarantor authorizes any attorney at law at any time or times to appear in any state or federal court of record in the United States of America after the amount guaranteed hereunder or any part thereof shall have become due and payable (whether the payment becomes due by lapse of time or by acceleration of maturity or otherwise), and in each case to waive the issuance and service of process, to admit the maturity of the debt in question and the nonpayment thereof when due, to present evidence of the debt in question or any part thereof to the court and to certify the amount of the debt then owing thereon, to confess judgment against Guarantor and each of them in favor of the Landlord for the amount of the debt then appearing due, together with interest and costs of suit, and thereupon to release all errors and waive all rights of appeal and stay of execution. The foregoing warrant of attorney shall survive any judgment, and should any judgment be vacated for any reason, the Landlord may nevertheless utilize the foregoing warrant of attorney in thereafter obtaining additional judgment or judgments against Guarantor.

IN WITNESS WHEREOF, this Guaranty is executed this _____ day of _____,
20_____.

WARNING--BY SIGNING THIS PAPER YOU GIVE UP YOUR RIGHT TO NOTICE AND COURT TRIAL. IF YOU DO NOT PAY ON TIME, A COURT JUDGMENT MAY BE TAKEN AGAINST YOU WITHOUT YOUR PRIOR KNOWLEDGE AND THE POWERS OF A COURT CAN BE USED TO COLLECT FROM YOU REGARDLESS OF ANY CLAIMS YOU MAY HAVE AGAINST THE CREDITOR WHETHER FOR RETURNED

GOODS, FAULTY GOODS, FAILURE ON THE CREDITOR'S PART TO COMPLY WITH THE AGREEMENT,
OR ANY OTHER CAUSE.

IN THE PRESENCE OF: GUARANTOR:

Residence Address



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Appendix Forms: CHECKLISTS AND FORMS

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§ Forms.syn Synopsis to Appendix Forms: CHECKLISTS AND FORMS

[D] Environmental Considerations in Real Estate Transactions



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Appendix Forms: CHECKLISTS AND FORMS

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[D] Environmental Considerations in Real Estate Transactions

D.1 Representation by seller that premises have never been used for storage or disposal of hazardous waste

COMMENT

In this clause, the seller represents that the premises have never been used for storage or disposal of hazardous waste. The seller also agrees to be liable for all damages suffered by the purchaser in the event that this representation is incorrect. The clause should be used in situations where the purchaser, as a prerequisite to obtaining financing, must either provide the lender with an environmental site assessment establishing that the premises are "clean", or with the type of representation found below.

It should be remembered that the representation and indemnification are only as good as the financial ability of the seller to reimburse the purchaser for losses which may occur if the seller is either mistaken in his belief that the property is free of hazardous waste, or makes a deliberate misrepresentation. The losses may include such things as clean-up costs under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 USC § 9601 *et seq.*, loss of use of the premises, and damage to person or property.

For further information, see Chapter 4.

FORM

Seller hereby represents and warrants that the subject premises have never been used for the storage or disposal of hazardous waste. The term "hazardous waste", as used herein, shall mean substances deemed hazardous pursuant to the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 USC § 9601 *et seq.*

This representation is made to induce Purchaser to enter into this contract for purchase of the subject premises. It is understood by the parties hereto that Purchaser's financing is contingent upon Seller making this representation. It is further understood that Purchaser's loan documents will provide that the loan will be due and payable in full if evidence of hazardous waste is discovered on the subject premises. Seller shall be liable for all damages, including economic and consequential damages, in the event that the representations contained in this section are inaccurate. D.2 Representation by seller that hazardous waste has been properly removed

COMMENT

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This form should be used when the parties are aware that hazardous waste has been located and removed from the property.

The concerns of the parties are fourfold:

- (1) that the waste has been completely removed;**
- (2) that removal has been performed in compliance with all state and federal laws;**
- (3) that the waste has been properly disposed of; and**
- (4) that all agencies with jurisdiction have been notified and have approved of the proceedings.**

This representation may assist the purchaser to establish an innocent purchaser defense under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 USC § 9601 *et seq.*, if a problem arises later.

For further information, see Chapter 4.

FORM

Seller hereby represents that the subject premises formerly contained approximately _____ barrels of _____, a substance deemed "hazardous" under various state and federal laws and regulations. Seller further represents and warrants that all known barrels of _____ have been removed from the subject premises. Said barrels have been packaged, transported and disposed of in strict compliance with all federal, state and municipal laws, regulations and policies.

Seller agrees to provide purchaser with copies of all shipping invoices and uniform hazardous waste manifests evidencing proper transfer of the barrels.

Seller agrees to indemnify and hold purchaser harmless for any loss including, but not limited to, damage to person or property or economic loss, including defense costs, and consequential damages arising out of the packaging, transportation and disposal of the above described barrels of _____. D.3 Representation by seller that it has complied with all federal, state and local environmental laws and regulations--long form

COMMENT

In the following clause, the seller makes a long series of representations for the benefit of the purchaser. These representations include, among others, that the seller has complied with all federal, state and local environmental laws and regulations affecting the subject property. The seller also represents that it is unaware of any legal actions or claims, either threatened or pending, arising out of an environmental mishap on the property or out of a violation of any environmental law or regulation on the property.

For further information, see Chapter 4.

FORM

Seller makes the following eight representations to purchaser:

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(1) Seller's counsel has carefully reviewed all federal, state and local environmental laws and regulations affecting the subject property.

(2) Any and all governmental approvals, permits and notifications required by federal, state and local environmental laws have been obtained.

(3) Seller is unaware of any action, either threatened or commenced, by any governmental agency arising out of an alleged violation of any environmental law or regulation on the subject premises.

(4) No governmental agency has notified the seller of any violation of any environmental law or regulation on the subject premises.

(5) Seller is unaware of any civil action, either threatened or commenced, by a party other than a governmental agency arising out of an alleged environmental mishap occurring on the subject premises.

(6) Seller is unaware of any environmental mishap on the subject premises.

(7) Seller is unaware of the presence on the subject premises of any hazardous waste or hazardous substances.

(8) The past and present uses to which the seller has put or is putting the subject premises do not violate any relevant federal, state or local environmental laws or regulations.

D.4 Representations by seller regarding present condition of subject premises--clause designed to protect purchaser

COMMENT

In this clause, the seller represents to purchaser that the subject property is not now, and never has been, used to produce, store, treat, handle or dispose of hazardous substances or wastes. The seller further represents that no storage vessel has ever existed on the premises. In addition, the seller states that no environmental mishap or violation of environmental law (federal, state or local) has ever occurred on the premises.

For further information, see Chapter 4.

FORM

Seller makes the following representations to purchaser:

(1) The subject premises are not now, nor have they ever been, used for any of the following purposes:

- (a) the production;
- (b) the manufacture;
- (c) the generation;
- (d) the storage;
- (e) the treatment;

(f) the handling;

(g) the refinement;

(h) the disposal; or

(i) the release of any hazardous substance or hazardous waste.

(2) Seller represents that the subject premises do not now contain, nor have they ever contained, the following hazardous substances: sulphur dioxide; hydrocarbons; vinyl chloride; mercury; asbestos; or urea formaldehyde insulation. Seller represents that the list of hazardous substances contained in the preceding sentence in no way limits representation (1).

(3) Seller represents that no storage vessel of any kind (including, but not limited to, an above-ground or underground tank) is currently on the subject premises or has ever been located on the subject premises.

(4) Seller's counsel has made a thorough review of the uses of the subject premises by seller and all previous owners and finds that no environmental mishap has ever occurred on the subject premises, and no violation of any federal, state or local environmental law or regulation has ever taken place.

(5) Seller's counsel has made a thorough review of the uses of the real property bordering the subject premises and has not discovered any evidence of the presence of hazardous substances or hazardous waste thereon which could in any way endanger the subject premises.

D.5 Representation by seller of its current and past uses of subject premises--long form--clause designed to protect seller

COMMENT

In the clause below, the seller represents to the purchaser that the seller is not now using, nor has it ever used, the subject premises to store, manufacture, use or dispose of hazardous substances or wastes. However, the seller expressly declines to make any representation about the uses of the property by *prior* owners.

For further information, see Chapter 4.

FORM

Seller hereby represents to purchaser that seller is not now using, and never has used, the subject premises for any of the following purposes:

(1) to produce;

(2) to manufacture;

(3) to generate;

(4) to store;

(5) to treat;

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- (6) to handle;
- (7) to refine;
- (8) to dispose of; or
- (9) to release any hazardous substance or hazardous waste.

Seller makes no representation, however, as to the uses which prior owners have made of the subject premises.D.6
 Promise of seller to indemnify and hold purchaser harmless for any existing conditions on premises--clause designed to protect purchaser

COMMENT

This form is designed to protect the purchaser from any adverse environmental conditions which may be discovered on the premises after the sale is completed. Because the form contains a requirement that the seller obtain environmental liability insurance, the hold harmless clause has more strength. The purchaser does not have to rely on the seller's financial ability alone for protection.

The form protects the seller by requiring that the purchaser give prompt notice of any potential claim, and that the purchaser cooperate with the seller.

It should be noted that environmental liability insurance is costly and generally requires some investigation of the property being sold, if not a full environmental site assessment.

For further information, see Chapters 2 and 4.

FORM

Seller agrees, for a period of _____ years from the date hereof, to indemnify and hold Purchaser harmless for and against any and all liability, claims and expenses of any kind whatsoever (including reasonable attorneys' fees and other defense costs) for any injury or damage to person or property sustained by anyone on or about the premises, which results from or arises out of any adverse environmental condition existing on the subject premises at or before the transfer of title of the subject premises from Seller to Purchaser.

Seller agrees, for a period of _____ years, to obtain environmental liability insurance from an insurance company rated "AA" or better in at least the amount of \$_____. Purchaser shall be named as an additional insured or loss payee on said policy. Seller's liability under this agreement shall be limited to the limits of this policy.

Purchaser shall give Seller notice of any claim or potential claim within ten (10) days after Purchaser shall received notice or have reason to know that a claim exists. Failure to provide prompt notice will relieve Seller of any liability hereunder.

Purchaser shall give Seller a reasonable opportunity to defend against such claim. Purchaser shall cooperate with Seller in such defense. Purchaser shall not compromise any claim without the consent of Seller. Violation by Purchaser of any of these provisions shall relieve Seller of any liability hereunder.

Purchaser agrees to cooperate with and comply with all reasonable requests of Seller's insurance carrier. In the event Purchaser fails to do so and the insurance carrier disclaims liability for that reason, Seller shall be relieved of any

liability hereunder.D.7 Sale is contingent upon results of inspection for radon gas

COMMENT

Radon gas is a natural, colorless, odorless vapor which emanates from the earth and enters the air supply of buildings. High levels of radon gas have been associated with lung cancer and other respiratory ailments. This contingency allows the purchaser to cancel the sale agreement if a particular level of radon gas is found. This gives the purchaser the ability to withdraw from the existing agreement and then negotiate a modification of that agreement if the parties so desire. Such a modification will provide for a reduction of the purchase price in an amount equivalent to the cost of remediation, leaving the purchaser responsible for remediation. In the alternative, the parties can maintain the purchase price while the seller takes the remedial action at his own expense.

For further information, see Chapter 4.

FORM

The Agreement is contingent upon the results of an inspection demonstrating that no radon gas exists on the premises. The inspection shall be performed by _____. The inspection shall be performed at the expense of _____.

Radon gas shall be deemed to exist if the inspection reveals a level of radon gas exceeding _____ pico curies per liter. The inspection report shall indicate the level of accuracy or tolerance of the measurements. A copy of the inspection report shall be provided to both Purchaser and Seller.

Seller agrees to comply with all requirements of the company or individual performing the inspection, provided that there shall be no monetary cost to Seller and no unreasonable effort or act required of Seller to comply.

This contingency shall be deemed waived unless Purchaser shall notify Seller of the existence of radon gas, in writing, on or before _____, 20____. Notice shall be deemed given when received by Seller, in person or by certified mail, return receipt requested. If notice is timely given, this Agreement shall be deemed canceled. All deposits made pursuant to this agreement shall be returned to the Purchaser immediately.D.8 Sale is contingent upon results of inspection for presence of lead-based paint

COMMENT

Lead is a non-organic element which can accumulate in the human body. Excessive levels of lead can cause serious harm to children, including damage to the brain and central nervous system, mental retardation, impaired hearing, epileptic seizures and death. The major source of lead poisoning is lead-based paint which, as it ages, cracks and chips. Those paint chips are often consumed by small children and pets. A second important source is lead dust, which is produced as lead-based paint ages and wears away.

The use of lead in paint was banned by the Consumer Product Safety Commission in 1978. However, a danger still exists in homes built before 1978, since their interior walls and other surfaces might have been painted with lead-based paint.

Accordingly, the purchaser of any structure built prior to 1978 should request that a lead paint contingency be inserted into the sale-purchase agreement. (This is especially important if the structure is a residence, and the purchaser has small children.) Even commercial property should be tested, since the normal aging process of lead-based paint will produce lead dust. Lead dust is especially dangerous

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because everyone, young and old alike, breathes it in, whereas paint chips only pose a danger to small children and pets, who frequently eat the chips.

If the structure contains lead-based paint, the purchaser should be able to terminate the agreement. Alternatively, if lead-based paint is discovered on the premises and the purchaser still wishes to purchase the premises, the parties may renegotiate the agreement and reduce the purchase price to reflect the cost to the purchaser of removal or containment of the paint. Alternatively, the seller may handle the removal or containment, leaving the purchase price intact.

For further information, see Chapter 4.

FORM

This Agreement of sale and purchase is contingent upon the results of an inspection and chemical analysis to be performed by _____ [_____ *insert name of inspector and laboratory that will perform the inspection and chemical analysis*], demonstrating that the premises to be transferred hereunder do not contain lead-based paint. The inspection and laboratory analysis shall be performed at the expense of the Purchaser. A copy of the inspection report and laboratory analysis shall be provided to both Purchaser and Seller. Seller consents to the inspector taking paint samples wherever the inspector deems it necessary and appropriate.

This contingency shall be deemed waived unless Purchaser shall notify Seller, in writing, of the existence of lead-based paint on or before _____, 20____. Notice shall be deemed given when received by Seller, in person or by certified mail, return receipt requested. If notice is timely given, this Agreement shall be deemed canceled. All deposits made pursuant to this Agreement shall be returned to the Purchaser immediately. D.9 Sale is contingent on results of asbestos inspection

COMMENT

Asbestos was once commonly used as an insulating material on pipes, boilers, furnaces and in ceiling and floor tiles. Asbestos can become "friable", that is, finely crumbled and airborne. Inhaled over an extended period of time, asbestos fibers and particles may lead to a variety of different lung diseases, including cancer.

This form provides the purchaser with the opportunity to withdraw from the agreement if any asbestos is discovered on the premises. The form provides two alternative methods to detect asbestos.

If asbestos is discovered, but the purchaser still wants the property, the purchaser can renegotiate the agreement to reduce the purchase price by an amount equivalent to the cost of removal and repair. In this case, the purchaser accepts responsibility for removal and repair. In the alternative, the parties can maintain the purchase price while the seller absorbs the cost, and effects the removal and repair.

For further information, see Chapter 4.

FORM

This Agreement is contingent upon the results of an inspection demonstrating that no asbestos exists on the premises. The inspection shall be performed by a licensed asbestos handler. Asbestos shall be deemed to exist if any asbestos-containing material shall be located within the structures on the premises, or, if the asbestos contained in air samples taken within the structures by a certified laboratory is _____ percent (____ %) above the

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level of asbestos contained in air samples taken outside of the structures. The inspection and all samples and analysis shall be performed at the expense of _____. A copy of the inspection report shall be provided to both Purchaser and Seller.

Seller consents to the taking of samples of ceiling material, pipe insulation and boiler or furnace insulation. Such samples shall be taken as inconspicuously as possible in the living areas of the structures.

This contingency shall be deemed waived unless Purchaser shall notify Seller of the existence of asbestos, in writing, on or before _____, 20____. Notice shall be deemed given when received by Seller, in person or by certified mail, return receipt requested. If notice is timely given, this Agreement shall be deemed canceled. All deposits made pursuant to this agreement shall be returned to the Purchaser immediately.D.10 Sale is contingent on results of inspection for urea formaldehyde insulation

COMMENT

During the 1970s urea formaldehyde insulation was used to insulate many existing houses. Frequently, it was blown into houses between the exterior siding and interior walls. Later, urea formaldehyde became associated with a number of health problems.

This contingency is designed to allow the purchaser to withdraw from the agreement if any urea formaldehyde insulation is found on the premises. Thereafter, if the purchaser still wishes to purchase the premises, the parties may consider renegotiating the agreement. This may be done by reducing the purchase price by an amount equal to the cost of removal of the insulation. The purchaser would then take responsibility for removal. In the alternative, the seller may take responsibility for the removal while the purchase price remains the same.

This contingency allows the purchaser's agent to remove and replace paneling or other finishing material in order to view the insulation and take samples.

For further information, see Chapter 4.

FORM

This Agreement is contingent upon the results of an inspection demonstrating that no urea formaldehyde insulation is located in or on any of the structures on the premises. The inspection shall be performed by _____ at the expense of _____. A copy of the inspection report shall be provided to both Purchaser and Seller.

Seller consents to the temporary removal of exterior siding and interior paneling, as deemed necessary by the inspector, for the purpose of the inspection. All materials removed shall be restored to their prior condition, all at Purchaser's expense, at the conclusion of the inspection. Seller further consents to the taking of samples of the insulation, if deemed necessary by the inspector.

This contingency shall be deemed waived unless Purchaser shall notify Seller of the existence of urea formaldehyde insulation, in writing, on or before _____, 20____. Notice shall be deemed given when received by Seller, in person or by certified mail, return receipt requested. If notice is timely given, this Agreement shall be deemed canceled. All deposits made pursuant to this agreement shall be returned to the Purchaser immediately.D.11 Sale is contingent on obtaining historic district approval of sale and planned modification to premises

COMMENT

Some older municipalities have made the preservation of historic structures in certain zones within the

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community a priority. Although the relevant municipal ordinances differ widely, it is often not possible to make certain changes to a structure located in that zone without the approval of the local historic review commission, or a similar body. The commission functions in a manner similar to a zoning board. Depending on the particular ordinance, changes in a structure's exterior color, windows, porches, trim design, or anything else for that matter, may require commission approval.

The contingency below allows the purchaser to terminate the agreement if the commission insists upon making "substantial" changes to the purchaser's proposed modifications of the property. Since the modifications are deemed essential to the purchaser's desire to purchase, the purchaser alone is entitled to determine whether any change to his proposal, required by the commission, is "substantial."

For further information, see Chapters 5, 6, and 7.

FORM

The parties hereto agree and acknowledge that the subject premises are located within the historic district of the City of _____. As a result thereof, the transfer of title is subject to the approval of the _____ Historic Review Commission.

It is further agreed and understood that the ability to make the modifications to the premises which are described in Schedule "A", annexed hereto and made a part hereof, are an essential part of this Agreement and the consideration therefor. In the event Purchaser is unable to obtain approval for said modifications, Purchaser shall not be required to purchase the Premises.

Purchaser and seller agree to make a joint application to the _____ Historic Review Commission for approval of the sale and the proposed modifications. Such application shall be prepared at Purchaser's expense by _____, Architects, and submitted no later than _____, 20____. Purchaser shall not be required to accept transfer of title unless all proposed modifications to the premises are approved by the _____ Historic Review Commission without substantial changes. The determination as to whether a change required by the _____ Historic Review Commission constitutes a "substantial" change shall be in the sole discretion of Purchaser. Purchaser may elect to cancel this Agreement if approval is not received on or before _____, 20____. This date may be extended by written agreement of the parties. Notice of election to cancel shall be given to Seller, in person or by certified mail, return receipt requested. Upon receipt of notice of election to cancel, Seller shall return the deposit made pursuant to this agreement immediately. D.12 Sale is contingent on obtaining conservation district approval of sale and planned modification of premises

COMMENT

Many states and municipalities have designated areas as "conservation districts", "forever wild", or some other similar designation. These areas are so designated because they contain something of nature that is worth preserving, such as wooded terrain, a marsh or stream, etc. The laws vary widely among states and municipalities and should be reviewed carefully. These laws often state that proposed modifications to existing structures, or to the use of land located within the conservation district, require review and approval of the proposal by a conservation council or its equivalent. These bodies function much like a zoning board or an arm of the zoning board.

The contingency allows the purchaser to terminate the agreement if the modifications which he wishes to make to the property are not approved without substantial changes. Since the modifications are deemed essential to the purchaser's desire to purchase, the purchaser alone is entitled to determine whether any change in his proposal, required by the conservation district council, is "substantial."

For further information, see Chapters 7 and 11.

FORM

The parties hereto agree and acknowledge that the subject premises are located within the conservation district of the County of _____. As a result thereof, the transfer of title is subject to approval of the _____ Conservation Council.

It is further agreed and understood that the ability to make the modifications to the premises which are described in Schedule "A", annexed hereto and made a part hereof, are an essential part of this Agreement and the consideration therefor. In the event Purchaser is unable to obtain approval for said modifications, Purchaser shall not be required to purchase the Premises.

Purchaser and Seller agree to make a joint application to the _____ Conservation Council for approval of the sale and the proposed modifications. Such application shall be prepared at Purchaser's expense by _____, Architects, and submitted no later than _____, 20____. Purchaser shall not be required to accept transfer of title unless all proposed modifications to the premises are approved by the _____ Conservation Council without substantial changes. The determination as to whether a change required by the _____ Conservation Council constitutes a "substantial" change shall be in the sole discretion of Purchaser.

Purchaser may elect to cancel this Agreement if approval is not received on or before _____, 20____. This date may be extended by written agreement of the parties. Notice of election to cancel shall be given to Seller, in person or by certified mail, return receipt requested. Upon receipt of notice of election to cancel, Seller shall return the deposit made pursuant to this agreement immediately. D.13 Model definition of phrase "adverse environmental condition"

COMMENT

The following clause provides a broad definition of the term "adverse environmental condition". It can be used not only in agreements for the sale and purchase of real property, but also in lease agreements, mortgages, real estate-based loan agreements and related documents, etc.

Basically, the clause describes the phrase "adverse environmental condition" as the release or spillage of hazardous or toxic substances or wastes into the air, water or ground. In addition, the violation of any environmental statute, regulation, permit, or an order issued by an administrative agency or judicial body, is also deemed to be an adverse environmental condition.

For further information, see Chapters 4 and 11.

FORM

"Adverse environmental condition" means:

(1) the existence or release (including, without limitation, sudden or nonsudden, accidental or nonaccidental leaks or spills) of, or exposure to, any hazardous substance, chemical, material, pollutant, contaminant, or audible noise in, into or onto the environment (including, without limitation, the air, ground, water or any surface); and

(2) the violation, or alleged violation, of any statute, ordinance, order, rule, regulation, permit or license of or from any governmental authority, agency or court relating to environmental matters.

D.14 Model definition of "hazardous substance"

COMMENT

This definition of "hazardous substance" can be used not only in agreements for the sale and purchase of real property, but also in lease agreements, mortgages, real estate-based loan agreements and related documents, etc.

The definition basically relies upon federal, state and local environmental statutes and regulations to specify the precise types of substances that are to be considered hazardous for the purposes of the sale/purchase agreement. However, the clause itself does list certain specific substances which are to be considered hazardous, including, asbestos, polychlorinated biphenyls ("PCBs") and radioactive substances. In addition, any other material or substance which has in the past or could in the future constitute a health, safety or environmental hazard to any person or property is likewise to be considered hazardous for the purposes of the sale/purchase agreement.

For further information, see Chapters 4 and 11.

FORM

"Hazardous substance" means those substances which are regulated by, or form the basis of liability under, any federal, state or local environmental laws, including, without limitation, asbestos, polychlorinated biphenyls ("PCBs"), and radioactive substances, or any other material or substance which has in the past or could in the future constitute a health, safety or environmental hazard to any person or property.

COMMENT

This definition of "environmental claim" can be used not only in agreements for the sale and purchase of real property, but also in lease agreements, mortgages, real estate-based loan agreements and related documents, etc.

An "environmental claim" is defined as any allegation, notice of violation, legal claim or order issued by any governmental authority, or by any private person, for personal injury, property damage, nuisance, contamination or other adverse effects on the environment, resulting from or based upon: (1) the release or spillage of hazardous substances into the air, water or ground; (2) the transportation, storage, treatment or disposal of hazardous substances; or (3) the violation of any environmental statute, order, regulation or permit.

For further information, see Chapters 4 and 11.

FORM

"Environmental claim" means any accusation, allegation, notice of violation, claim, demand, abatement, or order of direction (conditional or otherwise) by any governmental authority or any person for personal injury (including sickness, disease or death), tangible or intangible property damage, damage to natural resources, nuisance, pollution, contamination or other adverse effects on the environment, or for fines, penalties, or restrictions, resulting from or based upon:

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(1) the existence or release (including, without limitation, sudden or nonsudden, accidental or nonaccidental leaks or spills) of, or exposure to, any hazardous substance, chemical, material, pollutant, contaminant, or audible noise in, into or onto the environment (including, without limitation, the air, ground, water or any surface);

(2) the transportation, storage, treatment or disposal of hazardous substances; or

(3) the violation, or alleged violation, of any statute, ordinance, order, rule, regulation, permit or license of or from any governmental authority, agency or court relating to environmental matters.

D.16 Model definition of "environmental law"

COMMENT

The clause below provides a very expansive definition of the term "environmental law." The definition encompasses not only statutes enacted by legislative bodies, but also regulations, ordinances and policies promulgated by any governmental authority (whether federal, state, county or municipal) and pertaining to the environment or to public health or safety. It would be appropriate to include specific citations to applicable state and local environmental statutes.

For further information, see Chapters 4 and 11.

FORM

"Environmental law" means any applicable foreign, federal, state or local statute, law, ordinance, rule, regulation, or order (whether voluntary or not) relating to the environment, natural resources, or human health and safety, including, without limitation, the Comprehensive Environmental Response, Compensation, and Liability Act, 42 USC § 9601 *et seq.*; the Hazardous Material Transportation Act, 49 USC § 1801 *et seq.*; the Resource Conservation and Recovery Act, 42 USC § 6901, *et seq.*; the Federal Water Pollution Control Act, 33 USC § 1251 *et seq.*; the Clean Air Act, 42 USC § 7401 *et seq.*; the Toxic Substances Control Act, 15 USC § 2601 *et seq.*; and the Occupational Safety and Health Act, 29 USC § 651 *et seq.*, as such laws have been amended or supplemented now or in the future.D.17 Model definition of "environmental liabilities and costs"

COMMENT

The clause below provides a very expansive definition of the term "environmental liabilities and costs." It can be used not only in agreements for the sale and purchase of real property, but also in lease agreements, mortgages, real estate-based loan agreements and related documents, etc.

The term refers to any and all liabilities, obligations, losses, damages (including punitive, consequential and treble damages), expenses (e.g., attorneys' and environmental consultants' fees), fines, penalties and interest incurred as a result of a lawsuit based on: (1) an environmental mishap that occurs on the subject property (such as the sudden release or emission of toxic gases or liquids); or (2) the discovery of an adverse environmental condition already existing on the property (such as leaking barrels of hazardous waste buried beneath the ground).

For further information, see Chapters 4 and 11.

FORM

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"Environmental liabilities and costs" means all liabilities, obligations, responsibilities, remedial actions, losses, damages, punitive damages, consequential damages, treble damages, costs and expenses (including, without limitation, all reasonable fees, disbursements and expenses of counsel, expert and consulting fees, and costs of investigation and feasibility studies), fines, penalties, sanctions and interest, incurred as a result of any claim or demand, by any person, whether based in contract, tort, implied or express warranty, strict liability, criminal or civil statute, including any environmental law, permit, order or agreement with a governmental authority or other person, arising from environmental, health or safety conditions, or the release of a contaminant into the environment, resulting from the past, present or future operations of a business entity.D.18 Model definition of "release"

COMMENT

The clause below can be used not only in agreements for the sale and purchase of real property, but also in lease agreements, mortgages, real estate-based loan agreements and related documents, etc. The clause defines the environmental term "release" very broadly as any spill, leak, emission, discharge, disposal or migration of a contaminant into the exterior or interior environment, thereby contaminating the air, water, land or subsoil.

For further information, see Chapter 4.

FORM

"Release" means any release, spill, emission, leaking, pumping, injection, deposit, disposal, discharge, dispersal, leaching or migration of a contaminant into the indoor or outdoor environment, including the movement of contaminants through or in the air, soil, surface water, ground water or property.D.19 Model definition of "remedial action"

COMMENT

The clause below defines the environmental term "remedial action." It can be used not only in agreements for the sale and purchase of real property, but also in lease agreements, mortgages, real estate-based loan agreements and related documents, etc.

The clause defines the term as any action taken, whether voluntarily or by government order: (1) to clean up or remove contaminants from the environment; (2) to prevent further contamination of the environment; or (3) to perform pre-remedial or post-remedial studies and investigations to determine either the nature and extent of an environmental problem, or whether remedial efforts already taken have successfully eliminated the problem.

For further information, see Chapter 4.

FORM

"Remedial action" means all actions required or voluntarily undertaken to:

(1) clean up, remove, treat or in any other way address contaminants in the indoor or outdoor environment;

(2) prevent the release or threat of release or minimize the further release of contaminants so they do not migrate or endanger or threaten to endanger public health or welfare or the indoor or outdoor environment; or

(3) perform pre-remedial studies and investigations and post-remedial monitoring and care.

D.20 Model agreement to perform environmental site assessment

COMMENT

This form is a model agreement for an environmental site assessment. It sets forth, in very specific terms, the work to be performed by the environmental engineer (or other environmental consultant) and how it will be performed. The form also sets forth items which are specifically excluded from the scope of the assessment, such as soil testing.

With regard to payment, the form sets out the fee for the engineer's services and states when payment is required. It also provides for a *quantum meruit* payment in the event that the purchaser cancels the agreement after partial performance by the engineer. (Such cancellation might occur if a contingency in the sale and purchase agreement were to fail, e.g., where the purchaser is unable to obtain a mortgage at an acceptable interest rate.)

It is common practice for lenders to require an environmental site assessment as a condition of making a mortgage loan to a purchaser. Such an assessment is also required when the purchaser wants to obtain environmental insurance to protect himself or the lender against the economic consequences of the discovery of an adverse environmental condition on the premises after the transfer of title.

In the event that the environmental site assessment turns up evidence that there *might* be an adverse environmental condition on the premises, this agreement can be modified to have the engineer undertake whatever additional work may be necessary to make a definitive determination. This work might include laboratory testing of ground water or soil samples, or analysis of the composition of material removed from a building, such as insulation. If such work is necessary, the parties would simply execute a written amendment or addendum to this agreement, specifying the scope of the additional work, the added cost and payment terms.

For further information, see Chapters 4 and 11.

FORM

AGREEMENT made this _____ day of _____, 20____,
between _____ [*insert name of company performing environmental site assessment*], a corporation existing under the laws of the State of _____, with offices for the transaction of business at _____ (hereafter referred to as "Engineer"), and _____, residing at _____ (hereafter referred to as "Purchaser").

WITNESSETH:

WHEREAS, Purchaser is the contract vendee of a certain parcel of real property and premises commonly known as _____ (hereafter referred to as "subject premises");

WHEREAS, Engineer is in the business of performing environmental site assessments;

NOW, in consideration of the mutual promises contained herein, it is agreed as follows:

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1. *Scope of work.* Engineer will undertake the following tasks to determine whether there is any evidence of significant adverse environmental impact due to past or present practices or releases of hazardous material on the subject premises:

(a) Review of any maps which may be available which show adjacent property. These may include United States Geological Maps, maps filed in the

_____ County Clerk's Office, development maps filed with the Planning Office of the City of

_____, maps filed with the Department of Environmental Protection of the State of

_____, and maps filed with the

_____ County Health Department. It is unknown at this time whether any or all of the above maps may be in existence.

(b) Review of the title search of the property to determine the identity of previous owners. This title search will be provided to Engineer by Purchaser at Purchaser's expense.

(c) Personal interviews with:

(i) current owner to determine his use of the premises;

(ii) as many owners as can be reasonably located within a fifty-five (55) mile radius from the site or by telephone, to determine past uses of the premises;

(iii) representatives of the police department, fire department, sanitation department, and health department, to determine whether any records exist regarding environmental conditions or incidents existing or occurring on the subject premises or adjacent land;

(iv) occupants of neighboring properties to determine use of premises and neighboring land and whether any significant incidents can be recalled.

(d) Review of state and federal records of hazardous waste sites and other environmentally significant events.

(e) Personal inspection of the subject premises.

It is understood that no soil samples or other testing will be performed as part of this environmental site assessment. If Engineer discovers any piece of information which he reasonably believes warrants further investigation, he shall promptly notify Purchaser. Such further investigation shall be performed as part of an amendment to this Agreement, to be negotiated and executed prior to commencement of the further investigation.

2. *Findings.* Engineer shall present his findings in written form on or before _____, 20____. Time is of the essence. The findings shall include a statement of whether any evidence of significant adverse environmental impact was discovered. The findings shall also include whether Engineer recommends any additional testing or review. The findings shall also report whether any significant information was unavailable to Engineer and the import of such lack of information.

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3. *Cost.* The total cost of the environmental site assessment to be performed pursuant to the terms of this Agreement is the sum of \$_____, together with costs of disbursements made by Engineer for copies of maps, records, postage, photocopies, mileage, and long distance telephone calls. This sum shall be paid as follows:

(a) The sum of \$

_____ upon execution of this Agreement. This sum is non-refundable.

(b) The sum of \$

_____ is due upon delivery of the environmental site assessment. Engineer shall be entitled to withhold the assessment until this sum shall be paid in full.

In the event Purchaser cancels this Agreement after performance has begun, Engineer shall be entitled to a fee of \$_____ per hour for time expended to the date of cancellation, together with disbursements, as described above. The non-refundable deposit shall be applied to this amount. The balance, if any, shall be due and payable to Engineer upon his rendering of his statement for services.

4. *Confidentiality.* Engineer agrees not to discuss his findings or provide copies of his findings to anyone other than Purchaser, without the written authorization of Purchaser. Engineer acknowledges that Purchaser is under a contractual obligation to Seller to maintain confidentiality with regard to anything which he may learn about the subject premises. Engineer, for himself and his employees, agrees to comply with the confidentiality requirements.

Notwithstanding the foregoing, nothing contained herein shall prohibit Engineer from testifying before a duly constituted body of any state or federal government under compulsion of subpoena regarding his work or findings. Engineer shall provide a copy of the environmental site assessment to the owner at the premises address.

5. *Representations of engineer.*

(a) Engineer represents that he is qualified to undertake the work contemplated under this Agreement.

(b) The work will be performed in a professional manner, using generally acceptable practices in this field at this time.

(c) No other representations or warranties, express or implied, are made.

(d) Engineer shall be entitled to rely on oral information or representations made during interviews, unless Engineer reasonably believes such information to be of a questionable nature. In such case, Engineer shall report the information and the reason why he reasonably believes the information to be of a questionable nature.

6. *Representations of purchaser.* Purchaser will cooperate with Engineer and provide Engineer with all copies of maps and documents in his possession in a timely fashion so as to facilitate the timely completion of the work contemplated under this Agreement.

7. *Entire agreement.* This Agreement contains the entire understanding of the parties; there have been no representations made which are not contained herein.

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8. *Modification.* This Agreement may only be modified by a written amendment signed by all parties. An oral modification shall not be binding on any party.

9. *Governing law.* This Agreement shall be construed in accordance with the laws of the State of _____.

10. *Waiver.* Any failure by either party to enforce any right arising hereunder shall not be deemed a waiver of such right.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals the day and year first above written.

[Acknowledgements]

D.21 Model agreement with company for removal of hazardous condition on subject premises--clauses include licensing requirements, insurance requirements, scope of work, hold harmless provision, certificate of proper disposal

COMMENT

This agreement is used when contracting with a licensed hauler for the removal of hazardous matter located on the subject premises. The owner of the premises should demand copies of the hauler's certificate of insurance and state-issued license prior to providing a deposit to the hauler. The owner should also obtain proof of proper disposal of the hazardous matter before making the final payment required under the agreement.

The form contains provisions which require the hauler to inform his employees and agents of the nature of the substance being removed. In addition, the hauler agrees to provide any special training, protective clothing and other necessary gear for his employees and agents. This provision is designed to help prevent future claims, brought against *both* the hauler and the owner of the property by injured workers, that with proper training and protective gear, the injuries could have been avoided. It is also strongly recommended that the agreement include a requirement of worker's compensation insurance.

The removal process can be very dangerous, particularly where the hazardous matter is radioactive or highly flammable, or where it contains extremely carcinogenic chemicals. The owner should examine his own liability insurance coverage prior to the commencement of work. The owner must be certain that he has adequate coverage in the event that the hauler or its insurance company becomes bankrupt or is otherwise unable to meet its obligations to the owner and to anyone else who may be injured during the course of removal.

For further information, see Chapters 4 and 11.

FORM

AGREEMENT made this _____ day of _____, 20____,
between _____, a corporation licensed to do business in the State of _____, with
offices for the transaction of business at _____ (hereafter referred to as "Company"),
and _____, residing at _____ (hereafter referred to as "Owner").

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W I T N E S S E T H:

WHEREAS, a hazardous condition has been discovered on certain real property owned by Owner; and

WHEREAS, Company is in the business of correcting such conditions;

NOW, in consideration of the mutual promises contained herein, it is agreed as follows:

1. *Scope of work:*

(a) The Company will remove _____ [insert number of drums] fifty-five (55) gallon drums containing _____ [e.g., gasoline] from Owner's property located at _____. If any drums are not intact, Company will transfer the material to a suitable container and remove the container and damaged drum(s) as well.

(b) If any drums are found to be leaking, Company shall remove the contaminated soil as well. The amount of soil to be removed will be determined by soil samples to be taken by Owner's consultant and at Owner's expense.

(c) Company shall provide Owner with a hazardous materials shipping manifest, as required by state and federal laws and regulations.

(d) Company shall dispose of the items in Paragraphs (a) and (b), above, at an approved site, as required by law. Company shall provide owner with proof of proper disposal within ten (10) days after each item is removed from Owner's premises. Owner shall not be obligated to pay Company until such proof is provided in proper form.

2. *Cost:*

(a) Owner shall pay Company the sum of \$_____ per intact drum and \$_____ for any drum which requires replacement.

(b) Owner shall pay Company the sum of \$_____ per cubic yard of soil which is removed.

(c) Payment shall be made by certified check or bank draft as follows: \$_____ deposit shall be made upon execution of this Agreement. Company shall hold this sum in escrow until it has picked up all drums. A payment of \$_____ shall be made upon providing Owner with the shipping manifest and proof of proper disposal. The payment for soil removal shall be made in full upon Company providing Owner with proof of proper disposal.

3. *Insurance:*

(a) Company shall provide Owner with proof of worker's compensation insurance and liability insurance in at least the amount of \$_____. Owner shall be named as an additional insured on the policies.

(b) Company shall hold Owner harmless for any and all claims for injury to person or property arising from the removal and disposal as described in Paragraph 1, above, including, but not limited to, defense costs and consequential damages arising out of, or in any way related to, the_____.

(c) Company covenants that it will provide its employees and agents with appropriate protective clothing and equipment, including, but not limited to, ventilators, protective eyeglasses, coveralls, and gloves. Company also covenants that it will provide its employees and agents with any special training and other information necessary for the successful completion of this contract. Company will use only employees who are fully trained in the proper handling of such substances. Company will disclose to employees the identity and nature of the substance to be removed.

4. Representations:

- (a) Company represents that it is licensed by the appropriate federal and state authorities to undertake the work described in Paragraph 1. Company will provide a copy of its licenses to Owner upon execution of this Agreement.
- (b) Company represents that it has never been cited, convicted, fined, or the subject of any administrative proceeding for any action in connection with removal, storage or transportation of any hazardous substances.
- (c) Owner represents that the only substance contained in the drums is_____.

5. Time:

- (a) Company will remove all drums on or before_____, 20_____.
- (b) Company shall remove the contaminated soils, if any, within_____ days after receipt of the report from Owner's consultant stating the location and amount of soil to be removed.
- (c) Company shall be entitled to a reasonable extension of time, not to exceed_____ days, to compensate for adverse weather conditions.

6. Termination:

- (a) Either party may terminate this Agreement prior to performance by Company. Upon such termination, Company shall promptly refund the deposit.
- (b) If partial performance has occurred, Company shall be entitled to *quantum meruit* payment to be applied against the deposit. The balance of the deposit shall be promptly refunded. If the deposit is insufficient, Owner shall promptly remit the balance.
- (c) Notice of termination shall be given in writing and delivered as set forth in Paragraph 7 hereof.

7. *Notice.* Any notice required to be given to Company shall be in writing and sent certified mail, return receipt requested, to:

Any notice required to be given to Owner shall be in writing and sent certified mail, return receipt requested, to:

Notice shall be deemed given when received.

8. *Entire agreement.* This Agreement contains the entire understanding of the parties; there have been no representations made which are not contained herein.

9. *Modification.* This Agreement may only be modified by a written amendment signed by all parties. An oral modification shall not be binding on any party.

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10. *Governing law.* This Agreement shall be construed in accordance with the laws of the State of _____.

11. *Waiver.* Any failure by either party to enforce any right arising hereunder shall not be deemed a waiver of such right.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals the day and year first above written.

[Acknowledgements]

D.22 Model agreement for gift or donation of real property--hold harmless clause granted by transferor to transferee in the event environmental problems are discovered in future--transferee may reconvey property to transferor if environmental problems are discovered--warranty as to condition of premises

COMMENT

This agreement is designed to be used when an owner wishes to make a charitable donation of real property to a non-profit organization. Here, the tax benefits to the transferor are so great that he is willing to give to the transferee an environmental hold harmless and to agree to accept a reconveyance of the property if an environmental problem is discovered after the gift is made. The transferor is willing to take such a risk only because he had an environmental site assessment performed when he purchased the property. Thus, the transferor is aware that the property was free of any adverse environmental condition when he purchased it, and that no such condition arose during his tenure as owner.

If the transferor does not have this information available, paragraphs 7, 8, 9 and 10 should be omitted, and a disclaimer of warranties should be inserted. In such case, the transferee should strongly consider making the transfer contingent upon the results of an environmental site assessment. It should be remembered that under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 USC § 9601 *et seq.*, the transferee becomes liable for any condition on the property once the transfer of title occurs.

For further information, see Chapters 4 and 11.

FORM

AGREEMENT made this _____ day of _____, 20____, between _____, a corporation existing under the laws of the State of _____, with offices for the transaction of business at _____ (hereafter referred to as "Corporation"), and _____ Charities, a not-for-profit corporation organized under the laws of the State of _____, with offices for the transaction of business at _____ (hereafter referred to as "Charities").

WITNESSETH:

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WHEREAS, Corporation is the owner of certain real property and premises located in the City of _____, State of _____, with a street address of _____ (hereafter referred to as "property"); and

WHEREAS, Corporation no longer has use for said property; and

WHEREAS, Charities is seeking a site on which to house its _____ program;

NOW, in consideration of the mutual promises contained herein, it is agreed as follows:

1. *Transfer of property.* Corporation hereby agrees to transfer to Charities the property as a charitable donation. The transfer shall take place on or after _____, 20____.

2. *Terms and conditions of transfer.* Corporation shall provide Charities with a copy of its abstract of title to the premises. Charities shall obtain a continuation of title insurance at its own cost and expense.

Charities shall take title subject to any facts which may be revealed by a survey or personal inspection, any enforceable covenants, easements or restrictions which are of record, and any zoning ordinances in effect. In the event that Charities does not wish to accept title subject to any of the foregoing, the sole remedy shall be to terminate this agreement. Nothing contained herein shall require Corporation to take any steps to clear any title defects.

3. *Removal of all equipment and fixtures from property.* Corporation agrees to remove all equipment and fixtures from the structures located on the property. Corporation shall leave the structures "broom clean". Corporation shall not be required to repair any holes in the floors, walls or ceilings caused by removal of said fixtures as it is the intention of Charities to completely renovate the building into a center for its _____ program.

4. *Value of property.* The parties agree that the value of the property, including structures, is \$____. The parties have each obtained appraisals to that effect. Charities intends to insure the property for that sum. Corporation intends to use that sum for computation of its donation and tax deduction.

5. *Tax-exempt status of donee.* Charities represents that it is a not-for-profit organization and has received certification from the Internal Revenue Service. Charities further represents that it is a § 501(c)(3) charitable corporation under the Internal Revenue Code of 1986, as amended.

6. *Representation of condition of premises.* Corporation hereby represents that the premises are in good structural condition and that all systems, including plumbing, mechanical, and electrical, are in good working order and will be so on the date of transfer of title, reasonable wear and tear excepted.

7. *Premises have never been used to store or dispose of hazardous waste.* Corporation hereby represents and warrants that the subject premises have never been used for the storage or disposal of hazardous waste. The term "hazardous waste", as used herein, shall mean substances deemed hazardous pursuant to the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 U.S.C. § 9601 et seq.

This representation is made to induce Charities to enter into this contract for transfer of the subject premises. Corporation shall be liable for all damages, including economic and consequential damages, in the event that the representations contained in this section are inaccurate.

8. *Compliance with environmental laws, regulations and policies.* Corporation hereby represents and warrants that, during its period of ownership, Corporation, its agents and employees, complied with all federal, state and municipal environmental laws, regulations and policies as such relate to the subject premises.

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Corporation agrees to indemnify and hold Charities harmless for any loss, including, but not limited to, damage to person or property or economic loss, including defense costs arising out of any violation of environmental law which occurred during Corporation's ownership of the subject premises, which violation was caused by the knowing or purposeful act or omission of Corporation, its agents or employees.

9. *Indemnification and hold harmless.* Corporation agrees, for a period of _____ years from the date hereof, to indemnify and hold Charities harmless for and against any and all liability, claims and expenses of any kind whatsoever (including reasonable attorney's fees and other defense costs) for any injury or damage to person or property sustained by anyone on or about the premises, which results from or arises out of any adverse environmental condition existing on the subject premises at or before the transfer of title of the subject premises from Corporation to Charities.

Corporation agrees, for a period of _____ years, to obtain environmental liability insurance from a company rated "AA" or better in at least the amount of \$ _____. Charities shall be named as an additional insured or loss payee on said policy. Corporation's liability under this agreement shall be limited to the limits of this policy.

Charities shall give Corporation notice of any claim or potential claim within ten (10) days after Charities shall receive notice or have reason to know that a claim exists. Failure to provide prompt notice will relieve Corporation of any liability hereunder.

Charities shall give Corporation a reasonable opportunity to defend against such claim. Charities shall cooperate with Corporation in such defense. Charities shall not compromise any claim without the consent of Corporation. Violation by Charities of any of these provisions shall relieve Corporation of any liability hereunder.

Charities agrees to cooperate with and comply with all reasonable requests of Corporation's insurance carrier. In the event Charities fails to do so and the insurance carrier disclaims liability for that reason, Corporation shall be relieved of any liability hereunder.

10. *No environmental site assessment to be performed.* On the basis of the representations made herein by Corporation, Charities will not be undertaking an environmental site assessment. In the event that Charities, during the term of its ownership, discovers any adverse environmental impact caused by use of the property or release of hazardous materials on the property prior to Charities' ownership, in addition to any other rights or remedies which Charities may have, Charities may require Corporation to accept a reconveyance of the property.

In addition, Corporation shall reimburse Charities for the reasonable current value of the improvements which Charities has made to the property. The value shall be determined by an appraiser who is mutually agreeable to the parties. If the parties cannot agree upon an appraiser, each shall select an appraiser. The two appraisers shall select a third appraiser, who shall perform the appraisal. The third appraiser's valuation shall be binding on both parties.

Payment shall be made within _____ days after receipt of the appraisal and upon tender of the deed by Charities. Notwithstanding the foregoing, if Charities has caused or suffered any acts or omissions during its ownership which result in any adverse environmental impact of any nature, Charities shall have no right to reconvey the property.

The benefits contained in this paragraph may not be transferred by Charities to subsequent owners.

11. The provisions of this Agreement shall survive the transfer of title.

12. This agreement may not be assigned by Charities.

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13. This Agreement contains the entire understanding of the parties; there have been no representations made which are not contained herein.

14. This Agreement may only be modified by a written amendment signed by all parties. An oral modification shall not be binding on any party.

15. This Agreement shall be construed in accordance with the laws of the State of _____.

16. Any failure by either party to enforce any right arising hereunder shall not be deemed a waiver of such right.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals the day and year first above written.

FOR CORPORATION:

FOR CHARITIES:

DATED: _____

[Acknowledgements]

D.23 Conservation easement agreement

COMMENT

This form provides for the sale of an easement for recreational purposes by the owner of the subject property to the people of the State of New York. The agreement allows vast acreage to be made available to the general public for all-season use, including hiking, camping, skiing, snow shoeing, canoeing, fishing, etc. The property is to be preserved perpetually in its natural condition.

The form also allows the owner to maintain the right to use the property for harvesting forest crops. However, this right is predicated upon his adherence to environmentally-sound harvesting techniques.

The agreement allows the owner to mortgage or sell the property subject to the terms of the easement. The owner is also responsible for all taxes imposed on the property.

For further information, see Chapter 4.

FORM

UNDER THIS AGREEMENT made this _____ day of _____, 20____, between _____, a corporation existing under the laws of the State of _____, with offices for the transaction of business at _____ (hereafter referred to as "Owner"), and THE PEOPLE OF THE STATE OF NEW YORK (hereafter referred to as "Purchaser"), by THE NEW YORK STATE DEPARTMENT OF ENVIRONMENTAL CONSERVATION, and pursuant to the provisions of Section 3-0305 of the Environmental Conservation Law under which this purchase is being made, the parties hereby agree to the following terms and conditions:

W I T N E S S E T H:

WHEREAS, Owner claims to own the land hereinafter described and wishes to sell and convey same to the Purchaser, and desires the Purchaser to secure a search and make an examination of the title to said land; and

WHEREAS, the Purchaser desires to secure title to said land, but before doing so, it will be necessary that the Purchaser examine the title to said land and secure the approval of title thereto by the Attorney General;

NOW, THEREFORE,

The Owner, in consideration of the performance of the covenants hereinafter contained on the part of the Purchaser, hereby agrees to sell and convey unto the Purchaser a Conservation Easement affecting the land hereinafter described, by full covenant warranty deed free and clear from any and all liens and encumbrances, according to such description as approved by the Comptroller of the State of New York pursuant to his rules, such description to be made in accordance with an accurate survey or map to be made by or on behalf of the Purchaser and at the expense of the Purchaser, said deed to contain a trust covenant in accordance with Subdivision 5 of Section 13 of the Lien Law, for the sum of \$_____, and;

The Purchaser, subject to the approval of title to said land by the Attorney General, and in consideration of the performance of the covenants hereinabove and hereinafter contained on the part of the Owner, agrees to buy said land and to pay the Owner therefor the sum as aforesaid; such payment to be made after the deed from the Owner to the Purchaser shall have been duly recorded in the Office of the Clerk of the County in which said land is situated.

The Owner covenants with the Purchaser and the Purchaser covenants with the Owner as follows:

1. That the title to the land, hereinafter described, shall be examined with all convenient speed and said title shall be subject to the approval of the Attorney General of the State of New York after the same has been made satisfactory to him and that the Purchaser shall procure a search covering the said land if the Owner has not made such a search.
2. That said Owner will submit to the Attorney General all maps, deeds, and other papers and documents relating to, or affecting the title to, or right of possession of, the land hereinafter described, and will furnish the Attorney General such additional information and papers as the Attorney General may require, so far as the same may be in his possession or obtainable by him.
3. The Owner will cooperate with the Attorney General in an effort to clear any valid title objections which may arise.
4. That whenever notified by the Attorney General, by letter or otherwise, said Owner will execute and deliver to the Attorney General for the Purchaser, without delay, a full covenant warranty deed of the said land, hereinafter described. Said deed shall be subject to the approval of the Attorney General with respect to form, manner of execution and recordability.
5. The said Owner will pay and discharge all taxes and assessments which are due and payable or which are liens against said land at the time for the recording of the deed thereof to the Purchaser. All current taxes will be prorated accordingly.
6. That if the title of said Owner to the land hereinafter described is based on adverse possession, said Owner will, at its own expense, perpetuate the evidence of such possession in the manner provided by Article 31 of the Civil Practice Law and Rules before title will be approved by the Attorney General.
7. It is further mutually understood and agreed that the obligations of the Owner to clear objections to the title to said

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real property shall not include the extinguishment of easements, if any, for the construction, operation and maintenance of electric, telephone, telegraph, and pipe lines, or railroads and other transportation corporations, or the right of others in any public road, right-of-way, waterway, street or highway running through or along the premises. The above purchase price is exclusive of such other possible interests.

8. The conveyance shall also include the right, title and interest of the Owner in and to any lands lying in the bed of any right-of-way, highway, road, street, or avenue, or in the bed of any waterway, marsh, pond, lake, bay, drainage or irrigation ditch, river, creek or stream running through the premises to be conveyed or lying in front or adjacent thereto, together with any and all right of ingress or egress over and across any private drive, land, waterway or road leading to and from any highway, road, street, or avenue to the real property herein described.

9. It is further mutually understood and agreed, anything to the contrary notwithstanding, that if, in the opinion of the Purchaser, it is necessary or desirable to acquire the same by appropriation pursuant to law, title to said lands may be so acquired by the Purchaser in lieu of acquisition by conveyance from said Owner, and in such event upon the vesting of title in the Purchaser as provided by law, this Agreement shall be and become an Agreement of Adjustment of the Claim of said Owner for compensation for the value of the real property so appropriated, and shall constitute an agreement that the value of the real property so appropriated shall be and hereby is fixed and determined at the sum of \$_____ without interest, moving expenses, supplemental relocation payments and incidental expenses (except pro rata of taxes) and as payment in full of any and all such claims arising from the appropriation.

All covenants of this Agreement shall apply, in case of appropriation, with respect to disposition of objections to title, as that title and those objections are found by the Attorney General to have existed at the time of appropriation.

This Agreement, consisting of _____ pages, is executed in triplicate; both parties and the Comptroller have one and each is an original for all purposes.

It is further mutually understood and agreed that this Agreement is to apply to and bind the heirs, devisees, grantees, executors, administrators, successors, and assigns of the Owner.

The Conservation Easement being conveyed by this Agreement from the Owner to the Purchaser shall include but not be limited to "Partial Development" and "Partial Recreational" rights associated with the _____ acre parcel. The Owner will retain the underlying fee title together with the "Timber Rights in Perpetuity". The terms of the easement are more fully described in the attached Addendum "A."

The Conservation Easement hereby contracted to be sold by the Owner to the Purchaser is described as follows:

[Insert description here]

This Agreement is made subject to the approval of the Comptroller and the Department of Law.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals the day and year first above written.

OWNER

By: _____

THE PEOPLE OF THE STATE

OF NEW YORK,

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Acting by and

through the Department of

Environmental Conservation

By: _____

Director of Fiscal Management

[Acknowledgments]

D.24 Representation by borrower to lender of condition of premises

COMMENT

This form provides several alternative representations which may be made by a borrower concerning the condition of the premises that will secure the loan. The appropriate representation should be included in the mortgage document.

In its list of events that will trigger a default by the borrower, the mortgage should include: "any misrepresentation made by the borrower at the time the mortgage terms were negotiated or memorialized in writing, regarding the condition of premises." This provision would allow the lender to accelerate the debt and call the loan due and payable in full upon the lender's discovery of the misrepresentation. In the alternative, the lender could exercise any other options which it might have available to it under the mortgage terms, such as requiring the borrower to proffer substitute collateral or collecting the mortgage debt from guarantors.

For further information, see Chapter 4.

FORM

Borrower hereby represents and warrants to Lender that Borrower knows of no state of facts or circumstances which would indicate that any adverse environmental condition exists on the premises described in Schedule "A," which is annexed to this mortgage.

"Adverse environmental condition" is defined as:

- (1) the contamination of the soil, air or water (whether surface water or ground water) of the subject premises by hazardous substances or hazardous wastes; or
- (2) the presence of hazardous substances or hazardous wastes which are stored upon the subject premises.

[Or:]

Borrower represents that he has caused a phase I environmental site assessment to be performed on the subject premises (described in Schedule "A," which is annexed to this mortgage) by a reputable environmental consulting firm. The results of the assessment showed no evidence of any adverse environmental condition on the property.

"Adverse environmental condition" is defined as:

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(1) the contamination of the soil, air or water (whether surface water or ground water) of the subject premises by hazardous substances or hazardous wastes; or

(2) the presence of hazardous substances or hazardous wastes which are stored upon the subject premises.

[Or:]

Borrower represents that he has been the owner of the premises described in Schedule "A," annexed to this mortgage, for _____ (____) years. During that time, no hazardous materials, as defined in the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. § 9601 *et seq.*, the Resource Conservation and Recovery Act, 42 U.S.C. § 6901 *et seq.*, the Hazardous Materials Transportation Act, 49 U.S.C. § 1801 *et seq.*, or the Toxic Substances Control Act, 15 U.S.C. § 2601 *et seq.*, have been used, stored or disposed of on said premises.

[Or:]

Borrower represents that _____ [insert number] drums of _____, a substance considered to be hazardous, was stored on the subject premises (described in Schedule "A," which is annexed to this mortgage) for a period of _____ (____) years. Those drums were intact when removed. The drums have been properly removed and disposed of in strict compliance with all federal, state and municipal laws, regulations and policies. Borrower knows of no other adverse environmental condition affecting the premises.

[Or:]

Borrower represents and warrants to Lender that:

(1) to the best of his knowledge, neither the premises described in Schedule "A," which is annexed to this mortgage, nor any adjacent property is currently being used or has been used for the storage, treatment, generation, transportation, processing, handling, production, or disposal of any hazardous substances as hereafter defined, or as a landfill or other disposal site;

(2) no storage tanks are now or have previously been located on the premises;

(3) all required permits have been obtained and are in full force and effect; and

(4) there are no proceedings, pending or threatened, which could result in damages or an order for remediation for any alleged violation of any environmental law.

As used herein, the term "hazardous substances" shall mean any substance described in the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. § 9601 *et seq.*, the Resource Conservation and Recovery Act, 42 U.S.C. § 6901 *et seq.*, the Hazardous Materials Transportation Act, 49 U.S.C. § 1801 *et seq.*, or the Toxic Substances Control Act, 15 U.S.C. § 2601 *et seq.*

[Whichever of the above representations is used, the following should also be added:]

Borrower makes the representations contained herein as part of the consideration for this loan from Lender. Any misrepresentation made by Borrower shall be an event of default under the terms of this mortgage. In the event Borrower has made a misrepresentation, Lender shall be entitled to enforce all rights and remedies regarding defaults under the terms of this mortgage. D.25 Representation by borrower to lender that it has complied with all federal, state and local environmental laws and regulations--another form

COMMENT

In the following clause, which may be inserted into a mortgage or loan agreement, the borrower makes a long series of representations for the benefit of the lender. These representations include, among others, that the borrower has complied with all federal, state and local environmental laws and regulations affecting the subject property. The borrower also represents that it is unaware of any legal actions or claims, either threatened or pending, arising out of an environmental mishap on the property or out of a violation of any environmental law or regulation on the property.

For further information, see Chapters 4 and 11.

FORM

Borrower makes the following nine representations to lender:

- (1) Borrower's counsel has carefully reviewed all federal, state and local environmental laws and regulations affecting the subject premises.
- (2) Any and all governmental approvals, permits and notifications required by federal, state and local environmental laws have been obtained.
- (3) Borrower has complied with all federal, state and local environmental laws, regulations, ordinances and policies applicable to the subject premises.
- (4) Borrower is unaware of any action, either threatened or commenced, by any governmental agency arising out of an alleged violation of any environmental law or regulation on the subject premises.
- (5) No governmental agency has notified the borrower of any violation of any environmental law or regulation on the subject premises.
- (6) Borrower is unaware of any civil action, either threatened or commenced, by a party other than a governmental agency, arising out of an alleged environmental mishap occurring on the subject premises or out of the alleged violation of any environmental law or regulation on the subject premises.
- (7) Borrower is unaware of the occurrence of any environmental mishap on the subject premises or of the existence or discovery of an adverse environmental condition on said premises.
- (8) Borrower is unaware of the presence on the subject premises of any hazardous waste or hazardous or toxic substances.
- (9) The past and present uses to which the borrower has put or is putting the subject premises do not violate any relevant federal, state or local environmental laws or regulations.

D.26 Environmental indemnification and hold harmless granted by borrower to lender--long form

COMMENT

The form below is known as an "environmental indemnification and hold harmless" provision and is granted by a borrower to its lender. In it, the borrower agrees that if, as a result of an adverse environmental condition that is discovered or occurs during the term of the loan, the lender is subjected to any liability whatsoever, then the borrower will indemnify and hold the lender harmless against such liability. The form includes its own definitions of the terms "liability" and "adverse environmental condition."

For further information, see Chapters 4 and 11.

FORM

If, as a result of an adverse environmental condition that is discovered or occurs during the term of the loan, Lender is subjected to any liability whatsoever, then Borrower will indemnify and hold Lender completely harmless against such liability.

"Adverse environmental condition" is defined as:

- (1) the contamination of the soil, air or water (whether surface water or ground water) of the subject premises by hazardous substances or hazardous wastes;
- (2) the contamination of the soil, air or water (whether surface water or ground water) of any piece of realty adjoining the subject premises due to a release of hazardous substances or hazardous wastes upon the subject premises; or
- (3) the presence of hazardous substances or hazardous wastes which are stored upon the subject premises.

"Liability" is defined as any claim or action (whether civil, criminal or administrative, and whether brought by any governmental entity or non-governmental entity or person), judgment, settlement, damages, fine, penalty, loss or expense brought against, imposed upon, suffered by or paid by Lender. Liability shall also include Lender's attorneys' fees, court costs, consultants' fees, experts' fees, and other litigation-related expenses.

Borrower expressly guarantees that it will assume all costs incurred by Lender in:

- (1) investigating the nature and severity of the adverse environmental condition;
- (2) conducting studies to determine the impact of the adverse environmental condition upon the public health;
- (3) eliminating the adverse environmental condition;
- (4) conducting tests following the clean up in order to determine whether remedial efforts have been successful; and
- (5) compensating any person, or the estate, heirs or beneficiaries of such person, who suffered injury, death or property damage as a result of the adverse environmental condition.



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Federal Taxes Affecting Real Estate

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Appendix Forms: CHECKLISTS AND FORMS

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§ Forms.syn Synopsis to Appendix Forms: CHECKLISTS AND FORMS

[E] Real Estate Development & Subdivisions



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Appendix Forms: CHECKLISTS AND FORMS

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[E] Real Estate Development & Subdivisions

E.1 Option to purchase land for development--provision for partial releases from purchase money mortgage

COMMENT

This chapter illustrates various types of contracts in transactions for the acquisition of real estate where the buyer's principal objective is the improvement of the property. As in all matters relating to real estate, the law applicable to transfers varies considerably from state to state, so that no single set of forms can possibly meet the requirements of the real property and contract law of every state. Each agreement must be tested against the law of the appropriate jurisdiction.

Limit on financial involvement:

Even if substantial improvements are contemplated by the buyer, the transaction may take the form of a simple transfer of unimproved land. But in most large scale projects, the buyer is anxious to put a limit on his financial involvement, with the result that the seller must often retain a stake in the enterprise. This stake may be in the form of a purchase money mortgage with provisions for the release of specific parcels as improvements on these parcels are completed by the buyer.

The seller's interest in the type of improvements and in the time for their completion may come not only from a desire to protect his purchase money mortgage but from his concern over the effect the improvements may have on other land held by the seller. In many cases the first step in the transaction is merely an option to the buyer, giving him a chance to investigate the potentialities of the property. In some cases a sale may be made of one parcel with the understanding that additional parcels are to be made available to the purchaser when prior commitments with respect to other parcels are fulfilled. Frequently, the seller may want to retain temporary control over the property, or he may want to preserve a permanent interest by way of an easement or other encumbrance. On the other hand, the seller may undertake to make certain basic improvements in the land, such as streets, sewers, water mains, etc., before the buyer is required to take title. These and other contractual variations are illustrated by the forms in this group.

Partial release from mortgage:

This form is an option to acquire land, but with no special undertakings or limitations. However, it does

illustrate the usual technique employed in the sale of acreage for development and subdivision. The important provision is the one that permits partial releases from the purchase money mortgage (see paragraph 7(c)). With such a provision, the developer can sell unencumbered segments of the property as improvements on these segments are completed. Without such freedom, the developer's selling program would be inhibited since he could not convey clear title to any part of the property without satisfying the lien on all the acreage created by the purchase money mortgage.

Under this form, the developer, at the closing, is to be given a release of specific acreage in consideration for the down payment. Thereafter, the developer may obtain releases upon the payment of a specified amount for each acre, with the payments applied against the mortgage debt. Releases are to be granted only for acreage contiguous to previously release acreage. As a corollary to the release provision, the agreement provides for the prepayment of the mortgage debt without penalty.

Recording of plats:

Under the provisions of this form, the seller agrees to join in any plats that the purchaser may wish to record under local law. The agreement states that any such collaboration by the seller is only for the purpose of registering its consent to the subdivision, and is not to be construed as subdivision activity by the seller which might cause it to be classified as a "dealer" in real estate.

For further information, see Chapters 6 and 11.

FORM

OPTION AGREEMENT made December 10, 2002, between Hames Realty, Inc., a Florida corporation (the "Seller"), and James Baron, of St. Petersburg (the "Purchaser").

In consideration of the covenants hereinafter contained, and of other good and valuable considerations, it is agreed as follows:

1. *Grant of option.* The Seller grants to the Purchaser the exclusive option to purchase, upon the terms and conditions set forth below, the property situated in Sarasota County, Florida, particularly described as follows:

(Insert description)

2. *Exercise of option.* The Purchaser shall exercise this option within 90 days from the date of this agreement, by notice in writing to the Seller addressed in care of Harris & Harris, Esqs., 100 Professional Building, Sarasota, Florida. Said notice shall be either hand delivered or sent certified mail, return receipt requested. Notice shall be deemed given when received. Notice may not be given by facsimile transmission. Any attempt to give notice by facsimile transmission shall be void and of no effect.

3. *Default by purchaser.* If the Purchaser fails to exercise this option, or makes any default after he exercises it, the Seller shall retain all money paid to it by the Purchaser upon the execution of this agreement as consideration for the grant of the option to the Purchaser, and all rights of the Purchaser under this agreement shall terminate.

4. *Abstract of title.* Within 30 days after the Purchaser exercises this option as provided, the Seller, as its own expense, shall deliver to the Purchaser, or to the Purchaser's attorney, an abstract of title covering the property described in paragraph 1 continued down to date showing the Seller's title to be good and marketable or insurable. The Purchaser

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shall then have 30 days in which to exercise the title and to accept it if the title is good and marketable or insurable. If the abstract of title fails to disclose the Seller's title to be good and marketable or insurable, the Purchaser shall notify the Seller in writing of any defects within the 30-day period, and the Seller shall have a reasonable time (but not more than 25 days) in which to make the title good and marketable or insurable, and shall use due diligence in an effort to do so. If after using due diligence the Seller is unable to make the title good and marketable or insurable within such reasonable time, the Purchaser may either accept the title in its existing condition with no further obligation by the Seller to correct any defect, or cancel this agreement. If this agreement is cancelled, all money paid by the Purchaser to the Seller upon the execution of this agreement shall be returned to the Purchaser, and this agreement shall terminate without further obligation between the parties.

5. *Environmental site assessment.* Within thirty (30) days after the Purchaser exercises this option, as herein provided, the Purchaser shall obtain an environmental site assessment at his own expense. The environmental site assessment shall be performed by Cosmic Geo-Science, Inc., or by such other qualified environmental consulting company acceptable to both parties, in the event that Cosmic is not available. A copy of the environmental site assessment shall be provided to both Purchaser and Seller. In the event that the assessment report finds a need for testing of soil, water and/or air, or that there is an indication of a potential adverse environmental condition existing on the premises, Purchaser shall have the right to terminate this option agreement by giving written notice to Seller, as set forth in paragraph 2 above, within ten (10) days after receipt of the assessment report from Cosmic.

In the event that Purchaser decides to terminate the agreement based on the assessment report, all funds on deposit, including the deposit of \$2,000 paid upon the execution of this agreement, shall be refunded to Purchaser immediately. The parties shall also exchange mutual releases.

In the event that Purchaser elects to terminate the agreement, Purchaser agrees not to disclose the contents of the assessment report to anyone. Purchaser acknowledges that breach of this covenant may subject him to damages for any loss suffered by Seller as a result of such disclosure.

Notwithstanding the foregoing, Seller may delay the effective date of the termination of the agreement for sixty (60) days by giving written notice to Purchaser, as set forth in paragraph 2, and by arranging for any additional testing and/or remediation suggested in the assessment report during the said sixty (60) day period, at Seller's expense. Seller shall be required to obtain from Cosmic written evidence that the testing showed no evidence of unsatisfactory environmental conditions and/or that all remediation has been completed in compliance with all federal, state and local laws and regulations. In the event that Seller complies with the provisions of this paragraph, Purchaser shall remain obligated to complete the purchase of said property under the terms of this agreement.

6. *Purchase price.* The purchase price for the property described in paragraph 1 is \$165,000, to be paid by the Purchaser to the Seller as follows:

(a) \$2,000 upon the execution of this agreement, which is the consideration for the granting of this option to the Purchaser, but which shall be applied against the purchase price if this transaction closes in accordance with the terms of this agreement.

(b) \$46,000 in cash upon the closing.

(c) \$117,000 by a purchase money note and first mortgage to be executed by the Purchaser and delivered to the Seller at the closing. The note and mortgage shall contain the provisions enumerated in paragraph 7, and all other consistent provisions reasonably required for the mortgagee's protection.

7. *Purchase money note and mortgage.* The purchase money note and mortgage referred to in paragraph 6(c) shall contain the following provisions:

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(a) The amount of the purchase money note and mortgage shall be \$117,000, which shall be payable in five installments: the first installment of \$25,000 one year from the date of closing, and the remaining four installments of \$23,000 each successively two, three, four, and five years from the date of closing. Interest at 15 percent per annum on unpaid balances shall be payable semiannually.

(b) The purchase money note and mortgage shall provide for the standard 30-day default clause, and for prepayment, in whole or in part, at any time without penalty, after January 1, 2004.

(c) The purchase money mortgage shall provide that land subject to the lien of the mortgage may be released, in portions, under the following conditions:

(1) The Purchaser must be current on all required payments of principal and interest.

(2) Purchaser must not be in default on any of the terms and conditions of this contract, the note or the mortgage.

(3) Purchaser must tender the sum of \$1,500 per acre.

(4) The land sought to be released must be contiguous to a previously released parcel. For the first release only, the land must be adjacent to a public roadway. All acreage for release purposes shall include land used for parks, waterways and easements.

(5) The Purchaser must tender a proposed release for review and approval by Seller's attorney, together with the sum of \$150 as legal fees for said review.

Purchaser shall have the obligation to record all releases at Purchaser's sole expense.

Streets, as shown on the subdivision map, when completed and ready for dedication to the municipality, shall be released without the payment of any release fee.

(d) The purchase money mortgage shall provide that the Seller will join in any plat or plats which the Purchaser may place on record, so long as the same meets with the approval of proper governmental agencies having jurisdiction over such plats, for the purposes of evidencing the Seller's consent to such platting and of dedicating the streets, waterways, and easements as shown on such plat or plats. This provision is made at the Purchaser's request and it is not the Seller's intention to engage in or have any part in the subdividing or platting of the property as a dealer in real estate or otherwise.

(e) The purchase money mortgage shall provide that the digging of canals or lakes and the use of fill excavated on the property shall not constitute waste.

(f) Upon complete payment of the purchase money note and mortgage, the Seller shall execute and deliver to the Purchaser a satisfaction in recordable form.

8. *Closing.* The closing under this agreement shall take place at 10 a.m. in the office of the Seller's attorneys, Harris & Harris, Esqs., 100 Professional Building, Sarasota, Florida on the fifth day after the Purchaser's acceptance of the title (or on the fifth day after the Seller has made the title good and marketable or insurable, as provided above). If the fifth day falls on a Saturday or Sunday, the closing shall take place on the following Monday.

9. *Deed* At the closing, the Seller shall convey the property described in paragraph 1 to the Purchaser by good and

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sufficient warranty deed, subject only to the lien of the purchase money mortgage executed by the Purchaser and delivered to the Seller.

10. *Release at closing.* At the closing, after the payment of \$46,000 in cash to the Seller as required by paragraph 6(b), the Seller shall release from the purchase money mortgage a parcel of land in the northern end of the property described in paragraph 1 consisting of a strip across the north side of the SE 1/4 of Section 28, Township 40 South, Range 19 East, 330 feet wide, containing 20 acres.

11. *Expenses.* The Seller shall pay for the documentary stamps on the warranty deed, the intangible tax on the purchase money mortgage, and the fees for recording the purchase money mortgage. The Purchaser shall pay for state stamps on the promissory note delivered to the Seller at the closing, and for the cost of recording any partial releases from the lien of the purchase money mortgage.

12. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

13. *Notices.* All notices or other documents under this agreement shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

14. *Non-waiver.* No delay or failure by either party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

15. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

16. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of Florida.

17. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

18. *Binding effect.* This agreement shall be binding upon and inure to the benefit of the parties, and their respective heirs, representatives, successors, and assigns.

In witness whereof the parties have executed this agreement the day and year first above written.

Attest:

Homes Realty, Inc.

by _____

President, Seller

Secretary

James Baron Purchaser

E.2 Option to purchase land for subdivision development--partial releases by acre or by homesite

COMMENT

Partial release:

Under this agreement, the purchaser may obtain partial releases from the purchase money second mortgage on either a per acre or a homesite basis. Since the property is being acquired subject to an existing first mortgage, partial releases are probably also obtainable under that mortgage. Otherwise, the purchaser could not proceed with a piecemeal development of the land without first refinancing the existing first mortgage to provide for partial releases.

It should be noted that the seller, as the second mortgagee, agrees to join in the subdivision platting so that the lien of his mortgage becomes subordinate to any necessary dedications of streets, easements, and canals. The same subordination provision should also be contained in the existing first mortgage.

For further information, see Chapters 6 and 11.

FORM

OPTION AGREEMENT made September 29, 2002, by and between John S. Jacobs ("the Optionor"), and Central Land Company, a Florida corporation (the "Optionee").

Recitals

The Optionor has entered into a contract of sale to purchase a tract of land consisting of approximately 295 acres, more or less, in Lee County, State of Florida, and is preparing to purchase the tract under the contract of sale.

The Optionee desires to obtain an option to purchase the tract of land in order to determine to its satisfaction certain features of usability for its intended purposes.

Now, therefore, for good and valuable considerations, the parties agree as follows:

1. *Grant of option.* The Optionor grants to the Optionee the right to purchase under the terms and conditions hereinafter set forth, a tract of land consisting of approximately 295 acres, more or less, as described in a contract of sale dated September 29, 2002, between Jones Holding Company, as seller, and John S. Jacobs, as purchaser. The contract of sale is attached to and made part of this agreement as if incorporated herein. The parties acknowledge that, in the event the Optionor is unable to complete the purchase of the subject land from the current owner by January 31, 2006, this option shall become null and void, and the deposit of \$1,000 shall be returned to Optionee.

2. *Consideration for option.* The Optionee has paid to the Optionor at the time of the execution and delivery of this agreement, the sum of \$1,000, receipt of which the Optionor acknowledges. If the Optionee does not exercise the option herein granted, the Optionor may retain the \$1,000 as liquidated damages, and this agreement shall then be null and void.

3. *Term and exercise of option.* This option shall continue from the date this agreement is executed to and including January 31, 2003, and shall be exercisable only by the delivery, on or before its expiration, of written notice to the Optionor at 200 South Street, Palm Beach, Florida. Closing of the purchase transaction under this agreement shall take place at the office of William Borden, Esq., 100 Beach Drive, Palm Beach, Florida, at 10 a.m. on the tenth day (or on the next business day if the tenth day is a Sunday or legal holiday) after written notice of exercise is delivered to the Optionor.

4. *Purchase price.* If the Optionee exercises this option, it shall pay to the Optionor, against delivery of the deed as provided below, the sum of \$190,000 as follows:

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- (a) \$1,000 by the application of the consideration paid by the Optionee for the grant of this option.
- (b) \$114,000 by taking title subject to a first mortgage in that amount, which is recorded in the Public Records of Lee County, Florida, in Mortgage Book 20 at page 150.
- (c) \$75,000 by executing and delivering to the Optionor a purchase money note and second mortgage in that amount, payable in installments as follows: \$25,000 on August 28, 2003, and \$12,500 each on February 28, 2004, August 28, 2005, February 28, 2006, and August 28, 2007. The purchase money note and mortgage shall bear interest at 15 percent per year, payable with each installment of principal. The Optionee shall pay all required federal and state documentary stamps on the purchase money note, as well as the intangible tax on the purchase money mortgage.
5. *Additional terms of purchase money note and mortgage.* In addition to the terms set forth in paragraph 4, the purchase money note and second mortgage shall be in form acceptable to the Optionor and shall contain the other customary and usual covenants contained in second purchase money mortgages on real estate in the State of Florida. The purchase money note and second mortgage shall also contain the following provisions:
- (a) If the Optionee defaults in any payment or action required under the first mortgage referred to in paragraph 4(b), the entire unpaid principal and interest on the purchase money note and second mortgage shall immediately become due and payable. Alternatively, the Optionor, at his option, may cure the default on the first mortgage by paying whatever sums may be necessary to cure such default and by adding such sums to the second mortgage. Said sums, together with any legal fees incurred in connection therewith, shall be deemed secured by the lien of the second mortgage.
- (b) If the Optionee defaults under the purchase money note or second mortgage, the entire unpaid principal and interest thereon shall become due and payable after a 30-day grace period.
- (c) The Optionee shall be entitled to releases from the lien of the second mortgage by paying \$250 for each acre so released. The Optionee shall not be required to request releases of contiguous acres of land, but shall be entitled to releases of any tract it selects.
- (d) If any part of the property is platted into lots of less than one acre, the Optionee shall be entitled to releases from the lien of the second mortgage by paying \$100 for each homesite so released. For this purpose, one homesite shall be deemed to consist of two lots, together measuring 40 feet by 125 feet.
- (e) All payments made on account of releases shall be applied to the next installment of principal due under the purchase money note and second mortgage. Upon the payment of each installment of principal under the purchase money note and second mortgage, the Optionee shall be entitled to releases in accordance with the foregoing terms, to the extent not previously granted to the owner.
- (f) All the preceding release provisions shall be subject to the rules and regulations for subdivisions issued by the Florida Real Estate Commission.
- (g) The Optionor will, from time to time, join in a plat or plats of unreleased portions of the property encumbered by the second purchase money mortgage. The joinder by the Optionor will acknowledge, in effect, that the lien of the second purchase money mortgage, as to dedicated portions, is subordinate and subject in all respects to the plat or plats and to any dedications expressed therein. The joinder by the Optionor shall not be deemed or construed to render him liable for the paving of any streets shown on the plat or plats, or for any other obligations assumed by the owner in connection with the plat or plats, and all streets, easements, and canals shall be released without cost or charge to the owner.
- (h) The Optionee may, at any time and without penalty, prepay in whole or in part the purchase money note and second

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mortgage, but no partial prepayment shall be made during the calendar year 2002.

(i) The Optionee shall pay the Optionor's attorneys' fees for the preparation of partial releases, at the rate of \$25 for each acre of homesite released. Upon satisfaction of the entire purchase money note and second mortgage, the Optionee shall pay the Optionor's attorney a fee of \$100 for the preparation of a satisfaction in recordable form.

(j) The Optionee shall not assume any personal liability on the purchase money note and second mortgage, and in the event of any default thereunder no deficiency judgment will be taken against it.

6. *Deed.* At the closing, upon the payment of the purchase price by the Optionee, the Optionor shall execute and deliver to the Optionee a deed to the tract of land referred to in paragraph 1. The deed shall convey good and merchantable title to the Optionee, its successors and assigns, free and clear of all liens and encumbrances, but subject to the first and second mortgages referred to in paragraphs 4(a) and 4(b) and to the covenants and restrictions contained in the contract of sale referred to in paragraph 1. Except as herein otherwise provided, the usual practices in connection with sales of real estate in the State of Florida shall govern as to adjustments, prorations, documentary stamps, recording fees, and similar items.

7. *Brokerage.* Each party represents to the other that no broker is entitled to commissions by reason of this transaction.

8. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

9. *Notices.* All notices or other documents under this agreement shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses, return receipt requested. Notice shall be deemed given when received, as evidenced by the United States Postal Service return receipt. Notice given by any other method, including, but not limited to, facsimile transmission, shall not be deemed effective.

10. *Non-waiver.* No delay or failure by either party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

11. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

12. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of Florida.

13. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

14. *Binding effect.* This agreement shall be binding upon and inure to the benefit of the parties, and their respective heirs, representatives, successors, and assigns.

Witness the hands and seals of the respective parties the day and year first above written.

Corporate Seal

Attest:

Secretary

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 John S. Jacobs, Optionor

Central Land Company

by _____

President, Optionee

E.3 Options to purchase land for development--separate options exercisable progressively

COMMENT

A program of land development may require the owner of the land to retain at least a temporary stake in the enterprise. Frequently, this stake is represented by a purchase money mortgage from which the developer may periodically obtain partial releases. In contrast, the owner's stake under this agreement is represented by long-term options to which he has subjected his property. The developer is never obligated to purchase the entire tract of land from the owner, although he has an option to do so. In addition to the option to purchase the entire tract, the developer has a series of separate options to purchase the various parcels which make up the entire tract. At each stage in the program, the developer can preserve his option over the balance of the entire tract only by purchasing one parcel and by paying an additional consideration for an extension of the option period.

Purchase of separate parcels of land:

Upon each purchase of a parcel, the developer must pay in cash the full price for that parcel. Thus, as with the purchase of an entire tract with the right in the purchaser to obtain partial releases, this arrangement provides for the gradual acquisition of unencumbered land. In either case, the purchaser may subdivide, develop, and rent or sell according to a plan of gradual free and clear acquisition of property. However, in contrast with the purchase of an entire tract, this arrangement permits the purchaser to judge his future needs for additional land as his development progresses, without committing himself in advance to purchase the entire tract.

Many development programs start with an option in favor of the developer in order to give him time within which to check out the soundness and feasibility of the venture. Under this agreement, three preliminary requirements are introduced by the developer (see paragraph 5). No obligation of any kind is to be incurred by him unless before a fixed date prescribed conditions are fulfilled with respect to mortgage loans, zoning restrictions, and water and sewer services.

For further information, see Chapters 6 and 11.

FORM

OPTION AGREEMENT made November 25, 2002, between Smith Realty Corporation, a Colorado corporation (the "Seller"), and William M. Adkins, of Denver, Colorado (the "Purchaser").

1. *Grant of option.* In consideration of the sum of \$25,000 paid by the Purchaser to the Seller, the receipt of which the Seller acknowledges, the Seller grants to the Purchaser the rights and option, upon the terms and conditions set forth below, to purchase a tract of 640 acres of real property in the County of Arapahoe, State of Colorado, described as follows:

(Insert description)

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The consideration of \$25,000 is solely for the grant of this option. It shall not be applied against any purchase price that the Purchaser is required to pay under this agreement, and it shall not be repaid to the Purchaser except as specifically provided below.

2. *Option price for single purchase.* If the Purchaser exercises the option to purchase the entire tract of 640 acres on or before April 15, 2003, the purchase price shall be the sum of \$1,000,000.

3. *Option and option prices for progressive purchases.* If the Purchaser does not elect to purchase the entire tract of 640 acres as provided in paragraph 2, he may elect to purchase a minimum of 40 acres, to be designated by him, upon the payment of \$68,000 on or before April 15, 2003. Thereafter, the Purchaser shall have the following options to purchase a part or all of the balance of the tract, to be designated by him, upon the payment of the following amounts on or before the following dates, and such options shall continue as specified herein:

Date	Payment	Pays for
April 15, 2003	\$.....2 6,250	Option on 600 acres to October 15, 2003
October 15, 2003	68,000	40 acres land purchase
October 15, 2003	42,000	Option on 560 acres to October 15, 2004
October 15, 2004	136,000	80 acres land purchase
October 15, 2004	36,000	Option on 480 acres to October 15, 2005
October 15, 2005	36,000	Option on 480 acres to October 15, 2005
October 15, 2006	136,000	80 acres land purchase
October 15, 2006	30,000	Option on 400 acres to October 15, 1999
October 15, 2007	136,000	80 acres land purchase
October 15, 2007	24,000	Option on 320 acres to October 15, 2008
October 15, 2008	136,000	80 acres land purchase
October 15, 2008	18,000	Option on 240 acres to October 15, 2001
October 15, 2009	381,000	240 acres land purchase

4. *Condition of title.* Title to all property shall be conveyed by good and sufficient warranty deed, free and clear of all liens and encumbrances, except the current year's general taxes which shall be prorated to the date of the delivery of the deed, and except any and all special taxes levied or assessed for special improvements on such property after the date hereof. The Seller shall make a satisfactory settlement with the tenant farmer presently on the property, release the Purchaser from any obligation to such tenant farmer, and deliver possession upon closing.

5. *Conditions attached to option.* The consideration paid by the Purchaser for the options granted under this agreement is subject to the following conditions:

(a) The Seller shall cooperate with the Purchaser in his negotiations with the Arapahoe County Bank, so as to obtain loan approval on or before April 15, 2003.

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(b) The Seller shall cooperate with the Purchaser in his efforts to obtain zoning, including approval for 9,000 square foot lots for approximately 25 percent of the area of Section 30, Township 6 South, Range 68 West of the 6th P.M.; and zoning approval for 13,500 square foot lots for approximately 50 percent of the area of such Section 30; and zoning approval for one-half acre lots for approximately 25 percent of the area of such Section 30.

(c) Water and sewer service shall be available to such Section 30, Township 6 South, Range 68 West of the 6th P.M. at the present tap charge of \$250 for sewer taps and \$200 for water taps for each residential lot, plus any connection fees, inspection fees, or tap fees made by the water district or sanitation district of the City of Englewood. However, the Purchaser shall at his own expense run the water and sewer lines from the present facilities to the property purchased or to be purchased by him under this agreement.

In the event that water service is not available as described above, Purchaser, at his own expense, may drill wells and install storage tanks, pumping stations and such other facilities as are needed to supply water to the land. In such case, Seller shall extend the time in which to exercise each option described above in paragraph 3 by one (1) year.

In the event that, after installation of a water system, Purchaser does not exercise some or all of the options described above in paragraph 3, then Seller shall require all future purchasers of the land that was not purchased by the Purchaser to obtain water services from Purchaser.

If the Purchaser cannot meet or does not waive the above conditions regarding loan approval, zoning, and water and sewer service before April 15, 2003, the \$25,000 paid for the option shall be immediately returned to the Purchaser and both parties shall be completely released from this agreement.

6. *Wetlands*. Seller shall provide Purchaser with proof that no wetlands--as defined by federal or state laws or regulations--exist within the optioned areas. In the event that wetlands do exist, the purchase price shall be reduced by \$1,000 for each acre, or part thereof, containing such wetlands. In the event that 5 percent or more of any optioned section, as set forth in paragraph 3, is designated as wetlands, Purchaser shall not be obligated to purchase that section, but may purchase other sections instead.

7. *Environmental audit*:

(a) Purchaser shall be entitled to obtain, at his own expense, a phase I environmental site assessment. The assessment shall be completed on or before April 15, 2006. In the event that the phase I assessment indicates that there is evidence of an adverse environmental condition, Purchaser shall be relieved of his obligation to purchase, the \$25,000 shall be returned to him, and both parties shall be released from this agreement.

(b) In the event that the phase I assessment indicates that further testing is needed, Purchaser may either terminate this agreement and obtain a refund of the \$25,000 or have additional testing performed. Seller shall pay for half of the cost of such additional testing. If the testing reveals no adverse environmental condition, Purchaser shall remain obligated under the terms of this agreement. If the testing reveals an adverse environmental condition, then Purchaser may terminate the agreement and the \$25,000 paid for the option shall be returned to him.

(c) Unless presented with a valid subpoena or court order, each party shall not reveal the outcome of the phase I environmental site assessment, or the outcome of any additional testing, to any third person without the prior written permission of the other party. Notwithstanding the foregoing, Purchaser may reveal the results once he is the owner of the optioned parcels. Seller may reveal the results in the event Purchaser terminates the agreement and receives a refund of the \$25,000 payment.

8. *Right of entry*. The Seller grants to the Purchaser the right to enter upon the tract at any time prior to the closing for the purpose of making surveys, engineering studies, soil tests, and other tests or studies which the Purchaser may deem

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necessary in connection with the development of the property, but such work shall not interfere with the tenant farmer's farming activities.

9. *Title report.* The Seller shall furnish a preliminary title commitment satisfactory to the Purchaser for the entire tract on or before 20 days from the date hereof, and also an owner's title policy for each parcel of land purchased under this agreement.

10. *Exercise of option and closing.* The Purchaser shall notify the Seller if he desires to exercise any option granted herein and shall designate in the notice the acreage to be conveyed to him. The Purchaser shall furnish a copy of the notice to Mountain Title Company, Denver, Colorado, accompanied by his check in an amount equal to the purchase price of the designated parcel. Within ten days after receipt of the notice, the Seller shall deliver to the title company a good and sufficient warranty deed conveying the designated parcel to the Purchaser. The deed shall be free and clear of all liens and encumbrances, except the current year's general taxes which shall be prorated, and special improvement taxes as of the date of closing the escrow, plus any special taxes paid by the Seller after the date of this agreement. The closing shall take place upon the receipt by the title company of the Purchaser's check in the amount of the purchase price and of the Seller's warranty deed. Simultaneously therewith, the title company shall issue its policy of title insurance covering the designated parcel and shall record the warranty deed and disburse the net proceeds from the sale to the Seller.

11. *Time of the essence.* Time is expressly declared to be of the essence of this agreement. If the Purchaser does not make, tender, or perform any payment or other condition as provided herein, this agreement shall be void and of no effect. In that event, both parties shall be released from all obligations hereunder, the Seller shall retain any and all payments made to it by the Purchaser, and the Purchaser shall retain all property paid for in full.

12. *Assignment.* The Purchaser may assign this agreement in whole or in part by giving written notice to the Seller. The Purchaser and his assigns, by the execution of this agreement, shall incur no personal liability.

13. *Notices.* Any notice required under the terms of this agreement shall be deemed to have been given within 48 hours after the notice has been deposited in the United States mails, postage prepaid, addressed to the Seller at 100 Main Street, Denver, Colorado, and to the Purchaser at 200 South Street, Denver, Colorado, until the parties shall designate any other address. Notice sent by facsimile transmission or by private delivery service shall not be deemed effective.

14. *Commissions.* The Seller shall pay the commissions, as and when parcels are purchased and paid for by the Purchaser under this agreement, in accordance with the separate letter agreement made with Hayes Realty Company of Denver, Colorado. Seller shall hold Purchaser harmless against claims for commissions due.

15. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

16. *Non-waiver.* No delay or failure by either party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein. A valid waiver by either party shall not be deemed to extend the amount of time available to perform any other act required hereunder.

17. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

18. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of Colorado.

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19. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument. At the trial of any matter relating to this instrument, only one counterpart need be produced.

20. *Binding effect.* This agreement shall be binding upon and inure to the benefit of the parties, and their respective heirs, representatives, successors, and assigns.

In witness whereof the Seller has caused its corporate officers to execute this option, and the Purchaser has set his hand and seal at Denver, Colorado, this 25th day of November, 2002.

Attest:

Smith Realty Corporation

Secretary

by _____

President

William M. Adkins

E.4 Contract of sale--commercial property--tract of vacant land--sale is made contingent upon results of environmental site assessment--seller to take back a purchase money mortgage--release provisions for subdivision development

COMMENT

This agreement can be used in a transaction in which the purchaser of vacant real property envisions the subdivision of the land and construction of a residential development upon it.

Environmental considerations:

Whenever such a major project is undertaken, it is imperative that the prospective purchaser have a thorough environmental site assessment performed before accepting title to the land. The purchase of the property should be made contingent upon the results of the testing. By having an environmental site assessment performed, the prospective purchaser would be able to cancel the contract and walk away from the deal if a serious environmental problem were discovered. In so doing, the prospective purchaser would accomplish three important goals:

(1) It would escape liability under federal law for the cost of remediating environmental problems after taking title to the contaminated land.

(2) The prospective purchaser would be shielded from suit by future homeowners within the development and by owners of adjacent properties whose lands might be contaminated by seepage emanating from the purchased property.

(3) The prospective purchaser would escape the expenditure of vast sums of money on: purchasing the property, obtaining municipal subdivision approval, and constructing the infrastructure for the subdivision, including roads, water lines, sewer lines, storm sewers, etc.

Accordingly, before making any investment in vacant land and incurring potential liability, a developer should elicit the services of a qualified environmental consultant to perform an environmental site assessment.

Purchase money mortgage:

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In this particular form, the seller has agreed to take back a purchase money mortgage covering the cost of acquisition. (In other words, the seller will hold the mortgage on the property, rather than a lending institution such as a bank.)

It should be noted that if the purchaser-developer later seeks commercial financing to cover the cost of constructing the development's infrastructure, the lender would almost certainly require the purchaser-developer to obtain an environmental site assessment as a prerequisite for obtaining the financing. Thus, by making this purchase agreement contingent upon the results of an environmental site assessment, the purchaser-developer will be aware of any potential environmental problems long before committing itself to the purchase and making any sizeable financial investment.

Releases of individual parcels:

This agreement gives the purchaser-developer the right to obtain the release of individual parcels from the lien of the mortgage by making specific principal payments which are then applied against the mortgage debt. These releases are necessary in order for the purchaser-developer to transfer title to lots to future home buyers.

The agreement contains a specified geographical order in which parcels will be released from the purchase money mortgage. This geographical order is designed to prevent the developer from building upon and selling the most desirable lots within the development and then defaulting on the mortgage, thereby saddling the seller-mortgagee with the least desirable parcels--parcels which may even be difficult to gain access to in light of prior development.

Other provisions in the purchase agreement:

Finally, the seller-mortgagee is obligated to join in the execution of any subdivision documents or any instruments necessary to transfer roads, sewers, sidewalks and other parts of the infrastructure for public use.

For further information, see Chapters 11 and 19.

FORM

AGREEMENT made this _____ day of _____, 20____, between _____ [*insert name of seller*], residing at _____ (the "Seller"), and _____ [*insert name of purchaser-developer*], a corporation organized under the laws of the State of _____, with offices for the transaction of business at _____ (the "Buyer").

1. *Sale.* The Seller agrees to sell and the Buyer agrees to purchase the following _____ [*insert number, e.g., four*] parcels of property, located in the City of _____, County of _____, State of _____, and described as follows:

[*insert description*]

The approximate acreage listed in the description above for each parcel is as shown on the county tax map for that

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parcel. The Seller makes no representations as to the exact number of acres contained in any of the parcels. The purchase price set forth in this Agreement is a firm price and will in no way be affected by any variance between the actual number of acres in a particular parcel and the estimated number of acres within that same parcel as set forth above. Buyer has had an opportunity to inspect and survey all parcels prior to entering into this Agreement.

2. *Sale is contingent upon results of environmental site assessment.* This Agreement is contingent upon Buyer obtaining satisfactory results of a Phase I Environmental Site Assessment. The assessment shall be conducted by an environmental consultant of Buyer's choosing and at Buyer's expense. It shall demonstrate that the premises are free from all hazardous substances and are in compliance with all federal, state and local environmental laws and regulations. This contingency shall be deemed waived unless Buyer shall notify Seller--in writing and by certified or registered mail, return receipt requested, postmarked no later than _____, 20____, or by facsimile transmission or personal service by such date--of the unsatisfactory results of the site assessment report. Buyer must also supply a written copy of the site assessment report as part of said notice. If notice of unsatisfactory results is timely given, this Agreement shall be deemed canceled, null and void. All deposits made pursuant to this Agreement shall be returned to the Buyer immediately.

3. *Purchase price.* The purchase price for the property described above shall be the sum of \$ _____ [e.g., \$500,000]. The purchase price shall be paid as follows:

(a) As earnest money, the Buyer, upon execution of this Agreement, will pay to the law firm of

_____ [insert name of firm], as Escrow Agent, the sum of \$

_____ [e.g., \$10,000].

(b) On or before

_____, 20

_____, the Buyer shall pay to the Escrow Agent the additional sum of \$

_____ [e.g., \$40,000] on account of the purchase price.

(c) The closing shall occur on or before

_____, 20

_____. Time is of the essence. At that time, the Buyer shall pay to the Seller the additional sum of \$

_____ [e.g., \$50,000], plus or minus prorations for property and school taxes and interest as hereafter set forth. The Buyer shall also assume the existing mortgage on the property with a balance of \$

_____ [e.g., \$200,000], and the remainder of the purchase price, in the sum of \$

_____ [e.g., \$200,000], shall be paid by means of execution and delivery of a

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promissory note secured by a purchase money mortgage, from Buyer to Seller.

4. *Nonrecourse note and mortgage.* The promissory note shall be payable in _____ [insert number, e.g., ten (10)] equal semi-annual installments, on June 30th and December 31st of each year, of principal, with the first installment due and payable on June 30th, 20____, and shall bear interest at the rate of _____ [e.g., ten (10)] percent per annum, due and payable with each installment of principal.

Such purchase money mortgage shall be in the usual form, shall contain a grace period for the payment of any installment of principal and interest of _____ [e.g., ten (10)] days, shall provide for prepayment without penalty at any time after December 31, 20____, and shall further provide that, in the event the mortgagor shall fail to meet any installment of mortgage debt when due, the mortgagee may not accelerate the unpaid balance of principal and interest unless and until there has first been given to the mortgagor notice of the existence of a default by registered or certified mail (return receipt requested), and such default has not been cured within the _____ [e.g., ten (10)] days next following receipt thereof.

The purchase money note and mortgage shall also provide that the obligation of the Buyer with respect to the indebtedness secured thereby shall be limited wholly and solely to the value of the land encumbered thereby, without the Seller being entitled to any deficiency claim or judgment.

5. *Closing.* This Agreement shall be consummated and the purchase and sale concluded on or before _____, 20____, at the office of _____ [insert attorney's name], located at _____, attorney for the _____ [Seller or Buyer].

6. *Title insurance or abstracts.* At least _____ [e.g., thirty (30)] days prior to the closing date, the Seller shall furnish to the Buyer, at the Seller's own expense, either a commitment of title insurance issued by a recognized title company, or abstracts of title extended to such date, showing title to the property to be good and marketable and vested in the Seller, free and clear of all encumbrances, except:

- (a) the mortgage encumbrance to be assumed by the Buyer as part of the purchase price;
- (b) real property and school taxes and assessments for the year 20____ and thereafter;
- (c) conditions and restrictions of record that are common to the neighborhood;
- (d) any oil, gas and mineral leases of record, and reservations to receive royalties, rentals and other receipts therefrom; and
- (e) applicable zoning ordinances, if any.

7. *Objections to title.* The Buyer shall have _____ [e.g., ten (10)] days from the date of receipt of either the commitment or the abstract in which to examine it and make written objections. If the Buyer has valid objections to the state of the title, the Seller shall have a period of time, not to exceed _____ [e.g., thirty (30)] days from the receipt of the Buyer's written objections, within which the Seller may cause the objections to be removed, and the date of closing shall be extended for that purpose. If, at the end of the period set forth in the preceding sentence, the objections have not been eliminated, the Buyer may, at its option, refuse to accept title, or accept the same in its then-existing condition without any diminution in the purchase price. In the event of refusal by the Buyer to take title, all money paid on account of the purchase price shall immediately be refunded. In the event that there are valid objections to the condition of the title, then the closing will be held within _____ [e.g.,

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ten (10)] days after either elimination of the objections or receipt of notice from Buyer that it will accept title despite the existence of valid objections, but in no event later than _____, 20 ____ .

8. *Adjustments.* Real property and school taxes and interest on the existing mortgage shall be prorated as of the date of closing.

9. *Deed.* At the closing, the Seller shall convey good and marketable title to the Buyer by warranty deed, conveying the property free and clear of all liens and encumbrances, except as herein noted. The deed shall be prepared at the expense of the Seller.

10. *Tracts released from mortgage.* The purchase money mortgage to be delivered to the Seller shall provide that property in one-acre tracts shall be released from the lien of the mortgage upon payment to the Seller, at the rate of \$5,000 per tract, for tracts in Parcels No. 1, 2 and 3, and on payment to the Seller, at the rate of \$10,000 per tract, for tracts in Parcel No. 4.

The Buyer must obtain releases of all tracts in Parcel No. 1 prior to seeking a release in any other parcel. Buyer must obtain all releases in Parcel No. 2 prior to seeking releases in Parcels No. 3 or 4. Buyer may obtain releases of tracts in Parcels No. 3 and 4 at the same time; provided, however, that all such releases in either Parcel No. 3 or 4 shall commence at the southern boundary of such parcel and shall sequentially migrate toward the northern boundary of the parcel. All subsequent releases of tracts in a given parcel shall be contiguous to previous releases in the same parcel.

11. *Easements over released parcels.* In the event parcels released from the lien of the mortgage separate the still-encumbered property from access to an existing public road, then the Buyer, upon request of the Seller, shall grant an easement to the Seller, thereby furnishing access from the property still encumbered by the mortgage to a then-existing public road. However, the easement shall not be more than _____ [e.g., forty (40)] feet in width, the location thereof shall be selected by the Buyer, and, where possible, the easement shall follow the location of a planned, future road, if any, as shown on the subdivision map.

12. *Releases for public facilities.* The roads, green spaces and lots reserved for wells, water storage tanks, sewage treatment stations or other utilities shall be released either upon their dedication to the municipality or upon Buyer's payment in full of the mortgage, whichever event occurs first. The Seller shall join with the Buyer in the execution of any subdivision document or instrument dedicating to public use any and all roads, rights-of-way, easements for drainage, waterways, and similar public facilities after receipt of approval of the subdivision application and maps by the appropriate governmental authorities. The Buyer shall not be required to pay any release price for areas dedicated for public use as described above. However, the Buyer shall pay to the Seller the sum of \$ _____ per acre for any bodies of water created by the Buyer.

13. *Releases after mortgage default.* Nothing contained herein shall obligate Seller to release any lot from the lien of the mortgage in the event that Buyer is in default under any of the terms of the new or assumed promissory notes or mortgages or this Agreement.

14. *Application of release payments.* Payments made on account of releases shall be applied by the Seller to the next principal installment payment due and payable pursuant to the terms of the purchase money note and mortgage.

15. *Release preparation expenses.* All mortgage releases shall be prepared by Buyer for review by Seller's attorney. The Buyer shall pay to the Seller the additional sum of \$ _____ for each release requested in order to cover the attorney examination fee incurred by Seller.

16. *Broker.* The Seller represents to the Buyer that this Agreement was procured only by and through the efforts of _____ [insert broker's name], a licensed real estate broker, and that it has dealt with no other

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salesperson or broker in connection with this purchase. The Seller agrees to indemnify and hold the Buyer harmless against any claim for real estate brokerage commissions by _____ [insert broker's name], but assumes no responsibility or obligation with respect to any other claim or claims with respect to this Agreement by any other broker or salesperson. Seller agrees to pay _____ [insert broker's name] the commission set forth in the listing agreement dated _____, 20 ____.

17. *Benefit.* This Agreement shall be binding upon and inure to the benefit of the respective heirs, legal representatives, successors and assigns of the Seller and the Buyer.

18. *Entire agreement.* This Agreement, together with the other written agreements and instruments executed concurrently herewith or pursuant to the provisions hereof, contains the entire agreement between the parties respecting the matters herein set forth and supersedes all prior agreements between them respecting such matters.

19. *Counterparts.* This Agreement may be executed in two (2) or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one (1) and the same instrument. At the trial of any matter arising under this Agreement, only one (1) counterpart need be produced.

20. *Headings.* Paragraph headings are for purposes of convenience and identification only and shall not be used to interpret or construe this Agreement.

21. *Gender and number.* Whenever the singular or plural number, or masculine or feminine gender, is used herein, it shall equally include the other.

22. *Governing law.* This Agreement shall be construed and enforced in accordance with the laws of the State of _____.

23. *Modifications.* This Agreement may be modified only by a written document signed by both parties. A purported oral modification shall not be effective.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals the day and year first above written.

SELLER _____

BUYER _____ CORPORATION

By: _____

E.5 Joint venture between land owner and real estate developer

COMMENT

The form that follows is a joint venture agreement between two parties. The first party is the owner of prime land that is highly suitable for real estate development. The second party is a seasoned developer with considerable knowledge and experience in this area and a wealth of capital at her disposal. Together they agree to join forces for a common goal, namely, the construction of a residential real estate development.

The value of the parties' respective contributions is reflected in their split of the expected profits.

Under the terms of the agreement, the developer, due to her vast experience, has nearly unfettered control

over the management and operation of the project. The land owner's interests are protected by the ability to audit the accounting books and records at any time and to have the audit costs paid by the developer if significant discrepancies are found. The land owner is also protected by a built-in dispute-mediation mechanism.

Termination clause:

The parties have included a termination provision in their agreement. The agreement can only be terminated for certain specified reasons. In the event of termination, the land owner is entitled to receive the land back, or at least the monetary value of the land at the time the agreement was executed.

The financial burdens of termination are largely placed on the developer. There are three reasons why this is so:

- (1) Since the developer has complete control over constructing and financing the project, if some problem does arise, it is very likely to be the developer's fault, rather than the land owner's.
- (2) The developer is in a far better position than its passive co-venturer to predict problems, avoid them, or formulate solutions once problems arise.
- (3) The developer has much less capital invested in the project than does the land owner, at least until construction is well underway.

Accordingly, for all of these reasons, the termination provision makes it difficult and expensive for the developer to back out of the project.

For further information, see Chapter 11.

FORM

AGREEMENT made this _____ day of _____, 20____, between Mr./Ms. _____, an individual residing at _____ (hereafter referred to as "Land Owner"), and Mr./Ms. _____, an individual residing at _____ (hereafter referred to as "Developer").

WITNESSETH:

WHEREAS, Land Owner is the owner of a certain parcel of land containing approximately _____ [e.g., three hundred (300)] acres, located in the Town of _____, County of _____, and State of _____, which parcel is more particularly described in Schedule A, which is annexed hereto and made a part hereof; and

WHEREAS, Developer is in the business of constructing residential multi-unit developments; and

WHEREAS, the parties wish to enter into an agreement whereby they will form a joint venture for the purpose of building a residential multi-unit development on the real property described in Schedule A,

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NOW, therefore, in consideration of the mutual promises contained herein, it is agreed as follows:

1. *Joint venture.* The parties hereby form a joint venture under the name and style of _____ [e.g., "Cricket Creek"]. The joint venture shall have an office on the site of the development and a mailing address of _____.

2. *Preliminary plans:*

(a) The parties, in the name of the joint venture, shall engage the architectural firm of _____, located at _____, in order to prepare preliminary plans for the development. These plans shall show the general location of:

- (1) roads within the development;
- (2) access to public water and sewer lines;
- (3) the approximate location of lots;
- (4) the approximate location of any wetlands or other environmentally sensitive areas.

These plans shall include a survey of the boundaries of the real property described in Schedule A. The preliminary plans shall be completed on or before _____, 20____.

(b) Upon receipt of the preliminary plans, the parties shall meet to review the plans. The parties shall make a list of changes which need to be made prior to finalization of the plans. If the parties cannot agree on a particular change, the dispute-resolution procedure set forth in Paragraph No. 11 hereof shall be used. The changes shall be provided to the architectural firm of _____ on or before _____, 20____, with instructions that final drawings, sufficient for subdivision approval in the Town of _____, shall be completed within _____ [e.g., forty-five (45)] days thereafter.

(c) Upon receipt of the final plans, the parties shall review the plans. Both parties shall sign the application for subdivision approval in the name of the joint venture. The application, together with all supporting documentation, shall be filed before _____, 20____.

(d) It is the intention of the parties that the plans will provide for approximately _____ [e.g., two hundred seventy-five (275)] residential lots of approximately _____ [e.g., one-half to three-quarters of an acre] each, together with roadways. In the event that fewer than the number of lots specified above can be created, this Agreement shall terminate. All lots shall conform to the requirements of the Town of _____ for size, road width and road location, green space and setbacks. [Optional: At least one park measuring at least _____ (e.g., five [5]) acres shall be included in the development.]

3. *Subdivision approval.* Developer shall be responsible for taking all further steps necessary for obtaining subdivision approval. This shall include securing whatever expert assistance Developer deems necessary, including, but not limited to:

- (a) legal services;
- (b) engineering services;

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(c) architectural services; and

(d) environmental services.

Developer shall appear at any zoning or planning board meetings held by the Town of _____. Developer shall arrange for appropriate testimony at such meetings. Developer shall pursue whatever appeals may be necessary in the event governmental approval is either not granted, or is granted subject to conditions that are unacceptable to the parties. In the event that subdivision approval cannot be obtained after exhausting all appellate remedies, this Agreement shall terminate. Either party may terminate the Agreement if the subdivision approval is not obtained within _____ [e.g., thirty (30)] months of the date of this Agreement.

4. Infrastructure:

(a) Once subdivision approval is obtained, Developer shall make arrangements for the installation of sewers, water mains, storm sewers and roadways for each phase of the development.

(b) Developer shall have authority, on behalf of the joint venture, to negotiate a loan from a commercial lender for up to _____ [e.g., eighty (80)] percent of the estimated cost of the infrastructure. The loan shall be structured so that funds may be drawn upon as needed. The interest rate shall not exceed the prime lending rate plus _____ [e.g., one (1)] percent per annum.

(c) Land Owner agrees to allow the lender to secure the infrastructure loan with a mortgage on the real property described in Schedule A.

(d) The loan shall provide for partial releases of the mortgage as lots are completed and ready to be sold. Releases may be conditioned upon payment of a specific principal sum per lot. The loan agreement must provide for releases of the roadways without consideration upon dedication of the same to the Town of _____.

(e) Developer shall contribute the balance of the cost of the infrastructure, up to the amount of _____ [e.g., Three Hundred Thousand Dollars (\$300,000)].

(f) All loan documents shall be executed in the name of the joint venture by Land Owner and Developer.

5. *House plans.* Developer shall secure a licensed architect to draw up plans for _____ [e.g., five (5) to seven (7)] model homes to be used in the development. Such plans shall be ready for preliminary review within _____ [e.g., thirty (30)] days after subdivision approval is obtained. The parties shall transmit required changes to the architect within _____ [e.g., ten (10)] days thereafter. Final plans shall be ready to display to home buyers within _____ [e.g., twenty (20)] days thereafter. All plans shall comply with the building code of the State or County of _____, and with any additional requirements of the Town of _____. If any plans or changes thereto cannot be agreed upon between the parties, the dispute resolution procedure of Paragraph No. 11 hereof shall be used.

6. Planned unit development:

(a) Developer shall be responsible for having covenants and restrictions drawn up and filed for the benefit of all lots to be contained in the development. The preliminary covenants and restrictions shall be available upon submission of the subdivision application. The final form of the covenants and restrictions shall be filed with the _____ County Clerk before any lots are marketed to the public.

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(b) At a minimum, the covenants and restrictions shall provide for the following:

- (1) minimum house size;
- (2) controls on exterior style of house and on further construction on houses or lots;
- (3) prohibition on the conduct of commercial activities within the development;
- (4) prohibition on the posting of signs on lots or houses (except "for sale" signs);
- (5) prohibition on the harboring of animals, except cats, dogs or domestic birds;
- (6) prohibition on the erection of exterior clothes' lines;
- (7) prohibition on the storage of vehicles, boats, or recreational vehicles;
- (8) prohibition on the erection of other structures on the premises; and
- (9) any other restrictions designed to protect property values.

(c) The covenants and restrictions shall not include any of the following:

- (1) restrictions on sale or ownership based on race, color, creed, national origin, age, gender or sexual orientation;
- (2) restrictions on a house's exterior color;
- (3) restrictions on fencing or swimming pool installation; and
- (4) restrictions on planting.

(d) Developer may call for the creation of a homeowners' association if Developer should so desire. Developer shall obtain any approvals which may be needed for such covenants, restrictions and/or homeowners' association.

7. Marketing:

(a) Developer shall locate and engage a marketing firm to market houses to be built in the development. The marketing agent shall enter into a contract which is terminable by the joint venture on _____ [e.g., thirty (30)] days' written notice without cause, or on _____ [e.g., forty-eight (48)] hours' written notice with cause. The marketing agent shall be an independent contractor and shall be paid no more than _____ [e.g., three (3)] percent of the purchase price of each house and lot as a commission.

(b) The marketing agent shall be given written instructions as to representations which may be made to purchasers. All purchasers shall be given a copy of the covenants, restrictions and homeowners' association documents at least _____ [e.g., five (5)] business days before a contract may be signed.

(c) The marketing agent may do advertising. The text of all advertisements shall be approved by Developer in writing prior to use. The joint venture will do advertising as well.

8. Representations of Land Owner:

(a) Land Owner owns the land described in Schedule A free and clear of any and all liens and encumbrances, except for certain power-line easements set forth in Schedule B, which is also annexed hereto and made a part hereof.

(b) Land Owner will allow agents and employees of the joint venture to enter upon the land for the purpose of making improvements thereon and to otherwise fulfill the purposes of the joint venture.

(c) Land Owner has engaged a reputable and skilled environmental engineer to perform a phase I environmental site assessment. The true and accurate results of the assessment have been provided to Developer. There have been no changes on the land since the date of the assessment, to the best of Land Owner's knowledge.

(d) Land Owner will give a deed to any lot included in Schedule A upon the request of the joint venture, provided that all terms and conditions of this Agreement have been met, and the agreement is still in full force and effect at that time.

(e) The value of the land which Land Owner is contributing to the joint venture has an appraisal value of _____ [e.g., Six Hundred Thousand Dollars (\$600,000)].

9. Representations of Developer:

(a) Developer is skilled in the creation of a housing development. Developer has already successfully completed _____ [e.g., eight (8)] housing developments, each consisting of _____ [e.g., two hundred (200) or more] houses.

(b) Developer will deposit the sum of _____ [e.g., One Hundred Fifty Thousand Dollars (\$150,000)] in the joint venture's checking account upon execution of this Agreement. Developer will deposit additional sums, as needed, to arrive at a maximum total of _____ [e.g., One Million, Two Hundred Thousand Dollars (\$1,200,000)].

10. General provisions:

(a) Neither party may bind the joint venture to any obligation without the consent of the other party. Both parties shall sign all contracts, notes, mortgages, checks and other obligations of the joint venture. Neither party shall make any representation to the contrary to any third party.

(b) Developer shall be the manager of the project. Developer shall have the right to hire and fire staff, and purchase inventory and supplies in the ordinary course of business. Developer shall conduct all negotiations with any third party. Land Owner shall not interfere in any way. Developer shall run the day-to-day operations and supervise construction.

(c) The parties shall have the ability to review the accounting books and records of the joint venture and make copies thereof for personal use at any time. Either party may audit the financial records at any time at his/her own expense. If a discrepancy appears in excess of _____ [e.g., Five Hundred Dollars (\$500)], then Developer shall pay the cost of the audit.

(d) Developer shall arrange for the financing of the construction. The interest rate shall not exceed the prime lending rate, plus _____ [e.g., one (1)] percent per annum. All financing shall be non-recourse, unless Land Owner agrees to recourse financing.

(e) The profits of the joint venture shall be divided between the parties in the following manner: _____

[e.g., one-third (1/3) to Land Owner, two-thirds (2/3) to Developer]. Profits shall be defined as the net proceeds from the sale of any lot, after deduction of all construction and other costs attributable to that lot, and payment of any lot release fees.

11. *Dispute resolution.* Any disputes between the parties may be fatal to the project. In the event that a dispute arises which cannot be settled within _____ [e.g., forty-eight (48)] hours, the parties agree to submit the dispute to a mediator within _____ [e.g., two (2)] business days thereafter to resolve the dispute. The mediator shall be _____ [insert the name of the person or dispute resolution firm that will mediate the dispute]. The mediator may attribute mediation costs to either or both parties, or to the joint venture. The parties agree to be bound by the results of the mediation.

12. *Death or disability:*

(a) In the event of the death of Land Owner, Developer and the executor of Land Owner's estate shall continue to adhere to the terms of this Agreement. Land Owner agrees to create a will with provisions which bind his/her executor to the terms of this Agreement.

(b) In the event of Developer's death, Land Owner may withdraw from the joint venture or secure a new joint venturer to replace Developer. Payment to Developer's estate shall be as set forth in Paragraph No. 14 ("Termination").

(c) In the event of the disability of Land Owner, Developer shall continue to pursue the goals of the joint venture pursuant to the terms of this Agreement.

(d) In the event of the disability of Developer, Land Owner shall have the same rights as set forth in Subparagraph (b) above. The term "disability" shall mean the inability of the Developer or Land Owner, due to physical or mental incapacity, to fulfill his/her obligations under this Agreement.

13. *Bankruptcy.* In the event that either party files a petition in bankruptcy, this Agreement would be considered executory by the court. In the event that the debtor-party chose to reject the contract, he/she would be bound by the termination provisions contained in Paragraph No. 14 hereof.

14. *Termination:*

(a) This Agreement may not be terminated by either party except for cause. The term "cause" shall be limited to the following:

- (1) defalcation or fraud committed by one party against the other;
- (2) failure of one party to fulfill a material obligation under the terms of this Agreement;
- (3) failure to obtain approval for the subdivision from the Town of _____ ;
- (4) death or disability of Developer; and
- (5) sale of the project.

(b) The party seeking to terminate the Agreement shall give the other party written notice of intention to terminate this

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Agreement. The written notice shall specify the basis for the termination and the date on which the termination shall become effective. Such date shall be at least _____ [e.g., ten (10)] days after delivery of the notice. If the other party agrees to the termination, he/she shall so state in a writing delivered to the party seeking to terminate. If the other party does not agree to terminate, the matter shall be submitted to dispute resolution under Paragraph No. 11 hereof.

(c) Upon termination in the pre-development phase (*i.e.*, before any of the land has been disturbed), Land Owner shall receive his/her land back free and clear of the terms of this Agreement. After payment of all outstanding obligations of the joint venture, Developer shall receive a refund of any funds remaining which he/she contributed. If any obligations of the joint venture remain unpaid, they shall be the sole responsibility of Developer.

(d) Upon termination of the Agreement during the development phase (*i.e.*, after the land has been disturbed, but prior to construction of any house), Developer shall have the right to buy Land Owner's land for the sum of _____ [e.g., Six Hundred Thousand Dollars (\$600,000), plus interest at four percent (4%) per annum from the date of this Agreement]. Land Owner shall hold paper for the purchase price for a period of up to _____ [e.g., three (3)] years, secured by a first or second mortgage on the property with an interest rate equal to the prime lending rate, plus _____ [e.g., one (1)] percent per annum.

In the event Developer chooses not to purchase the land, Developer shall take whatever steps are needed to release any liens from the land. Land Owner shall receive his/her land back free and clear of all liens and any obligations under this Agreement. Developer shall not be entitled to any credit for improvements on the land. After payment of all obligations of the joint venture, Developer shall receive a refund of any funds remaining which he/she contributed. If any obligations of the joint venture remain unpaid, they shall be the sole responsibility of Developer.

(e) Upon termination of the Agreement in the late development stage (*i.e.*, after commencement of construction of any house), rights upon termination shall be the same as in Subparagraph (d) above, except that Developer shall be obligated to complete any structure then under construction. In the event Developer purchases the land, Developer shall receive a credit against the purchase price for any profit distributions previously made to Land Owner. In the event Developer does not purchase the land, Developer shall be entitled to a lien against the land of Land Owner equal to the value of any improvements made by Developer.

(f) Upon the sale of the entire project, payments shall be made in the following order: Land Owner shall receive _____ [e.g., \$600,000, plus interest paid at the rate of four percent (4%) per annum from the date hereof]. All debts of the joint venture shall be paid in full by Developer. Developer shall receive payment of all sums contributed by him/her. Any balance remaining shall be divided _____ [e.g., one-third (1/3) to Land Owner and two-thirds (2/3) to Developer]. If a shortfall exists, Developer shall be solely responsible for any debts of the joint venture.

15. *Taxes.* Upon execution of this Agreement, all taxes which are levied against the lands described in Schedule A shall be paid by the joint venture until said lands are sold to a third party.

16. *Insurance.* The joint venture shall, at its expense, maintain liability insurance on the lands described in Schedule A. When construction begins, builder's all-risk insurance shall be obtained. Developer shall determine appropriate policy limits. The joint venture and the parties shall be named insureds on all policies of insurance.

17. *Tax returns.* Developer shall cause income tax returns to be prepared and filed for the joint venture in each year of its existence.

18. *Miscellaneous:*

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(a) *Entire agreement.* This Agreement, together with the other written agreements and instruments executed concurrently herewith or pursuant to the provisions hereof, contains the entire agreement between the parties respecting the matters herein set forth and supersedes all prior agreements between them respecting such matters.

(b) *Counterparts.* This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument. At the trial of any matter arising under this Agreement, only one counterpart need be produced.

(c) *Headings.* Paragraph and subparagraph headings are for purposes of convenience and identification only and shall not be used to interpret or construe this Agreement.

(d) *Notice.* Any notice to be given hereunder shall be in writing, signed by the party giving notice, and delivered by any one of the following methods:

- (1) personal delivery;
- (2) facsimile machine transmission;
- (3) certified or registered mail, return receipt requested; or
- (4) overnight courier service, provided that a receipt is maintained in the ordinary course of business.

Notices shall be given at the following addresses:

If to Land Owner:

Attn: _____

If to Developer:

Attn: _____

Either party may designate a new address by giving notice thereof to the other party.

(e) *Governing law.* This Agreement shall be construed and enforced in accordance with the laws of the State of _____.

(f) *Binding effect.* This Agreement shall be binding upon and inure to the benefit of the parties, their respective heirs, representatives, successors and assigns.

(g) *Amendments.* Any amendment of this Agreement must be made in writing and signed by both parties. Any attempted oral modification will not be valid.

(h) *Waiver.* Any failure by either party to enforce any right arising under this Agreement shall not be deemed a waiver of the ability to later enforce that right. Any waiver must be in writing and signed by the person waiving the right in order to be enforceable.

IN WITNESS WHEREOF, the parties hereto have set their hands the day and year first above written.

Land Owner

Developer

[*Acknowledgements*]

E.6 Joint venture for land development--finances by one party- development assumed by other party-profit and income distribution provisions

COMMENT

In this form a construction corporation and an investing corporation combine in a joint venture to purchase acreage for development. The areas of responsibility assigned to each venturer follow a pattern in which one venturer is to provide the necessary funds, while the other is to arrange for the construction of the improvements.

Funds and financing:

Since funds will be required to purchase the land to be developed, a significant contribution to initial capital is to be made by the investing venturer. Additional funds are first to be obtained through nonrecourse loans secured by the property, upon which neither coventurer will be individually liable. Any additional financing is to be arranged by the investing venturer, either by direct interestbearing loans to the venture or by guaranteeing outside loans for which it will receive a guarantor's premium. The investing venturer is to handle all other financial matters, including bookkeeping, purchasing, insurance, and banking.

Development and construction:

Responsibilities of the developing venturer include the formulation of a master development plan, the securing of governmental permits, the demolition of existing buildings, the installation of utilities, the construction and completion of improvements, and the lease or sale of the improved property.

For further information, see Chapter 11.

FORM

AGREEMENT made by Atlas United Corporation, an Illinois corporation having its principal office in the Lakeside Building, Chicago, Illinois ("Atlas"), and Wayne Construction Corp., a Delaware corporation having an office at 300 Fifth Avenue, New York, New York ("Wayne").

Atlas and Wayne hereby enter into a joint venture upon the following terms and conditions:

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1. *Name.* The name of the joint venture is Riverside City.

2. *Capital.* The capital of the joint venture, to be contributed by Atlas, shall consist of \$2,000,000 which shall be paid in as required. It is intended that funds required for the purposes of the joint venture, in addition to those for which commitments have been entered into prior to the closing, shall, to the extent reasonably possible, be supplied by loans from institutional lenders without personal liability on either Atlas or Wayne and from retained earnings. To the extent that such funds are not reasonably available from those sources, Atlas shall either lend such funds to the joint venture at _____ percent interest and upon terms which are mutually satisfactory to Atlas and Wayne, or shall guarantee loans by third parties to the joint venture and be entitled to guarantor's premium of the excess, if any, of _____ percent over the interest rate on such loans. No loans to the joint venture, whether by Atlas or others, shall impose any personal liability on either Atlas or Wayne unless expressly assumed.

3. *Purposes.* The purposes of the joint venture are:

(a) To purchase or otherwise acquire the property consisting of approximately 300 acres located in Los Angeles, California, which is presently owned by Riverside Corporation of California ("Riverside Property").

(b) To develop and improve the Riverside Property.

(c) To operate, maintain, lease, sell, or otherwise dispose of the Riverside Property, in whole or in part, and the improvements made thereon.

(d) To carry on any other activities necessary or incidental to the foregoing purposes, including the establishment of offices and the employment of personnel.

The joint venture shall not engage in any other business or activity without the written consent of Atlas and Wayne.

4. *Responsibilities of Wayne.* Wayne shall be responsible for:

(a) The preparation of a master plan for the development of and improvements to the Riverside Property, including the selection, subject to Atlas' prior written approval, of architects and engineers for this purpose.

(b) The preparation for development of the Riverside Property including (1) the securing of all necessary governmental permits, (2) the demolition of any buildings presently on the Riverside Property, and (3) the construction of roads and installation of utilities.

(c) The design, preparation of plans and specifications, construction, and completion of developments and improvements to those portions of the Riverside Property which Atlas and Wayne mutually agree to develop and improve.

(d) The operation, maintenance, leasing, sale, or other disposition of the Riverside Property, in whole or in part, and the improvements made thereon.

(e) The preparation of an environmental site assessment and the supervision of the remediation of any adverse environmental condition which may be found, including, but not limited to: removal of underground storage tanks, removal of contaminated soils, and removal of hazardous substances and materials, as is needed to comply with applicable federal, state and local laws and regulations.

5. *Responsibilities of Atlas.* Atlas shall be responsible for:

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(a) All financial matters involved in carrying on the business of the joint venture, including the negotiation of loans, maintenance of bank accounts, and payment of all obligations and expenses of the joint venture.

(b) Keeping all books and records and doing all accounting work in accordance with paragraphs 9, 11, 12, and 13 of this agreement.

(c) All purchasing by the joint venture.

(d) The insurance of the joint venture and its properties. The Riverside Property and its improvements and all other tangible property of the joint venture shall be insured against fire, wind-storm, and other risks protected by extended coverage of the kind usually carried for comparable properties in the general vicinity of the Riverside Property. The joint venture shall be insured against liability arising from its operations and activities, to the extent and of the kinds of insurance coverage normally carried for similar operations. All insurance shall be placed with responsible insurance companies and in the amounts determined by Atlas and Wayne.

6. *Management representatives.* For convenience of operation, Atlas and Wayne shall each designate management representatives to carry out the decisions of their principals and to serve as the channels of communication for disseminating information to and securing necessary action by their principals.

7. *Reimbursements.* The joint venture shall reimburse Wayne and Atlas for all costs and expenses incurred by each in performing its duties pursuant to paragraphs 4 and 5, including all allocation of compensation of employees performing substantial services for the joint venture, but not including any part of the compensation of management personnel (including management representatives) of either Wayne or Atlas. The reimbursement of costs and expenses incurred by Wayne and Atlas prior to closing on the Riverside Property shall include interest at _____ percent per annum.

8. *Limitations.* The performance by Wayne and Atlas of their responsibilities under paragraphs 4 and 5 shall be subject to the following limitations:

(a) The plans and specifications referred to in paragraph 4 for the development of and improvements to the Riverside Property, in whole or in part, shall be approved in writing by Atlas before any commitment is made by the joint venture with respect to them.

(b) No part of the Riverside Property and its improvements and no other property or assets of the joint venture may be leased, sold, or otherwise disposed of without the prior written consent of both Atlas and Wayne.

(c) No steps shall be taken by Wayne which may result in a substantial change in the operation or policies of the joint venture without the prior written consent of Atlas.

(d) The office manager or other person in charge of the activities of the joint venture shall be selected by Wayne, but if he or any successor is not satisfactory to Atlas, he shall, at Atlas' written request, be replaced by Wayne.

(e) Wayne shall only receive renting and management agent fees with respect to the Riverside Property or parts thereof as shall be agreed to in writing by Atlas and Wayne.

(f) No financing shall be committed by Atlas without the prior written consent of Wayne as to the terms of the financing commitment.

(g) No purchase commitment exceeding \$10,000 shall be made by Atlas without the prior written consent of Wayne.

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(h) The joint venture shall not mortgage, pledge, create a security interest in, encumber, or otherwise subject to any lien any property or assets owned or used by the joint venture or confess any judgment against the joint venture without the prior written consent of Atlas and Wayne.

(i) No legal action shall be commenced to enforce the rights of the joint venture without the prior written approval of Atlas and Wayne.

9. *Books and records.* There shall be kept for the joint venture accounts and complete books and records, on the accrual basis, in accordance with generally accepted accounting principles (which shall not be changed without mutual consent), showing all costs, expenditures, sales, receipts, assets, and liabilities, and profits and losses, and all other records necessary, convenient or incidental to recording the joint venture's business and affairs and sufficient to record the division of profits or losses as provided for in paragraphs 14 and 15.

10. *Fiscal year.* The fiscal year of the joint venture shall be the calendar year.

11. *Reports.* Promptly after the end of each month, there shall be prepared and delivered to each party a statement showing the results of operations during such month and for the year to date and a balance sheet. Promptly after the end of each fiscal year, there shall be prepared a balance sheet showing the assets and liabilities of the joint venture at the close of the year and a statement of income showing the results of operations for the year. The joint venture shall have an audit of its books made immediately after the close of each year by a nationally recognized firm of public accountants mutually agreed to from year to year. On or before February 1 following the close of each year, the joint venture shall furnish each party copies of the annual balance sheet and statement of income, together with the certificate of the public accountants covering the results of the annual audit.

12. *Bank accounts.* All moneys of the joint venture shall be deposited in the joint venture's account in banks selected by Atlas. Withdrawals from bank accounts shall be made by signatures only of such person or persons as shall be authorized by Atlas.

13. *Accounting decisions.* All decisions as to accounting principles, whether for book or tax purposes (and such decisions may be different for each such purpose), shall be made by Atlas, including all elections to be made by or for the joint venture under the provisions of the Internal Revenue Code or under any superseding Revenue Code or federal income tax legislation.

14. *Division of profits and losses.* (a) As used in this paragraph, the following definitions shall apply:

(1) "Capital" is defined as the amounts contributed as capital by Atlas under paragraph 2.

(2) "_____ percent annual return" is defined as _____ percent of the daily average of the capital remaining in the joint venture during the year.

(3) "Cumulative _____ percent annual return" is defined as the sum from the beginning of the joint venture of all of the _____ percent annual returns.

(4) "Cumulative tax profit" or "cumulative tax loss" is defined as the sum from the beginning of the joint venture of all of its annual tax profits and annual tax losses as reported in its annual United States income tax returns, adjusted to reflect any changes resulting from Internal Revenue Service audits which the parties have mutually accepted or with respect to which a final determination has been made.

(b) The current year's tax profit shall be shared as follows:

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(1) Up to the amount of any cumulative tax loss at the beginning of the year previously shared two-thirds by Atlas and one-third by Wayne, the current year's tax profit shall be shared two-thirds by Atlas and one-third by Wayne.

(2) Up to the amount of any remaining cumulative tax loss at the beginning of the year previously allocated entirely to Atlas and any unearned cumulative _____ percent annual return at the end of the year, the current year's tax profit shall be allocated to Atlas.

(3) Any balance shall be shared two-thirds by Atlas and one-third by Wayne.

(c) The current year's tax loss shall be shared as follows:

(1) Up to the amount of any cumulative tax profit at the beginning of the year previously shared two-thirds by Atlas and one-third by Wayne, the current year's tax loss shall be shared two-thirds by Atlas and one-third by Wayne.

(2) Up to the amount of any remaining cumulative tax profit at the beginning of the year previously allocated entirely to Atlas and all capital and loans to the joint venture on which Atlas is the lender, co-maker, or guarantor, remaining in the joint venture at the end of the year, the current year's tax loss shall be allocated to Atlas.

(3) Any balance shall be shared two-thirds by Atlas and one-third by Wayne.

15. *Distributions.* As mutually determined by Atlas and Wayne, any excess assets of the joint venture not needed to carry out the purposes of the joint venture (whether in the form of cash, securities, or other property, and whether arising from operations, loans on the security of assets of the venture, or proceeds from sales or other dispositions) shall first be used to repay the obligations of the joint venture on which Atlas or the joint venture is personally liable as Atlas shall determine. As mutually determined by Atlas and Wayne, any excess assets of the joint venture not needed to carry out the purposes of the joint venture and which are not used to repay obligations of the joint venture pursuant to the preceding sentence shall be distributed in the following priority:

(a) To the extent of the previously undistributed cumulative _____ percent annual return, all to Atlas.

(b) To the extent of previously undistributed capital, all to Atlas.

(c) Any remaining assets shall be distributed two-thirds to Atlas and one-third to Wayne.

Except as required in subparagraph (b) of paragraph 19, neither Atlas nor Wayne shall be required to return to the joint venture any amounts distributed pursuant to this paragraph 15.

16. *Events of termination.* The joint venture shall terminate upon the first to occur of the following events:

(a) Upon the expiration of 30 years from the date of this agreement.

(b) Upon notice by either party if the other party shall fail to perform its obligations hereunder and such failure shall continue for a period of at least three months after written notice from the party claiming the default. The party desiring to terminate under this provision shall, after the expiration of the three-month period, give one month's written notice of its intention to terminate.

(c) Upon three months' written notice by either party that such party elects to terminate the joint venture because of the failure of the parties to agree upon any proposed action or nonaction by the joint venture resulting in the inability to carry on the business of the joint venture under normal standards of commercial reasonableness, provided that at the end of the three-month period the parties still fail to agree.

(d) Upon the sale of all of the Riverside Property and its improvements.

(e) At the option of the other party, upon the purported assignment of rights or delegation of obligations under this agreement or upon the voluntary liquidation or dissolution of either party.

(f) At the option of either party within a reasonable time after notice that the other party shall have had filed against it pursuant to a statute of the United States or of any state, a petition in bankruptcy or insolvency or for reorganization or for the appointment of a receiver, custodian, or trustee of all or a portion of such other party's property and within 30 days thereof such other party fails to secure a discharge thereof or that such other party shall make an assignment for benefit of creditors or petition for or voluntarily enter into an arrangement, or be unable to meet its obligations as they become due.

(g) By mutual agreement of the parties.

17. *Distributions on termination.* Upon termination of the joint venture, a final audit shall be made by a mutually agreeable nationally recognized firm of public accountants and all of the property and assets of the joint venture shall be distributed as follows:

(a) All of the property and assets, if any, other than cash, shall be sold or collected and turned into cash or purchase money obligations within a period of three years from the date of such termination. Both Atlas and Wayne shall have the right to bid on and purchase any or all of the property and assets being sold.

(b) All of the debts and obligations of the joint venture on which the joint venture is separately and personally liable or on which Atlas is separately and personally liable shall be paid in full.

(c) The remaining cash and other property, if any, shall be distributed to the parties as provided in paragraph 15.

18. *Title.* Legal title to the Riverside Property shall be held by Atlas as nominee of and for the benefit of the joint venture or by such other nominee or nominees as Atlas and Wayne shall hereafter mutually designate. Atlas or the other nominee or nominees shall execute all deeds, leases, and other documents and instruments relating to the Riverside Property or any part thereof as required by the joint venture, and shall not lease, sell, mortgage, pledge, create a security interest in, encumber, lien, or otherwise dispose of the same without the prior written consent of both Atlas and Wayne.

19. *Liability.* (a) The liability of the joint venture or of Atlas or Wayne as joint venturers arising out of any of the activities of the joint venture shall be covered by appropriate policies of insurance to be purchased by the joint venture as provided in subparagraph (d) of paragraph 5.

(b) In the event that any liability shall not be adequately covered by insurance, the uninsured liability shall first be satisfied out of the assets of the joint venture. If the assets of the joint venture are not sufficient to fully satisfy the uninsured liability, Atlas and Wayne shall return to the joint venture in the ratio of two-thirds by Atlas and one-third by Wayne prior distributions made pursuant to subparagraph 15 (c) to the extent needed to satisfy such liability. Atlas shall, in accordance with paragraph 2 and subparagraph 8(f), be responsible for obtaining for or furnishing to the joint venture any additional funds necessary to satisfy the balance of the uninsured liability.

(c) Atlas and Wayne shall each be indemnified by the other and held harmless against and from all claims, demands, actions, and rights of action which shall or may arise by virtue of anything done or omitted to be done by the other (through or by agents, employees, or other representatives) outside the scope of, or in breach of the terms of this agreement provided the other shall be promptly notified of the existence of the claim, demand, action, or right of action and shall be given reasonable opportunity to participate in the defense thereof.

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(d) Nothing contained in this agreement shall be construed to constitute either party the general partner of the other party or the agent of the other party other than in connection with the activities included within the scope of the joint venture nor in any manner to limit the parties in the carrying on of their other respective businesses or activities.

(e) If on partial or complete termination of the joint venture or at a time of any distribution to the parties there are insufficient assets to repay any part or all of the capital contributions or the cumulative _____ percent annual return which is then unpaid, Wayne shall not be liable to Atlas for any deficiency in any such unpaid amounts nor shall Wayne be required to make any capital contributions to the joint venture or payments to the other party in order to cover such deficiencies, it being expressly understood that Atlas' capital contribution is made at its sole risk.

20. *Inspection.* Each party or its authorized representatives may examine any of the books and records of the joint venture or the Riverside Property or its improvements at any time and without notice.

21. *Integration.* This agreement is the entire agreement between the parties with respect to its subject matter hereof and supersedes all prior agreements between the parties with respect thereto. No alteration, modification, or interpretation hereof shall be binding unless in writing and signed by both parties.

22. *Interpretation.* This agreement shall be interpreted and construed in accordance with the laws of the State of Illinois. The titles of the paragraphs have been inserted as a matter of convenience of reference only and shall not control or affect the meaning or construction of any of the terms and provisions hereof.

23. *Assignment.* Neither Atlas nor Wayne may assign or pledge any of its right, title, or interest in this joint venture.

24. *Notices.* All notices required or permitted by this agreement shall be in writing and shall be sent by registered or certified mail addressed, in the case of Atlas, to: Atlas United Corporation Room 2001 Lakeside Building Chicago, Illinois

and, in the case of Wayne, to: Wayne Construction Corp. 300 Fifth Avenue, New York, New York

or to such other address or to the attention of such other person as shall be supplied in like manner.

In witness whereof the parties have caused this joint venture agreement to be executed in duplicate this 29th day of March, 2002.

Attest:

Secretary

(Seal)

Attest:

Secretary

(Seal)

Atlas United Corporation

by _____

Vice President

Wayne Construction Corp

by _____

President

E.7 Contract to prepare and implement master plan for subdivision of property

COMMENT

The forms in this group are for planning and completing a development program. In the form illustrated here, the owner of a large tract of undeveloped land hires an engineering company to prepare a master

plan for the property and supervise all the details for carrying out the plan. The engineering company is in effect taking over all the responsibilities of the developer. In addition to preparing the master plan, the company is to arrange for and supervise the necessary engineering, negotiate with utility companies, direct and manage the required construction, plan and promote sales and leases, and perform general management and administrative services. The owner has therefore turned over to the engineering company full control of the development program even to the sale and lease of the finished land sites.

Tax accounting:

Compensation for the services to be rendered by the engineering company generally falls into two classes. For its general services the company receives a fixed monthly payment. For its engineering services it is reimbursed for specified categories of costs plus a fixed percentage of certain of these costs as its fee. The fixed monthly payment is reportable by the engineering company when received or accrued depending upon its accounting method. If the company is on the accrual basis, its fee for performing the engineering services should be accrued as the costs for those services are incurred.

Cost allocation of future expenses:

Improvement costs are allocated to individual land sites for the purpose of determining gain or loss on each separate sale or other disposition. But in the sale of the first lots there may be also included in their tax basis an allocation of the estimated costs of future development which may benefit those lots. In order to sustain the allocation of an estimate of such future expenses on the basis of lots first sold, the owner must submit information supporting the following: (a) the cost of the entire tract on which the lots are located, and the suitable allocation of such costs to each lot; (b) a description of the proposed improvements, with evidence that the owner is contractually obligated to make such improvements; (c) an explanation of the method of estimating the costs of the future improvements; (d) an allocation of the estimated costs to each lot, accompanied by a plat map; and (e) if estimates have been allocated to lots sold in prior years, complete information as to the allocation, including actual expenditures for the improvements and their proper allocation. Estimates may be corrected in the light of actual experience.

For further information, see Chapter 11.

FORM

AGREEMENT dated and entered into on March 25, 2002, between Land East Corporation, a California corporation, (the "Owner"), and Hodges & Harrison Company, Inc., a New York corporation (the "Company").

The Owner and the Company agree as follows:

1. *Managerial services* The Company will, subject to the general direction and control of the Owner, perform for the Owner the following services:
 - (a) Prepare a master plan for the entire property of the Owner (in coordination with an environmental impact study) which will set forth the proper relationship of residential areas, golf courses, beach and recreational facilities, apartment houses, hotels, shopping centers, industrial parks, highways and road networks, and sewer, water, and power systems.
 - (b) Arrange for and supervise the engineering necessary to execute the master plan including detailed design of utilities, streets, subdivisions, and prepared building sites.

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- (c) Negotiate with each of the various utility companies to obtain installation of power, rail, gas, and telephone facilities required to implement the master plan on the most favorable terms and conditions, and coordinate the scheduling and installation of such facilities.
- (d) Arrange for and supervise the construction necessary to execute the master plan, and prepare budgets for various stages of development and specific projects.
- (e) Coordinate with the various municipal, county, and state agencies in design of services required to implement the master plan including schools, fire stations, locations of roads, access to existing roads, and major drainage systems.
- (f) Plan, coordinate, and supervise all sales, promotion, and advertising to facilitate at the earliest date possible the sale or lease of bulk land sites, individual land sites, and all finish uses which might be deemed to be the highest and best use of the land involved. sites, individual land sites, and all finish uses which might be deemed to be the highest and best use of the land involved.
- (g) Negotiate sales and leases, and work with tenants and prospective purchasers.
- (h) Negotiate for temporary and permanent financing of land development and building construction.
- (i) Arrange for and supervise on a coordinated program all necessary insurance.
- (j) Perform general management and administrative services for the Owner including, but not limited to, the following:
 - (1) Manage all property;
 - (2) Propose projects for sale or investment and make complete financial analysis and recommendations on each project to the Owner;
 - (3) Investigate and make financial analysis and recommendations on all proposals submitted to the Owner by other parties;
 - (4) Keep accounting books and records;
 - (5) Offer tax advice, consult with tax attorneys and advisers, and prepare tax returns;
 - (6) Review all legal documents, including land purchase and sale agreements, leases, construction loan agreements, notes, mortgages, and deeds;
 - (7) Represent the Owner at public functions as required, and recommend policies to be followed on public matters affecting the Owner;
 - (8) Work with municipal, county, and state officials and with municipal bodies, such as planning boards, water boards, board of appeals, and board of assessors;
 - (9) Seek short-term loans as needed, and offer financial advice;
 - (10) Handle advertising and public relations for the Owner, including preparation of press releases, opening ceremonies, releases of special sales and large sales, and the handling of magazine articles, trade publication articles, and anything else deemed to be in the best interests of the Owner.

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2. *Compensation for managerial services.* The Owner shall pay the Company for the services in paragraph 1 the sum of \$30,000 a month, payable in advance, the first payment to be due June 1, 2002, and each payment to be made on the 1st day of each and every calendar month thereafter to and including May 1, 2003. In addition the Company shall be entitled to a monthly reimbursement for costs and expenses incurred in rendering the services. Without limiting the generality of the foregoing, the Company shall be reimbursed for the following:

(a) All direct costs of any branch office that may be opened and operated by the Company in relation to the performance of the terms and conditions of this agreement, including but not limited to payroll, office overhead, advertising and promotion, legal fees, consulting fees, and transportation.

(b) Out-of-pocket expenses of Company personnel, including but not limited to travel, lodging, and communication expenses.

(c) The costs and expenses shall not include salaries of officers or employees of the Company, or general overhead expenses of the Company.

3. *Engineering services.* The Company shall have its Engineering Division perform engineering services required by the Owner, including site engineering and planning for the land owned by the Owner, preparation of necessary site development plans and specifications, environmental impact studies and statements, and such other engineering services as directed by the Owner, all to be in accordance with state Codes and Ordinances. Any such work may be cancelled at any stage by the Owner.

4. *Compensation for engineering services.* In consideration of the performance of the engineering services in paragraph 3, the Owner shall make monthly payments to the Company as follows:

(a) All direct costs of the work, including wages, supplies, blueprints, payroll taxes, and insurance. Direct costs, however, shall not include items such as rent, lights, clerical services, salaries of officers of the Engineering Division or of the Company, or other expenses of a similar nature.

(b) 70 percent of direct wages for overhead expenses. The premium portion of salaries and wages for overtime work shall be a reimbursable expenditure but shall not be included as a part of direct wages for the computation of overhead expenses.

(c) 20 percent of the total of the above two items as its fee for performing the work.

(d) Costs of any outside engineering services. The Engineering Division shall submit to the Owner for approval any contracts for outside engineering services amounting to more than \$60,000.

(e) Travel expenses.

(f) Living expenses incurred by personnel of the Engineering Division while away from their homes in connection with the rendering of the services required under paragraph 3 of this agreement.

5. *Term.* Services under this agreement shall commence June 1, 2002, and terminate June 1, 2003.

6. *Monthly statements.* The Owner may request and receive from the Company on request a detailed report of all or any item or items contained in any other usual monthly statement covering costs and expenses. Each monthly statement shall be subject to the approval of the Owner, such approval not to be unreasonably withheld.

7. *Assignment.* The Company may assign or transfer this agreement or any part to any other person, firm, trust,

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association, or corporation, hereinafter called the Assignee, provided only:

(a) That the Company receives the Owner's prior written consent to such assignment; and

(b) That the principal owners of the Company have at the date of the assignment and at all times during the term of this agreement (1) full and complete management and controls of the Assignee; and (2) are the owners of a majority interest in the Assignee.

8. *Personal liability.* No director, shareholder, officer, or agent of the parties shall be held to any personal liability under this agreement, but only the property of each party shall be liable hereunder or by reason hereof.

9. *Licenses and registration.* The Company shall procure, and thereafter during the term of this agreement maintain in effect, all necessary licenses and registrations for the performance of the activities to be engaged in under this agreement, or the Company shall have duly associated with it personnel duly licensed to perform the activities on behalf of the Company. Notwithstanding any other provision, this agreement shall not be deemed to have taken effect with respect to any activities which would be unlawful without proper licensing or registrations until the same have been procured, or the personnel having and maintaining the licenses to engage in the activities on behalf of the Company are associated with the Company.

Executed in duplicate as of the date first above written.

Attest:	Land East Corporation
_____	by _____
Secretary	President
Attest:	Hodges & Harrison
_____	Company, Inc.
Secretary	by _____
	President

E.8 Contract to plat and subdivide land and construct homes and other buildings--separate categories for contractor's cost plus percentage compensation--owner to pay construction costs

COMMENT

In this form, the owner of a large tract of undeveloped land employs a contracting corporation to supervise the platting and subdivision of the land and to construct homes and other buildings in accordance with plans and specifications furnished by the owner. There is a careful definition of the areas of activity for each of the parties. Essentially, the owner has reserved control over the planning and financing of the venture while passing on to the contractor the responsibility for substantially all of the construction work.

Since the development program involves the sale of building lots, the construction and sale of residences, and the construction of other buildings, the compensation of the contractor takes these various factors into account. Compensation to the contractor is to consist of the following: a percentage of the sales price of each building lot; a percentage of the cost of each residence, but not in excess of one-half the profit resulting from the sale of the residence; a percentage of the cost of each building (other than a residence) constructed by the contractor; and all of the overhead incurred by the contractor. The agreement carefully defines the terms "cost," "profit resulting from the sale of a residence," and "overhead," and the times and manner in which compensation payments are to be made to the contractor. In addition, the owner is obligated to pay all construction costs incurred under the contract, whether incurred in the name of the

owner or the contractor. Rights to inspect books of account are allowed to each party to permit verification of financial matters.

For further information, see Chapter 11.

FORM

AGREEMENT made December 15, 2002, in Miami, Florida, by and between General Realities Corporation, a Florida corporation ("General"), and Central Construction Corporation, a Delaware corporation authorized to do business in Florida ("Central").

The parties agree as follows:

1. *Definitions.* For the purposes of this agreement, the following terms have the following meanings:

- (a) "Lots" or "tracts" or "plots" mean property owned and hereafter acquired by General which are contained in a proposed unrecorded plat or a recorded plat of land.
- (b) "Land" or "property" means property owned and hereafter acquired by General which is not contained in a proposed unrecorded plat or a recorded plat.
- (c) "Residence" means a single-family residence.
- (d) "Building" means any structure other than a residence.

2. *Employment.* General employs Central to perform the work covered by this agreement and Central accepts such employment.

3. *Contractor's obligations.* Central shall perform the following work:

- (a) Supervise the platting and subdividing of the land General designates, from time to time, into lots, tracts, or plots; supervise the preparation of plats of the land and cause the plats to be recorded; and supervise the improvement of and development of land designated by General from time to time;
- (b) Construct residences and buildings on the land or the lots, tracts, or plots General designates, from time to time, in accordance with plans and specifications furnished by General, which plans and specifications shall comply with all building code provisions covering the construction of the residences and buildings covered by the plans and specifications. The construction of residences and buildings shall be at actual cost though subject to the payment by General to Central of the compensation and other moneys provided in paragraph 6, and its accompanying subparagraphs; and
- (c) Any and all other work necessary or incidental to accomplish any of the foregoing.

4. *Owner's obligations.* In connection with the work referred to in paragraph 3, General shall:

- (a) Construct and install the roads and other improvements on and across the land to enable Central to do and perform the work provided for under this agreement;
- (b) Execute all plats, procure all bonds, and pay all bond premiums, and make all disbursements which may be

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necessary or requisite to the preparation and recording of plats of the land;

(c) File all applications and pay all fees and expenses necessary to procure the approval of lots for financing under Federal Housing Administration or conventional mortgages;

(d) Furnish all financing and supply all funds for the construction of residences and buildings; in order to assure Central that all construction costs will be paid promptly;

(e) Do all things, award all contracts with subcontractors and materialmen, and place all orders, all of which shall be done in the name of General, to enable Central to perform the work provided in paragraph 3;

(f) Pay all bills for work, labor, services, and materials furnished for the doing of the work, and to pay the same within 30 days after Central has made demand that payment be made;

(g) Make the advances necessary for the purchase of materials, supplies, machinery, and equipment for the work;

(h) Indemnify and hold Central harmless from liability for the payment of any or all of the foregoing; and

(i) Pay Central its compensation and overhead hereinafter provided for.

5. *Time of performance.* In each instance, the work to be performed, under this agreement, shall be commenced as quickly as possible after General has notified Central of the particular work to be done. The work, when commenced, shall be carried through expeditiously and continuously to completion as rapidly as the proper doing of the work and the availability of crews of labor and materials permit. In no event shall Central ever be deemed liable to General for any delay in the completion of any work caused by act of God, or the public enemy, or by casualty, or by strike, or by governmental restriction upon the availability or use of labor or materials, or by reason of any other fact which shall not have been caused by the act or default of Central or any employee or agent of Central.

6. *Compensation to contractor.* General shall pay Central for the work performed under this agreement the following sums:

(a) A sum equivalent to 2 2/3 percent of the sales price of each lot, tract, or plot sold or contracted to be sold by General between and including January 1, 2003, and December 31, 2007, and payment shall be made in the following manner, and at the following times:

(1) If any lots, tracts, or plots are sold under sales contracts or agreements for deed, the compensation to be paid Central shall be paid in equal installments concurrently with the first 36 payments made by the purchasers under the sales contracts or agreements for deed; but if any of the sales contracts or agreements for deed are payable over a period of less than 36 months, then the compensation to be paid Central shall be paid in equal installments out of the payments received by General during the term of such sales contracts or agreements for deed; but

(2) If any lots, tracts, or plots are sold for cash or are sold partially for cash and the balance of the purchase price is evidenced by a purchase money mortgage, or other instrument evidencing the unpaid balance of the purchase price, and a deed of conveyance is delivered to the purchaser, General shall pay Central the compensation simultaneously with the execution and delivery of the deed of conveyance by General to the purchaser; and

(3) Payment of the compensation provided for in subparagraph (1) hereof is contingent upon payments being made under the sales contracts and agreements for deed, and if a purchaser defaults, and as a result of a default the sales contract or agreement for deed is cancelled, then General shall only be liable to pay Central the compensation out of the installments paid on contracts and agreements for deed up to the date of the cancellation of the sales contract or

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agreement for deed.

(b) A sum equivalent to 5 percent of the cost of each residence constructed by or for General between and including January 1, 2003, and December 31, 2006, but such sum equivalent to 5 percent of the cost of each residence shall not exceed one half of the profit resulting from the sale of the residence.

(1) The compensation for each residence shall be paid by General to Central within 30 days from the date of the execution and delivery to the purchaser of a deed of conveyance. If a residence is sold under an agreement providing for the payment of the purchase price in installments and the delivery of a deed to the purchaser after payment of installments in accordance with the agreement, then the compensation for the residence shall be paid by General to Central within 30 days from the date of the execution and delivery of the agreement.

(2) In the event the compensation to be paid Central, as herein provided, cannot be determined with mathematical precision at the time the compensation is required to be paid, then the compensation shall be estimated by the then Certified Public Accountants of General and the estimated amount shall be paid to Central. When such compensation can be accurately computed the parties will account to each other for the exact amount to be paid to Central.

(3) In the event General is unable to dispose of any residences, then General shall not be obligated to pay Central the sum of 5 percent of the cost of the residence for any residence remaining unsold. If a purchaser under a sales contract or agreement for deed purchases a residence from General and in connection with such purchase surrenders the sales contract and receives a credit on the purchase price of the residence for the amounts paid under the sales contract, then there shall be credited against the compensation to be paid Central upon the sale of the residence the amount of the compensation General previously paid Central on the sales contract surrendered in exchange for part payment on the purchase of a residence.

(c) A sum equivalent to 5 percent of the cost of each building constructed by or for General between and including January 1, 2003, and December 31, 2006; and for the purposes of this paragraph, the parties have agreed that the cost of each building shall be determined by taking the sum total, in the aggregate, of the lot improvement cost, actual cost of constructing, and overhead. Compensation for buildings shall be paid within 30 days from the date of the completion of the building. "Completion of the building" has occurred when the governmental agency having jurisdiction over the approval of the construction work issues a certificate of occupancy. If there is no governmental agency having authority to issue a certificate of occupancy then completion means the actual completion of all of the work required to be done by or through Central pursuant to the terms of this contract for the completion of the building. The fact that there may remain minor items of touching up to be done, which can be done after the occupancy of the building by General, or parties claiming by, through, or under General, will not prevent the building from being considered completed for the purpose of determining whether Central has completed the building and is entitled to payment.

(d) All of Central's overhead covering the work provided for under this agreement.

(e) The cost of each residence shall be determined in the following manner:

(1) First, the number of acres contained in and covered by the plat in which the lot, tract, or plot where the residence is to be constructed is located shall be determined; and then the actual cost paid by General per acre for the land included in the plat shall be determined; and then the total acreage covered by such plat shall be multiplied by the amount paid per acre and the resulting figure shall then be divided by the number of lots, tracts, or plots included in the plat, and the quotient shall be the "base cost" of the lot, tract, or plot. When the base cost of a lot, tract, or plot, is inequitable by reason of location and size of particular lots, tracts, or plots, then the base cost may be increased or diminished in accordance with sound accounting and business practices, agreed to by the parties, and upon their failure to agree to such change, then the same shall be resolved in the manner provided for in paragraph 15 hereof.

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(2) The cost shall be determined of surveying, platting, and laying out of the land contained in and covered by the plat in which the lot, tract, or plot is located, upon which the residence or building is to be constructed, including engineering and architect's fees, (other than the fees of engineers and architects employed by General or Central) and the cost of laying out and building all roads, streets, sidewalks, and parkways, and the cost of preparing the property for the construction of residences and buildings, and the cost of installing water and sewer mains to service all of the property included in the plat, and the cost of installing drainage systems, street signs, subdivision gates, and all other improvements necessary or required to create a complete subdivision of the land covered by the plat. The aggregate of all of these costs shall be divided by the number of lots, tracts, or plots included in such plat and the quotient shall be the "lot improvement cost." If there are any lots, tracts, or plots in such plat abutting on a canal or waterway, then the entire cost of creating the canals and waterways contained in such plat shall be divided by the number of lots, tracts, or plots, abutting the canals and waterways and the quotient shall be added to and included as a part of the lot improvement cost of each canal or waterfront lot, tract, or plot.

(3) The actual cost of constructing the residence or building shall then be determined. The term "actual cost of constructing" shall include the actual cost of all work, labor, services, and materials furnished for the construction of the residence or building, and all utilities furnished to the residence or building in connection with the construction work; and the cost of all machinery, equipment, and appliances installed in the residence or building; and the premiums for or the cost of comprehensive-liability insurance and workmen's compensation insurance and all other insurance carried on the residence or building being constructed, including any bond which the law may require, including drayage, cartage, gasoline, and oil used for or in connection with the doing of the work, and salaries or wages of employees, superintendents, foremen, supervisors, timekeepers, expeditors, and other personnel engaged upon and being paid wages for the construction of the residence or building; and all other improvements or installations on the lot, tract, or plot which are not included in the lot improvement cost; and including, in general, everything which, for example, under the terms of an A.I.A. cost-plus contract would be cost. The actual cost of constructing shall also include sales commissions paid for the sale of a residence and direct advertising costs applicable to a residence and interest paid on a construction mortgage on a residence.

(4) The overhead of Central in the proportions provided in this agreement shall be included in and deemed a part of the cost of each residence or building. In each "taxable year" of Central, the overhead of Central for the taxable year shall be ascertained by taking the sum total of Central's cost (not included in actual cost of constructing) of maintaining and operating its construction equipment, automobiles, trucks, and rolling stock, salaries and bonuses paid to Central's employees, charitable donations and contributions not exceeding \$30,000, dues, subscriptions for services, periodicals, and literature, premiums paid for general comprehensive-liability insurance, workers' compensation insurance, employees' health and accident insurance, legal and professional fees, lights, water, and all utility charges, salaries paid to the officers of Central which shall not exceed \$200,000 rent, in each year, office supplies, promotion, travel, and entertainment expenses, and all other items of expense which under sound accounting principles are included in and considered as overhead. The method of charging overhead against the work performed for General shall be as follows: there shall first be determined the entire amount of land development costs for General and actual cost of constructing residences and buildings for General in each taxable year of Central, but for the purposes of this subparagraph only, actual cost of constructing residences shall not include sales commissions, advertising, or interest on construction loans; and that proportion of the entire overhead allocable to work performed under this contract which the actual cost of constructing residences and buildings bears to the entire amount of land development costs and actual costs of constructing residences and buildings will be the overhead allocable to residences and buildings, and the balance of the overhead will be the overhead allocable to land development work. That proportion of the overhead (allocable to residences and buildings) which the actual cost of constructing the buildings bears to the actual cost of constructing residences and buildings shall be charged against the buildings constructed by Central for General, and the balance will be charged against the residences constructed by Central for General, and the overhead allocable to residences shall be divided by the number of residences constructed by Central for General in Central's taxable year and the quotient will be the overhead charged to each residence constructed by Central for General. The overhead allocable to buildings shall be divided by the number of buildings constructed by Central for General in Central's taxable year and the quotient will

be the overhead charged to each building constructed by Central for General. In determining the overhead and its allocation, consideration shall be given to uncompleted residences and buildings being constructed at the time the overhead and allocation is determined.

The sum total, in the aggregate, of the base cost of the lot, tract, or plot and the lot improvement cost and actual cost of constructing and the overhead of Central shall be the cost of each residence constructed by or for General; and the sum total, in the aggregate, of the lot improvement cost and actual cost of constructing and overhead of Central shall be the cost of each building constructed by or for General.

(f) The "profit resulting from the sale of a residence" shall be computed as follows:

(1) For a minuend or gross figure, there shall be first computed the net proceeds of the sale of the residence. The "net proceeds" are the sum total of the gross selling price of the residence less the actual deductions made at the time of the closing to give effect to the actual closing costs, including abstracting bills, mortgage loan creation costs, proration of taxes, and any other actual prorations or adjustments made upon the occasion of the closing; and

(2) The subtrahend will constitute the cost of each residence, determined under subparagraph (e) and its accompanying subparagraphs; and

(3) The subtrahend shall be subtracted from the minuend and the amount of the remainder shall be and constitute the profit resulting from the sale of a residence, for the purposes of subparagraph (b).

7. *Statements and books.* General will, at the time of making the payments to Central, furnish a statement to Central showing the manner in which the compensation has been determined, and the particular sales contracts and sales upon which the compensation is being paid. Central shall have the right to examine General's books and records, from time to time, for the purpose of determining the names of purchasers, and the lots, residences, and buildings being purchased and the amounts being paid; and General shall have a corresponding right to examine Central's books and records for the purpose of determining Central's overhead, and for any purpose germane to this agreement.

8. *Payments by owner.* In addition to the payments provided for in subparagraphs (a), (b), and (c) of paragraph 6, General will pay Central, upon demand, all moneys advanced or paid by Central for work, labor, services, and materials furnished in connection with the work covered by this agreement which, by the terms of this agreement, General is obligated to pay; and General will pay Central its overhead in the manner and at the times provided in paragraph 9.

9. *Time of payments.* The parties acknowledge that from an accounting standpoint it may be impractical to determine with mathematical precision the amounts to be paid to Central under subparagraphs (b) and (c) of paragraph 6, until the end of Central's taxable year in which the residences or buildings are completed; and, therefore, the parties agree as follows:

(a) General shall, on or before the tenth day of each calendar month, commencing with the calendar month next succeeding the date of the execution of this agreement, pay to Central a sum equivalent to 1/12th of Central's annual overhead as estimated by General and Central, and upon any failure to agree upon the annual overhead the matter shall be resolved as provided for in paragraph 15.

(b) Within 60 days after the end of each taxable year of Central, the overhead of Central will be determined for the taxable year, and if the overhead is in excess of or less than the amount paid by General to Central, then the overhead will be readjusted and whichever party owes the other any sums by reason thereof, will pay the same upon demand.

(c) General shall pay Central a sum equivalent to 5 percent of the cost of each residence and building constructed by or for General within the time provided for in subparagraphs (b) and (c) of paragraph 6 but with the understanding that the

amount or amounts so paid shall be subject to adjustment to give effect to the provisions of such subparagraphs. The adjustment will be made within 60 days after the end of the taxable year of Central in which payment has been made, and whichever party owes the other any sums by reason of the adjustment, will pay the sums upon demand. For the purpose of determining the cost of each residence and cost of each building a sum equivalent to 4 percent of the actual cost of constructing shall be included as "overhead" until the actual overhead is determined in accordance with the provisions of subparagraph (e)(4) of paragraph 6.

10. *Exclusive services of contractor.* During the term of this agreement Central will confine its efforts and work exclusively to the performance of the work provided for under this agreement. Anything in this agreement to the contrary notwithstanding, if at any time the construction of the residences and buildings by Central for General is insufficient to use Central's building and construction personnel normally used by Central, then Central shall have the right to construct residences and buildings for itself and other parties without being in default hereunder. If Central does so construct residences and buildings for itself and other parties, then the overhead of Central allocable to work performed under this agreement shall be that proportion of Central's overhead which the actual cost of land development work and the actual cost of constructing residences and buildings by Central for General bears to the actual cost of land development work and the actual cost of constructing residences and buildings by Central for itself, for General, and for other parties. General will not, during the term of this agreement, enter into any agreement or employ any party to do any of the work provided for by this agreement without the consent, in writing, of Central, and Central shall have the exclusive right to do and perform, for General, its successors and assigns, all of the work contemplated and provided for under the terms of this agreement.

11. *Term of agreement.* The term of this agreement shall be from the date hereof up to and including December 31, 2007. General shall be obligated to continue to pay Central the compensation provided for in subparagraph 6(a), after the expiration date, on those lots, tracts, or plots sold or contracted to be sold up to and including the expiration date. In the event there are any uncompleted residences, and buildings on the expiration date, Central shall be obligated to complete the construction of such residences and buildings, and General shall be obligated to pay Central the compensation provided for in subparagraphs 6(b) and 6(c) for all work completed subsequent to the expiration date. The compensation on any unsold residences completed prior to or subsequent to the expiration date shall be paid to Central when such residences are sold.

12. *Additional obligations of owner.* General agrees that:

(a) General shall pay Central the sums of money required under this agreement as and when they become due and payable in accordance with the terms of this agreement.

(b) General will take all actions, do all things, let all contracts, and make all payments and disbursements which, under the terms of this agreement, General is obligated to do and perform.

(c) General shall carry fire, windstorm, and extended coverage insurance on all residences and buildings constructed by Central, and shall pay all the premiums, and the insurance shall be taken out upon the commencement of the construction work and carried continuously until General sells the residences and buildings.

(d) From and after the completion of the construction of a residence and building by Central, General shall be responsible for the maintenance and repair of the residence and building; but the provisions herein contained shall not relieve Central of the obligation to make repairs to residences or buildings which become necessary as a result of defective materials and workmanship.

(e) General will hold Central harmless against any claim made against Central by reason of the use by General of Central's name in connection with the development and sale of General's properties; and

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(f) Upon the termination or expiration of this agreement, General shall not in any manner use Central's name in connection with the development and sale of General's properties, and shall not in any manner make reference to the fact that Central prior to termination or expiration developed General's properties. Upon a breach of the provisions herein contained, Central shall have such rights and remedies as the law permits to enforce the provisions herein contained and to recover damages for such breach.

13. *Additional obligations of contractor.* Central agrees that it:

- (a) Shall cooperate with General in the preparation and filing of the applications referred to in paragraph 4(c).
- (b) Will procure bids from subcontractors and materialmen to enable General to award the contracts referred to in subparagraph 4(e), and Central will do all necessary work to procure such bids.
- (c) Will supervise the work of all parties furnishing work, labor, services, and materials for the doing of the work provided for under this agreement.
- (d) Will represent General, if requested by General, in any and all disputes arising between General and parties furnishing work, labor, services, and materials for the doing of the work provided for under this agreement.
- (e) Will not assign this contract.
- (f) Will indemnify and hold General harmless against damages for injury to persons or property that may arise by reason of the work being performed by Central under this agreement.
- (g) Will execute such receipts, waivers, and releases as are appropriate and necessary to acknowledge payments made under this agreement upon the payment by General to Central of the sums due Central in accordance with the terms of this agreement; and
- (h) Will perform all work required under this agreement in compliance with any and all building laws, ordinances, and regulations of any and all governmental agencies entitled to impose such laws, ordinances, and regulations; and all such work shall be done in good and workmanlike fashion.

14. *Relationship between parties.* The relationship between the parties is that of owner and contractor, and the law relating to such relationship shall govern the rights of the parties.

15. *Settlement of disputes.* If any dispute shall arise between the parties as to the manner of computing the amounts due Central under this agreement, then the same shall be resolved by the certified public accountants then representing General and Central. If the certified public accountants are unable to resolve the dispute, then the accounting firms shall designate an independent certified public accountant who shall have the authority to resolve the dispute. If the accounting firms then representing General and Central are unable to agree upon an independent accountant to resolve the dispute, either of the parties shall have the right to procure the appointment of an independent accountant by filing an action in the Circuit Court of Dade County, Florida, for the appointment of a certified public accountant to resolve the dispute. The fees to be paid the independent certified public accountant, shall be borne equally by the parties, and the costs of procuring the appointment of the independent certified public accountant shall be borne equally by the parties hereto.

16. *Entire agreement.* This agreement contains the entire agreement between the parties, and supersedes, and extinguishes all previous agreements, contracts, and undertakings heretofore existing between the parties.

17. *Notice.* If either party desires to give notice to the other in connection with and according to the terms of this

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agreement, such notice shall be given by registered or certified mail, and it shall be deemed given when deposited, with sufficient prepaid postage to carry it to its addressed destination. Notices shall be addressed as follows:

For General:

200 Biscayne Blvd.,
Miami, Florida.

For General:

100 S. E. 2d Street,
Miami, Florida.

18. *Waivers.* Except as herein expressly provided, no waiver by either party of any breach of this agreement, or of any warranty or representation hereunder, shall be deemed to be a waiver by the same party of any other breach of any kind or nature (whether preceding or succeeding the breach in question, and whether or not of the same or similar nature).

No acceptance by a party of payment or performance after any such breach shall be deemed to be a waiver of any breach of this agreement or of any representation or warranty hereunder, whether or not the party knows of the breach when it accepts such payment or performance.

No failure by a party to exercise any right it may have under this agreement or under law upon another party's default, and no delay in the exercise of that right, shall prevent it from exercising the right whenever the other party continues to be in default. No such failure or delay shall operate as a waiver of any default or as a modification of the provisions of this agreement.

19. *Amendment.* This agreement may be modified only by a written document signed by both parties. A purported oral modification shall not be effective.

20. *Governing Law.* This agreement shall be construed and enforced in accordance with the laws of the State of Florida.

In witness whereof the parties have caused these presents to be executed by their proper officers, who are duly authorized, and their corporate seals to be affixed, all of which has been done at the place and on the day and year first above written.

Signed, sealed, and
delivered in the presence
of:

General Realities
Corporation

—

—

(As to Officers of
Gen-

by:

President

Attest:

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eral).

Secretary

Central Construc-
tion Corporation

by:

President

(As to Officers of
Cen-

Attest:

tral).

Secretary

E.9 Management agreement between owner of retail strip mall under construction and real estate agent--agent to locate tenants for mall--advertising budget provided to agent--agent to manage mall once it is built and occupied

COMMENT

This form is a management agreement for a retail strip mall. The construction of the mall is nearing completion, and the owner wishes to begin obtaining commitments from prospective tenants as soon as possible. Accordingly, it provides the agent with a substantial advertising budget for the first six months covered by the agreement, or until the units are fully rented, whichever comes first. The agent may supplement the budget itself, if it so desires.

In addition to the advertising budget, the landlord offers the agent other incentives so that the agent will rapidly lease the premises. For example, the agent's compensation is tied to a percentage of: (1) gross rentals; and (2) the "overhead" charge to be imposed on all tenants.

The agent will be responsible for virtually all aspects of the operation of the shopping center. For that reason, the agent must hold the landlord harmless for any claims arising out of the operation of the shopping center (see the "hold harmless" clause in paragraph 13). The sole exception is where the claim alleges an intentional act on the part of the owner. The agent is also required to provide insurance to order to "fund" the hold harmless provision in the event that a successful claim is brought by an injured party. After all, a hold harmless is only as good as the ability of the party providing it to cover the financial losses suffered by the recipient.

Under the terms of the agreement, the landlord has ownership of all books and records of the shopping center. However, such books and records are actually to be maintained and held by the agent. The landlord has the right to review all books and records at any time. Monthly, quarterly and annual statements must be produced by the agent for the owner's benefit. The owner may audit these statements at any time.

For further information, see Chapter 11.

FORM

AGREEMENT made this _____ day of _____, 20____, between DOTSON ASSOCIATES, a partnership existing under the laws of the State of New York, with offices for the transaction of business at 500 Broadway, New York, New York (hereafter referred to as "Dotson" or "Agent"), and THE MARLIN GROUP, LTD., a corporation organized under the laws of the State of Delaware with offices for the transaction of business at 92 Federal Street, Wilmington, Delaware (hereafter referred to as "Marlin" or "Owner")

W I T N E S S E T H:

WHEREAS, Marlin is the owner of a certain strip mall of approximately _____ square feet located in Guilderland, New York; and

WHEREAS, Dotson is in the business of managing strip malls in New York State;

NOW, in consideration of the mutual promises contained herein, it is agreed as follows:

1. *Managing agent.* Dotson agrees to act as managing agent for Marlin for its strip mall located on U.S. Route 20 (Western Avenue) in Guilderland, New York. In furtherance of its duties, upon execution of this Agreement, Dotson shall do the following:

- (1) seek and secure an anchor tenant which shall be one of the following: a major chain grocery store, a major chain discount department store, or a major discount catalogue store;
- (2) seek and secure a discount drug store as a key tenant; and
- (3) seek and secure such other tenants as will fill the available space in the mall and attract customers.

2. *Leases.* Dotson shall provide Marlin with a proposed lease to be used by all tenants in the mall. The leases shall provide for common area maintenance charges, taxes, overhead and insurance expenses to be paid *pro rata* by the tenants. All rental rates shall be approved by Marlin and shall be based on the number of square feet occupied by the tenant.

3. *Advertising.* Dotson shall advertise, as it deems necessary, to locate tenants for the initial rent up. Marlin shall contribute the sum of \$ _____ monthly toward the cost of advertising for six months, or until rent up is complete, whichever event occurs first. Thereafter, when a vacancy occurs, Marlin will contribute \$ _____ per month towards the cost of advertising. Any expenses of locating a tenant above these amounts shall be borne by Dotson. Dotson shall account to Marlin for all sums expended on advertising.

4. *Duties.* Dotson shall perform the following duties:

- (1) Collect rent, common area maintenance, insurance, taxes and overhead charges monthly from each tenant. Dotson shall also maintain accurate records relating thereto.
- (2) Evict tenants where violations of the lease occur. The expenses of an attorney, if needed, shall be

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charged to Marlin.

(3) Locate additional tenants, as needed. This shall include negotiation of the leases, as well as negotiation of fit-up expenses and incentives, if offered by Marlin. Dotson shall obtain an executed lease from each tenant.

(4) Minor maintenance and repair, such as changing light bulbs, repairing door handles, and similar things. This shall be done by the Dotson staff at Dotson's expense.

(5) Arrange for janitorial service, landscaping care, major repairs and maintenance, snow removal and trash removal. This shall be charged to the tenants as part of the common area charges. Funds shall be advanced by Marlin, as needed, until such funds are collected from tenants.

(6) Arrange for payment of taxes and insurance. These expenses shall be charged to the tenants. Funds shall be advanced by Marlin, as needed, until such funds are collected from tenants.

(7) Inspect the premises on a regular basis to be certain that the terms of all leases are adhered to, and to ascertain the need for maintenance and repair.

(8) Purchase necessary equipment and supplies to carry out the duties set forth herein. Equipment shall be charged to Marlin. Supplies shall be charged to the tenants as part of common area charges.

(9) Maintain the shopping center as a first-class establishment, in conformance with the high standards of all Marlin-owned malls.

5. *Accounting.* Dotson shall provide monthly, quarterly and annual summaries of income and expenses to Marlin. Marlin shall be deemed to own all books and records maintained by Dotson. Marlin may inspect and audit the books of Dotson at any time without notice to Dotson. Summaries shall be delivered to Marlin within fifteen (15) days of the close of the period to which they relate.

6. *Term.* The term of this agreement shall be for a period of one (1) year, commencing upon the date of execution. The agreement shall be automatically renewed for additional one (1) year periods unless either party shall give the other party notice of termination at least sixty (60) days prior to the expiration date.

7. *Termination.* Marlin may terminate this agreement for cause upon fifteen (15) days' notice. Upon receipt of notice to terminate by either party, an audit shall be performed by Marlin's accountants. Upon completion of the audit, final payments shall be made. Dotson shall execute a general release and return all keys to Marlin. Dotson shall cooperate with its successor by supplying all books and records and responding promptly to all reasonable requests for information.

8. *Compensation.* Dotson shall receive _____ percent of all gross monthly rents received, plus one-half of the overhead charges added to all common area maintenance payments. Dotson shall take its compensation from the receipts once each month.

9. *Payment to owner.* Dotson shall pay Marlin's mortgage each month from rental funds received after deduction of all expenses, including Dotson's compensation. In the event of a shortfall, Dotson shall notify Marlin of the amount. Marlin shall be responsible for the shortfall. In the event that there are excess funds, Dotson shall place up to \$1,000 of such excess funds in a savings account known as a "sinking fund", the purpose of which is to cover future major repairs. Any excess above that sum shall be delivered to Marlin.

10. *Conditions.* Dotson shall notify Marlin of any damage to the mall caused by fire or other casualty. Dotson shall notify Marlin of any incident which may give rise to a claim for personal injury. Dotson shall promptly notify the insurance company involved in either event. Dotson shall be responsible for all negotiations with the insurance company. Dotson shall arrange for any repairs needed as a result of the fire or other casualty.

11. *Laws.* Dotson shall promptly bring the shopping center into compliance with all laws, rules and regulations of any governmental entity having jurisdiction. The cost of such compliance shall be chargeable to Marlin or to the tenants as part of common area charges, depending on the nature of the item.

12. *Bond.* Dotson, at its sole expense, shall bond its employees who will be working to fulfill any aspect of Dotson's obligations under this agreement.

13. *Hold harmless.* Dotson shall indemnify and hold Marlin harmless for any claim arising out of the use or operation of the shopping center, except to the extent that the claim shall allege an intentional act on the part of Marlin. This indemnification shall include, but not be limited to, costs of defense, legal fees, disbursements, court costs and any monetary judgment or settlement, including interest and penalties, if any. Dotson shall provide Marlin with a certificate of insurance coverage adequate to fully fund the contractual liability set forth above. The policy shall contain a provision requiring notice to Marlin at least ten (10) days prior to the effective date of cancellation of the insurance policy.

14. *Entire agreement.* This Agreement, together with the other written agreements and instruments executed concurrently herewith or pursuant to the provisions hereof, contains the entire agreement between the parties respecting the matters herein set forth and supersedes all prior agreements between them respecting such matters.

15. *Counterparts.* This Agreement may be executed in two (2) or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one (1) and the same instrument. At the trial of any matter arising under this Agreement, only one (1) counterpart need be produced.

16. *Headings.* Section headings are for purposes of convenience and identification only and shall not be used to interpret or construe this Agreement.

17. *Waivers.* Except as herein expressly provided, no waiver by Marlin of any breach of this Agreement or of any warranty or representation hereunder from Dotson shall be deemed to be a waiver of any other breach by Dotson of any kind or nature (whether preceding or succeeding, and whether or not of the same or similar nature). No acceptance of payment or performance by Marlin after any such breach by Dotson shall be deemed to be a waiver of any breach of this Agreement or of any representation or warranty hereunder by Dotson, whether or not Marlin knows of the breach when it accepts such payment or performance.

No failure by either party to exercise any right it may have under this Agreement or under law upon the other's default, and no delay in the exercise of that right, shall prevent it from exercising the right whenever the other party continues to be in default. No such failure or delay shall operate as a waiver of any default, or as a modification in any respect of the provisions of this Agreement.

18. *Gender and number.* Whenever the singular or plural number, or masculine or feminine gender, is used herein, it shall equally include the other.

19. *Notices.* Any notice which any party is required or may desire to give hereunder shall be in writing and may be personally delivered, transmitted by facsimile machine, or delivered by the United States Postal Service or private delivery service to the above addresses. Notice is deemed given when received.

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20. *Governing law.* This Agreement shall be construed and enforced in accordance with the laws of the State of New York.

21. *Binding effect.* This Agreement shall be binding upon, and inure to the benefit of, all the parties, and their respective heirs, representatives, successors, and assigns.

22. *Modifications.* This Agreement may be modified only by a written document signed by both parties. A purported oral modification shall not be effective.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals the day and year first above written.

DOTSON ASSOCIATES

By: _____

William Todd Dotson,

General Partner

MARLIN GROUP, LTD.

By: _____

Marietta T. Marlin,

President

[Acknowledgements]

E.10 Construction loan agreement--residential construction--proceeds of loan disbursed by lender--additional deposit by borrower--note and allied instruments

COMMENT

This group of forms illustrates instruments involved in financing the acquisition and development of real property. The nature of the documents utilized in connection with financing transactions depends to a great extent upon local law. There is considerable variation from state to state in the rules applicable to many significant aspects of financing arrangements, such as the relative priority of different liens, the nature of a mortgage interest as legal or equitable, and the procedures and consequences which come into play upon a default by the debtor. Since these distinctions may cause language which is appropriate in one jurisdiction to be abortive in another, the draftsman must exercise great caution in his use of model instruments. Despite the inevitable linguistic variations, there are many common problems in this area, and the methods for dealing with them illustrated in the following forms have widespread application. There are basically three stages of borrowing in connection with the acquisition and development of real property, viz., borrowing upon the purchase of the property, borrowing upon the construction of improvements, and long-term financing upon the completion of construction. This form illustrates a construction loan agreement for the purpose of residential construction.

In addition to the problems inherent in financing transactions in general, the construction loan involves a unique risk to the lending institution. The security for the loan is not in existence when the agreement is entered into, and will never be adequate if the owner or his builder fails to complete the intended

construction. This kind of uncertainty does not exist with respect to purchase money mortgages, or permanent financing, where the underlying security is at least tangible. The intrinsic problem of assuring completion of construction permeates the construction loan agreement.

To a certain extent, a guarantee as to the existence of some tangible security for repayment of outlays by the lender is provided by the schedule for the disbursement of funds. Advances are made to the borrower only as specified stages of construction are completed. The possibility that construction will be completed is enhanced by making certain that the owner will have enough funds to pay for the total construction costs in excess of loan proceeds. Under this agreement, the borrower must deposit with the lending institution the estimated amount required to complete the project in addition to the proceeds of the construction loan. Even assuming the adequacy of funds, the lender usually seeks assurance that the loan proceeds will be applied to the payment of construction costs. This agreement permits the lender to require the owner to submit contractors' bills or other proof of amounts due, and specifies that the owner is to hold the loan proceeds as trustee for the payment of construction costs. At the same time, the lender may require a builder's bond for the completion of construction. In some cases, the lender may waive the necessity for such a bond in return for the builder's promise to complete lien-free construction.

Besides measures to assure the existence of a security interest, this agreement includes provisions designed to insure repayment of the loan. In some instances, the grant of the construction loan is predicated upon the existence of a commitment for long-term financing. Where, as here, improvements are to be sold immediately upon the completion of construction, this type of protection would not be appropriate. In this instance, the owner undertakes to maintain a minimum price for the residential lots to be sold. Another common arrangement is for any purchase money mortgage holder to subordinate his interest to that of the construction lender. Also, where the owner is a corporation, the principal shareholders may be required to guarantee repayment.

Another type of control retained by the lender is the right to approve plans and specifications for construction, and to inspect work in progress to establish that plans and specifications are being adhered to. In the event of work stoppage or failure to conform to plans, further disbursements are to be withheld and amounts previously advanced may become due immediately.

For further information, see Chapters 11, 12, and 19.

FORMS

(1) Construction loan agreement

AGREEMENT entered into January 4, 2002, for the acquisition by Valiant Building Co., Inc. (the "Borrower") of a construction loan from Eagle Rock Savings and Loan Association (the "Association"), such loan to be evidenced by the Borrower's note for \$1,000,000, dated January 4, 2002, in favor of the Association. Such note shall be secured by a Deed of Trust affecting real property in the County of Contra Costa, State of California (the "property"), described as follows:

(Insert description)

1. *Construction agreement.* The Borrower proposes to construct on the above-described property single-family residences, according to plans and specifications attached hereto as Exhibit A and made a part hereof.

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2. *Deposit of proceeds.* The net proceeds of this loan, upon recordation of the Deed of Trust, are to be placed on deposit with the Association, together with the sum of \$300,000, to be deposited by the Borrower, in a special noninterest bearing account entitled "Loans in process, Valiant Building Co., Inc., building loan account" (the "account"). The deposit of such sums in the account shall be conclusively deemed a full and complete consideration for such note and Deed of Trust. Such funds are to be paid out, and are to be used, for the purposes set out herein. Subject to the provisions of this agreement, the Borrower hereby irrevocably assigns to the Association, as security for the obligations secured by such Deed of Trust and the due performance of this agreement by the Borrower and for any other obligation of the Borrower to the Association, such account and all moneys to be placed therein, specifically including amounts that may be deposited in such account from time to time in the future either by the Borrower or by the Association. The Borrower acknowledges that it has no right to the moneys in such account other than to have the same disbursed by the Association in accordance with this agreement. Except as hereinabove mentioned, any assignment or transfer, voluntary or involuntary, of this agreement, or of any right hereunder, shall not be binding upon, nor in any way affect, the Association without its written consent, and the Association may pay out the moneys in such account, as provided herein, notwithstanding any such assignment or transfer.

3. *Borrower's obligations.* The Borrower shall complete the proposed improvements to be constructed upon the property promptly, in accordance with plans and specifications approved or to be approved by the Association including any minimum specifications prescribed by the Association. If there is any difference between any such minimum plans and specifications and any plans and specifications approved by the Association, then the requirements of whichever are the higher shall be met in constructing such improvements. The Borrower shall furnish the Association with a policy of title insurance satisfactory to it, showing such Deed of Trust to be a first lien or charge on the property, excepting only such items as shall have been approved by the Association. No work of any character shall be commenced nor shall any materials be delivered upon or near the property prior to the recordation of the Deed of Trust. Should any work be commenced or materials delivered upon or near the real property prior to the recordation of the Deed of Trust, the Association may apply as much of the funds in such account as may be required to satisfy in full the indebtedness secured by the Deed of Trust, and to pay all expenses incurred in connection with this transaction. No materials, equipment, fixtures, or any other part of such improvements shall be purchased or installed pursuant to a security agreement or under any other arrangement wherein the right is reserved to remove or to repossess any such item, or to consider it as personal property.

4. *Schedule of loan disbursements.* The proceeds of the account, except as herein otherwise provided, are to be disbursed by the Association subject to the provisions of this agreement, in order to provide funds for the construction of improvements, in accordance with the schedule set forth in this paragraph. At such time as construction has, to the satisfaction of the Association, reached the following stages in accordance with the plans and specifications, the following payments shall be made:

\$200,000 when the foundation is completed, first-floor joists and subfloor are in place, and all rough lumber required to complete improvements is on the building site.

\$200,000 when improvements are framed and ready for lathing and plastering, rough plumbing, wiring, and heating are completed, and roof is on.

\$200,000 when improvements are plastered, complete inside and all except brush coat outside, or, if frame building, the exterior has received a prime coat.

\$200,000 when improvements and all work are fully completed and a valid notice of completion has been filed with the Association for recordation by it.

\$200,000 (being the balance remaining in the account) when the title company which issued a policy of title insurance

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will make an endorsement on the policy insuring against loss by reason of any mechanic's lien arising out of construction of improvements.

5. *Procedure for loan disbursements.* The Borrower may present to the Association (or its designated representative) a written loan disbursement order, drawn upon the moneys in the account, payable to a contractor, materialman, or laborer for work done or materials furnished in construction. The presentation to the Association of such order shall constitute a representation on the part of the Borrower that the moneys therein referred to have been used in the construction of the improvements, and the Association shall be entitled to rely thereon and shall be held harmless for all liability in connection therewith. Such orders may be approved and paid by the Association upon such terms and conditions as it may see fit to impose. The Borrower shall, if and when required by the Association, as a condition precedent to any disbursement from the account, furnish receipt bills and releases of lien rights covering work done or materials furnished for the improvement, showing the expenditure of an amount equal to the total funds at such time disbursed from the account, including the then requested payment. The Association shall be authorized to act upon, and shall be fully protected by, the written order or receipt of the Borrower in making any advances or payments, and in any other matter arising under this agreement. All funds received hereunder are received in trust for the purpose of paying in full all contractors, materialmen, and laborers then or theretofore engaged in construction, and the Borrower shall not have any beneficial interest in the funds unless and until such purpose has been fulfilled.

6. *Governmental mortgage insurance.* If payment of the indebtedness secured by the Deed of Trust is to be insured or guaranteed by the Federal Housing Administrator, or the Veterans Administrator, or by any other governmental agency, the Borrower shall conform to and abide by all of the rules, regulations, and requirements of such agency, and shall cause the indebtedness to be so insured or guaranteed.

7. *Additional deposits.* Whenever the Association shall determine and notify the Borrower that the balance remaining in the account is less than the amount required fully to complete and pay for improvements, and the Association shall demand that the Borrower deposit with the Association in the account an amount equal to such deficiency as estimated by the Association, the Borrower shall comply with such demand within ten days from the date thereof, and the judgment of the Association shall be final and conclusive in this respect.

8. *Inspection by association.* The Association or its agent shall have the right at all times to enter upon the property during the period of construction, and if the work is not in conformance with the plans or specifications or is not otherwise satisfactory to the Association, it shall have the right to stop the work and order its replacement, and to withhold all disbursements from the account until such work is satisfactory to it. If the work is not made satisfactory to the Association within 15 calendar days from the date of stoppage by the Association, such failure shall constitute a default by the Borrower under the terms of this agreement. The Association is under no obligation to construct or supervise the construction of improvements and inspection by the Association of the construction of improvements is for the sole purpose of protecting the security of the Association. Such inspection is not to be construed as a representation that there will be strict compliance on the part of the builder with the plans and specifications, or that the construction will be free from faulty material or workmanship. The Borrower will make or cause to be made such other independent inspections as it may desire for its own protection. In the event work should cease on such improvements, specifically including stoppage by the Association in accordance with paragraph 10 hereof, or for any reason whatsoever, for an aggregate of 15 calendar days, whether consecutive or not, the same shall be construed as an event of default hereunder.

9. *Default by borrower.* In the event of a default by the Borrower in the performance of any term, covenant, or condition contained in this agreement, all sums disbursed or advanced by the Association shall immediately become due and payable, and the Association may withdraw any balance on deposit with it under the terms of this agreement and credit the same upon the Borrower's indebtedness under the note referred to above. The Association shall thereupon be released from all obligations to the Borrower under the terms of this agreement. In the event such sums are so credited on the note, the same shall not in any respect cure or waive any default under the Deed of Trust, or any notice of default,

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or invalidate any act done pursuant to any such notice, and such credit on the note shall not change, alter, or prejudice any rights of the beneficiary given by the Deed of Trust.

10. *Appointment of association as agent.* The Borrower hereby irrevocably appoints, designates, empowers, and authorizes the Association, as agent, to file for record all notices of completion, cessation of labor, or any other notice that the Association deems necessary to file for record to protect its interest under the provisions of this agreement or the note and Deed of Trust. Such appointment of the Association as agent is hereby expressly declared to be that of an agency coupled with an interest, and as such to be irrevocable.

11. *Change in plans.* No change in the plans or specifications shall be made after the same have been approved by the Association without first obtaining its written consent to such change. All contracts let by the undersigned or any of them in connection with the construction shall contain this provision.

12. *Waiver.* The waiver by the Association of any breach hereof shall not be deemed, nor shall the same constitute, a waiver of any subsequent breach on the part of the Borrower.

13. *Legal action.* The Association shall have the right to commence, to appear in, or to defend any action or proceeding purporting to affect the rights, duties, or liabilities of the parties hereunder, or the payment of any funds in the account, and in connection therewith to incur and pay all costs and expenses, including its attorneys' fees, in a reasonable amount, in any such action in which the Association shall appear. To the extent deposited funds are sufficient, the Association shall have the right, but is not obligated, to pay costs, expenses, or attorneys' fees out of such funds.

14. *Time is essence.* Time is hereby expressly made of the essence of this agreement.

15. *Application of agreement.* This agreement is made for the sole protection of the Borrower, and the Association, its successors and assigns, and no other person or persons shall have any right of action hereon. This agreement and the note and Deed of Trust above mentioned contain all of the terms and conditions agreed to by the undersigned, or any or all of them, and no other agreement regarding the subject matter of this contract, unless it is in writing and signed by the Association and the Borrower, shall be deemed to exist or to bind any party hereto. The Borrower has read and understands the whole of the above agreement and now states, and in consideration of the contract agrees, that no representation, promise, or agreement not expressed in this agreement or the note or Deed of Trust has been made to induce the Borrower to enter into it.

16. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

17. *Notices.* All notices under this agreement shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

18. *Non-waiver.* No delay or failure by either party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

19. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

20. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of California.

21. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

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22. *Binding effect.* The provisions of this agreement shall be binding upon and inure to the benefit of both parties and their respective legal representatives, successors, and assigns.

In witness whereof this agreement is executed the day and year first above written.

Attest:	Valiant Building Co., Inc.
_____	by _____
Secretary	President
Attest:	Eagle Rock Savings and
_____	Loan Association
Secretary	by _____
	President

(2) *Installment note*

NEW CONSTRUCTION

\$1,000,000 Loan No. 3415 California, January 4, 2002

In installments and at the times hereinafter stated, for value received, the undersigned promises to pay to Eagle Rock Savings and Loan Association, a corporation, or order, at its office in the City of San Francisco, State of California, the principal sum of \$1,000,000, with interest from January 4, 2002, on the unpaid principal at the rate of 5 percent per year; the principal to be payable in semiannual installments of \$100,000 each, with interest on the unpaid principal, payments to be made on January 1 and July 1 of each year, commencing July 1, 2002, and continuing until principal and interest have been paid in full. Each payment shall be credited first on interest then due and the remainder on principal; and interest shall thereupon cease upon the principal so credited. Should default be made in the payment of any installment when due, or in the performance of any agreement of the Deed of Trust securing the payment of this note, the whole sum of principal and interest shall become immediately due at the option of the holder of this note. The undersigned promises to pay a late charge in an amount equal to 10 percent on any installment not paid within ten days after its due date. Principal and interest are payable in lawful money of the United States. If action is instituted on this note, the undersigned promises to pay such sum as the court may fix as attorney's fees. Privilege is reserved to prepay this note without penalty, provided that, when the aggregate amount prepaid in any one year equals or exceeds 20 percent of the original principal amount of this note, six months' advance interest on the amount prepaid may be charged. This note is secured by a Deed of Trust to Eagle Rock Savings and Loan Association, a California corporation.

Attest:	Valiant Building Co., Inc.
_____	by _____
Secretary	President

(3) *Agreement to maintain minimum sales prices*

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AGREEMENT entered into January 4, 2002, by and between Eagle Rock Savings and Loan Association, a California corporation (the "Association"), and Valiant Building Co., Inc. (the "Borrower").

Whereas the Borrower has applied to the Association for certain construction loans to be secured by a first Deed of Trust on each of the lots described as follows:

(Insert description)

Whereas in connection with the Borrower's application for such loans the Borrower has represented to the Association that it will construct single-family residences and appurtenances upon each of such lots and will sell each of them to subsequent purchasers for a minimum sales price of no less than \$20,000, and

Whereas the Association is unwilling to grant the loans applied for by the Borrower unless the Borrower adheres to the minimum sales price set forth herein.

Therefore, it is agreed as follows:

1. In the event the Borrower sells, transfers, conveys, or otherwise disposes of any interest in any property set forth herein, whether such interest be legal, equitable, or both, the Borrower shall immediately, upon demand of the Association, pay in cash to the Association as a payment of loan principal the sum of \$80 for each \$100 of sales price deficiency at which the property has been sold, transferred, conveyed, or otherwise disposed of.

2. The Association, by reason of any required payment as set forth above, shall charge the Borrower no prepayment penalty fee.

If the Borrower fails to comply with the promises set forth in this agreement, the Association reserves the right to disapprove of the Borrower's successor in interest and to declare that the then unpaid balance of the note is immediately due and payable.

Witness our hands the day and year first above written.

Attest:

Secretary

Attest:

Secretary

Valiant Building Co., Inc.

by _____

President

Eagle Rock Savings and

Loan Association

by _____

President

(4) Subordination agreement

AGREEMENT made January 4, 2002, between Valiant Building Co., Inc., owner of the property described below (the "Owner"), and Donald Bell, present owner and holder of the Deed of Trust and note described below (the

"Beneficiary").

Whereas Valiant Building Co., Inc., did on December 1, 2001, execute a purchase money Deed of Trust to Peter Small, as trustee, covering the following described property:

(Insert description)

to secure a note in the sum of \$200,000, dated December 1, 2001, in favor of the Beneficiary, and

Whereas the Owner has executed, or is about to execute, a construction loan escrow and construction loan agreement together with a Deed of Trust and note in the sum of \$1,000,000, dated January 4, 2002, in favor of Eagle Rock Savings and Loan Association (the "Lender"), payable with interest and upon the terms and conditions described therein, which Deed of Trust is to be recorded contemporaneously herewith, and

Whereas it is a condition precedent to obtaining such loan that the construction loan Deed of Trust shall be and remain a lien or charge upon the property hereinbefore described, prior and superior to the purchase money lien or charge of the Deed of Trust, first above mentioned, and

Whereas the Lender is willing to make such loan provided the Deed of Trust to secure the same is a lien or charge upon the above-described property prior and superior to the lien or charge of the Deed of Trust owned by the Beneficiary, and provided that the Beneficiary will specifically and unconditionally subordinate the lien or charge of his Deed of Trust above described to the lien or charge of the Deed of Trust of the Lender,

Now, therefore, in consideration of the premises and other valuable consideration, receipt of which is hereby acknowledged, and in order to induce the Lender to make the loan above referred to, it is agreed as follows:

1. *Subordination.* The Deed of Trust securing the note in favor of the Lender referred to above and all renewals or extensions of such Deed of Trust and the note secured thereby shall be and remain at all times a lien or charge on the property herein described, prior and superior to the lien or charge of the Deed of Trust in favor of the Beneficiary, first above mentioned.

2. *Acknowledgment of subordination.* The Beneficiary acknowledges that he hereby intentionally waives, relinquishes, and subordinates the priority and superiority of the lien or charge of the Deed of Trust first above mentioned in favor of the lien or charge upon such land of the Deed of Trust in favor of the Lender, and that he understands that in reliance upon and in consideration of this waiver, relinquishment, and subordination specific loans and advances are being and will be made, and as part and parcel thereof specific monetary and other obligations are being and will be entered into by third parties which would not be made or entered into but for such reliance upon this waiver, relinquishment, and subordination. The Beneficiary further acknowledges that an endorsement has been placed on the note secured by the purchase money Deed of Trust, and that such Deed of Trust has by this instrument been subordinated to the lien or charge of the Deed of Trust in favor of the Lender.

3. *Approval of construction loan agreement.* The Beneficiary hereby declares that he has personal knowledge of and hereby approves and consents to all the provisions of the loan escrow and loan agreement between the Owner and the Lender for the disbursement of the proceeds of the loan of the Lender. The Beneficiary further acknowledges that the Lender in making disbursement pursuant to such loan agreement is under no obligation or duty nor has the Lender made any representation that it will see to the application of such disbursement by the Owner, and any diversion by the Owner will not defeat this subordination agreement as to the funds so diverted.

4. *Cancellation of certain provisions of purchase money deed of trust.* The Beneficiary acknowledges that this

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agreement shall supersede, and operate as a cancellation of, those provisions, if any, in the purchase money Deed of Trust first above mentioned which provide for the automatic subordination of the lien of such Deed of Trust to the lien or liens of a mortgage or Deed of Trust, or mortgages or Deeds of Trust, affecting the whole or part of the above-described property.

5. *Entire agreement.* This agreement contains the whole agreement between the parties hereto as to the Deed of Trust loans, and the priority thereof, herein described. There are no agreements, written or oral, outside or separate from this agreement, and all prior negotiations, if any, are merged into this agreement.

6. *Binding effect.* This agreement shall inure to the benefit and be binding upon the legal representatives, heirs, devisees, successors, and assigns of the parties.

Attest:

Secretary

Donald Bell

Valiant Building Co., Inc.

by _____

President

(5) Guaranty agreement

AGREEMENT made January 4, 2002, by and between John Dill, Edward Rollins, and Thomas Fays (collectively the "Guarantors"), and Eagle Rock Savings and Loan Association, a California corporation (the "Association").

Whereas the Guarantors are the principal stockholders of Valiant Building Co., Inc. (the "Borrower"), and

Whereas the Borrower is, or is about to become, the owner of certain real property in the County of Contra Costa, State of California, described as follows:

(Insert description)

and proposes (a) to improve such tract of land by the construction of streets, gutters, curbs, sidewalks, sewers, and other off-site improvements, all as contemplated in the plans and specifications for the project, or required to be done on such project by the state, county, city, or other governmental authority having supervision of such work; (b) to construct a dwelling house upon each of such lots above described; and (c) then to sell each of such dwelling houses, and

Whereas to aid in carrying out such project the Borrower has sought from the Association a building loan in the amount of \$1,000,000, to be evidenced by a note and to be secured by a Deed of Trust covering all of the property above described, and

Whereas the Association is willing to make the Borrower such a building loan, but only upon condition that the Guarantors shall execute this guaranty agreement,

In consideration of the premises, and other valuable consideration, the Guarantors do hereby unconditionally guarantee to the Association, on demand of the Association, as follows:

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1. *Completion of improvements.* The Guarantors shall: (a) furnish or cause to be furnished all labor or materials, or both, needed to complete any proposed improvements on such project, or the real property covered by such Deed of Trust, in accordance with such construction loan agreement, and in accordance with any plans and specifications for any such improvements, approved or to be approved by the Association; (b) pay, or cause to be paid, all claims for labor or materials, or both, performed or furnished in connection with any such work of improvement; and (c) cause the prompt release of record of any mechanic's lien or liens recorded against any part of such property.

2. *Independence of guarantors' obligations.* The obligations of the Guarantors hereunder are independent of the obligations of the Borrower, and a separate action, or actions, may be brought and prosecuted against the Guarantors, whether action is brought against the Borrower or whether the Borrower be joined in any such action or actions.

3. *Effect of waiver or modification.* The Guarantors consent to indulgences and extensions of time on the part of the Association being afforded to the Borrower, the waiver from time to time by the Association of any right or remedy on its part as against the Borrower, and any and all modifications, supplementations, or amendments of and to the agreement, or agreements, between the Association and the Borrower. The Guarantors hereby agree that no act or omission on the part of the Association, nor any agreement, modification, supplementation, or amendment thereof or of any other agreement between the Association and the Borrower, shall in any wise or manner affect or modify the obligation and liability of the Guarantors hereunder, and shall have the same force and effect as if the Guarantors were joint and several debtors with the Borrower to the Association.

4. *Attorney's fees.* In the event any action or proceeding be brought by the Association to enforce this guaranty, or the Association appears in any action or proceeding in any way connected with or growing out of this guaranty, then and in any such event the Guarantors agree to pay to the Association reasonable attorney's fees, but only if the Association is successful in obtaining judgment.

5. *Duration.* This guaranty shall continue in force until construction as contemplated in the construction loan agreement has been completed, and thereafter until sufficient time has elapsed to secure the Association from all statutory liens for work and material, or, in the alternative, until the Association has been supplied with a standard endorsement to a title policy securing the Association against any such liens for work or materials.

John Dill _____ (L.S.)

Edward Rollins _____ (L.S.)

Thomas Fays _____ (L.S.)

E.11 Construction loan agreement--commercial construction--loan predicated upon commitment for long-term financing--security interest to cover personal property

COMMENT

Frequently, the lender may require a commitment for permanent long-term financing. The permanent loan will be committed before construction is started, and the proceeds will provide the funds for repayment of the construction loan. In this case, the construction loan is granted on the condition that a specified permanent loan commitment has been made. The borrower agrees to complete construction by a certain date, and repayment of the construction loan falls due shortly thereafter. Normally, the permanent loan will be closed on or about the date the construction loan is to be repaid. In some situations, the arrangement between the borrower, the construction lender, and the long-term lender is contained in one instrument, commonly referred to as a buy-sell agreement. If the improvements are to

be sold following construction, the lender will not be as concerned with the availability of permanent financing.

Security interest in personal property:

Additional security for the lender is provided by the fact that personal property to be installed will be part of the mortgaged premises. Before the full amount of the loan is made available, the borrower is to install the personal property. The borrower will execute and deliver a security agreement when and if requested by the lender. This clause permits the lender to perfect its security interest in the personal property, and fixtures, under Article 9 of the jurisdiction's Uniform Commercial Code. A financing statement is filed in the appropriate office to protect the lender against competing security interests and claims.

Lien priority:

The relative priority of the liens of contractors, materialmen, and laborers obviously affects the lender's position. The local rules vary from granting such liens preference over interests recorded earlier to basing priority on the order of recording. In this instance, the lender's priority over such liens is protected if no work is commenced prior to the recording of the deed of trust securing the construction loan. Depending upon local law, a different form of protection, such as a separate agreement executed by the contractor, may be secured.

Lender protection:

Other forms of protection are contained in this instrument: the lender approves the original plans and has the right to supervise construction in order to make certain that such plans are adhered to; advances are to be made according to the stages of production completed to the satisfaction of the lender; and the borrower is to maintain adequate insurance and obtain a certificate of occupancy and any other form of approval of use required by governmental authorities.

Tax aspects:

No gain or loss results for tax purposes upon the borrowing or complete repayment of a loan, or the delivery or termination of a mortgage.

For further information, see Chapters 11, 12, and 19.

FORM

AGREEMENT made January 8, 2002, between Sandy Point Builders, Inc., a Delaware corporation with its principal place of business at 101 Massachusetts Avenue NE, Washington, D.C. (the "Borrower"), and Spring Lake Trust Company, a Virginia corporation having an office and its principal place of business at 120 Roanoke Street, Richmond, Virginia (the "Lender").

Whereas the Borrower owns the land described in Schedule A, hereto annexed and made a part hereof, and has applied to the Lender for a loan of \$3,000,000 to aid the Borrower in erecting and equipping on such land the building and other improvements described in Schedule B, hereto annexed and made a part hereof (the "Building"), and

Whereas the Lender has agreed to make the loan upon the terms, covenants, and conditions hereinafter set forth, and the Borrower has agreed to take such loan, and

Whereas Richmond Life Insurance Company, a Virginia corporation with its principal place of business at 300 Madison Avenue, Richmond, Virginia (the "Long-Term Lender"), has issued a commitment dated January 2, 2002, to make a \$3,000,000 long-term loan to the Borrower, to be evidenced by a note in that amount and to be secured by a deed of trust conveying the land described in Schedule A, on and subject to the terms and conditions set forth in such commitment,

Now, therefore, in consideration of the mutual promises herein after contained and of other valuable consideration, the parties hereto agree as follows:

1. *Agreement to make loan.* Subject to the terms hereof, the Borrower shall take, and the Lender shall make a loan in the principal sum of \$3,000,000 (the "Loan"), to be advanced as provided below. Such loan shall be evidenced by the Borrower's promissory note of even date herewith for such amount, and made payable to the order of the Lender on March 1, 2004, or such earlier date as may be provided in the note. Interest shall accrue from the date of each advance at the rate of 8 percent per annum, payable monthly on the first day of each and every month until the note is fully paid. The note shall contain such other terms and provisions as the Lender and Long-Term Lender shall determine are needed for their protection. Such note shall be secured by a deed of trust of even date herewith (the "Deed of Trust"), on the fee title to the land described in Exhibit A (the "Property").

2. *Construction by borrower.* The Borrower shall erect and complete on the Property on or before December 31, 2003, the Building substantially in accordance with the plans and specifications therefor to be filed with and duly approved by all governmental authorities having jurisdiction in respect thereof. Such plans and specifications for the Building shall be submitted to and approved by the Lender and the Long-Term Lender and shall be initially for identification by the parties hereto and the Long-Term Lender. The plans and specifications shall not, however, be deemed to be complete or finally approved unless they include provisions for the installation of all sidewalks, curbs, gutters, landscaping, utility connections, and all essential equipment required by and necessary for the operation of the completed Building. After approval of such plans and specifications, all changes therein must be approved by the Lender, and the Lender may also require the prior approval of the Long-Term Lender.

3. *Protection against prior liens.* The Borrower represents and promises that no excavating or work of any character has been or will be commenced, nor any material of any description delivered on or near the Property for the erection of the Building, prior to the recording of the Deed of Trust.

4. *First deed of trust on land and personal property.* The Lender shall not be obligated to make any advances hereunder unless the Deed of Trust is a valid and enforceable first lien on the Property and the Building, except for taxes and assessments not yet due and payable and other liens, if any, acceptable to the Lender. All fixtures and articles of personal property to be installed in the Building or on the Property or used in the operation thereof by the Borrower (including, without limitation, all furniture, furnishings, fixtures, decor, business and service equipment, linen, china, silverware, and glassware) shall form part of the mortgaged premises covered by and subject to the lien of the Deed of Trust. The Borrower shall, at its own expense, execute and deliver, as additional security for the payment of the note, when and if requested so to do by the Lender or Long-Term Lender, a Security Agreement, in form and substance acceptable to the Lender and the Long-Term Lender, on all fixtures and articles of personal property that may hereafter be installed or placed in the Building or on the Property.

5. *Fees paid by borrower.* The Borrower, at the time fixed for the delivery of the note and Deed of Trust, shall pay all fees heretofore agreed to be paid to the Lender, the expense of examination of title, mortgagee's title insurance in such amount and form as may be satisfactory to the Lender, the recording fee and tax upon the Deed of Trust, and any present or future assignment or assignments or collateral security, if any, required by the Lender. The Borrower shall, at its expense, furnish a survey to the Lender at the time the first advance is made hereunder and shall also furnish to the Lender such other and additional surveys during the course of construction, including a survey after the completion of

construction, as may be required by the Lender, all at the expense of the Borrower. No advances shall be made to the Borrower unless title to the Property is satisfactory to the Lender's counsel at the time such advance is requested and due. In case the Lender pays or advances any money for fees, surveys, recording, recording tax, examination of title, mortgagee's title insurance policies, preparation of loan documents, and any expenses incurred in the procuring and making of the loan, and in the payment of any insurance premiums, encumbrance, tax, assessment or other charge or lien upon the property, and any other amounts necessary for the payment of the cost of improvements, the Lender may reimburse itself out of any subsequent advances to be made in accordance herewith, and such reimbursement shall be deemed an advance under this agreement and secured by the note and Deed of Trust.

6. *Disbursements of loan.* Advances upon the note and Deed of Trust shall be made at such times and in such amounts as the Lender shall determine, but shall be substantially in accordance with the schedule contained in Schedule C hereto annexed and made a part hereof. The making of an advance or any part of an advance shall not be deemed an approval by the Lender of the work theretofore done. When requested, the Borrower shall exhibit to the Lender satisfactory evidence, by receipts or other vouchers, that there are no outstanding overdue claims and demands for labor and materials used in the Building, before each or any payment shall be due or demandable under this agreement. The title company shall furnish the Lender with a summary of the title before any payment is made. If any notice of lien be filed against the Property, or any part thereof, under the law commonly called the Mechanics' Lien Law, the Lender may suspend further payments under this agreement until such lien shall have been discharged of record, or may satisfy such lien and deduct the amount paid on account thereof from the money in its hands.

No advance shall be due unless, in the judgment of the Lender, all work usually done at the stage of construction when the advance is made payable is done in a good and workmanlike manner, and all material and fixtures usually furnished and installed at this time are furnished and installed, but the Lender may advance parts or the whole of any installments before they become due if the Lender believes it advisable so to do. All such advances or payments shall be deemed to have been made in pursuance of this agreement and not in modification thereof.

The Lender may require five-days' notice in writing from the Borrower before an advance shall be called for. All advances are to be made at the office of the Lender or at such other place as it shall designate.

7. *Extension of time for repayment.* The Lender or any holder of the note and Deed of Trust referred to above may extend the time of payment of the principal evidenced and secured by such note and Deed of Trust, and any extension so granted shall be deemed to be made in pursuance of this agreement and not in modification thereof.

8. *Installation of personal property.* On or before the making of the final advance hereunder, the Borrower shall install all furniture and equipment required for the operation of the Building as a Class A transient hotel, including, without limitation, all furniture, furnishings, fixtures, decor, business and service equipment, linen, china, silverware, and glassware. Prior to such final advance, the Borrower shall also exhibit to the Lender the final certificates of approval of the various governmental authorities having jurisdiction, including a final certificate of occupancy or a temporary certificate of occupancy for the entire Building, hotel, restaurant, bar, public assembly, and other operating permits, and the certificate of the board of fire underwriters acting in and for the locality in which the Property is situated, and thereafter the Borrower shall furnish the Lender with photocopies of each such certificate and permit.

9. *Fire insurance.* The Borrower shall furnish to the Lender, with premiums prepaid, or the Lender may procure at the expense of the Borrower, in companies and in amounts satisfactory to the Lender, insurance policies insuring the Property against loss or damage by fire and other hazards as the Lender may reasonably require. In any event, the amount of insurance in effect at any time shall be no less than the amount advanced under the loan agreement up to that point in time, or the cost of replacement of the improvements made and on-site materials, whichever amount is greater.

10. *Effect of borrower's default.* If the construction of the Building is at any time discontinued (unless such discontinuance is due to strikes or force majeure) or abandoned for a period of 20-consecutive days, or if the Borrower

does not proceed continuously with the erection and completion of the Building in such manner as reasonably to insure completion on or before the date herein specified, the Lender may, at its option, at any time thereafter take possession of the Property together with all materials, equipment, and improvements thereon, whether affixed to the realty or not, and perform any and all work and labor necessary to complete the improvements substantially according to the plans and specifications referred to in this agreement, and at the Borrower's expense may employ a watchman to protect the Property from theft or injury. For this purpose, the Borrower hereby appoints the Lender its true and lawful attorney-in-fact with full power of substitution in the premises to complete the project in the name of the Borrower and pay all bills and expenses incurred thereby and hereby empowers such attorney-in-fact to use any funds of the Borrower, including any balance which may not have been advanced for the purpose of completing improvements; to make such additions and changes and corrections in the plans and specifications which shall be necessary or desirable to complete the improvements in substantially the manner contemplated in the plans and specifications; to employ such contractor, subcontractors, agents, architects, and inspectors as shall be required for such purposes; to pay, settle, or compromise all existing bills and claims which may be or become liens against the Property or which may be necessary or desirable for the completion of improvements or for the clearance of title; to retain or deposit with the United States District Court for the District of Columbia a sum sufficient to discharge any mechanic's lien or other liens that may be filed against the Property; to execute all applications, certificates, or instruments in the name of the Borrower which may be required by any governmental authority or contract; and to do any act which the Borrower might do in its own behalf. This power of attorney shall be deemed to be a power coupled with an interest and cannot be revoked. The attorney-in-fact shall also have power to prosecute and defend all actions and proceedings in connection with the construction of the Building and to take such action and require such performance under any surety or other bond or other obligation or to execute in the name of the Borrower such further bonds or obligations as may be reasonably required in connection with construction work. The Borrower hereby assigns and quitclaims to the Lender all sums unadvanced under such Deed of Trust conditioned upon the use of such sums in trust for the completion of the improvements, such assignment to become effective only in case of the Borrower's default. All sums paid or expended in accordance with any of the foregoing provisions shall be deemed advances to the Borrower and secured by such note and Deed of Trust and may be applied at the option of the Lender or any other holder of the note and Deed of Trust to any advances thereafter becoming due. The Lender shall be under no obligation to do any of the things provided in this paragraph, and instead may exercise any of the remedies provided for hereunder or under the Deed of Trust, including, without limitation, the termination of this agreement, in which event the entire indebtedness shall be and become immediately due and payable at the election of the Lender.

11. *Assignment by borrower.* In the event the Borrower shall part with or be in any way deprived of title to the Property, the Lender may, at its option, continue to make advances under this agreement, subject to all its terms and conditions, to such persons or corporations as may succeed to the Borrower's title. All sums so advanced by the Lender shall be secured by the note and Deed of Trust.

12. *Events of default.* If any of the following events shall occur, all of the Lender's obligations to make the loan or to make any further advance shall, if the Lender so elects, cease and terminate, and the note shall at the option of the holder thereof become immediately due and payable, but the Lender may make advances without becoming liable to make any other advances:

- (a) If the Deed of Trust offered by the Borrower shall not give to the Lender a first lien on the Property for the indebtedness to be secured thereby, satisfactory to the Lender's attorney.
- (b) If the Property is encumbered in any way without the Lender's consent.
- (c) If improvements on the Property shall, in the opinion of the Lender's attorney, materially encroach upon the street or upon adjoining property.
- (d) If the Borrower does not take the loan or the advances within 30 days after they are made payable, or the Building is

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not fully completed and open to the public as an operating hotel by December 31, 1995.

(e) If the improvements on the Property are, in the Lender's reasonable judgment, materially injured or destroyed by fire or otherwise.

(f) If the Borrower shall fail to comply with any of the covenants contained in this agreement, the note, or the Deed of Trust.

(g) If a petition in bankruptcy is filed by or against the Borrower, or a receiver or trustee of the property of the Borrower is appointed; or if the Borrower files a petition for reorganization under any provision of the Bankruptcy Law or of any other state or federal law, or makes an assignment for the benefit of creditors, or is adjudged insolvent by any state or federal court of competent jurisdiction.

(h) If the Borrower does not erect the Building in accordance with the plans and specifications initialled by the Lender, the Borrower, and the Long-Term Lender and approved by the governmental authorities having jurisdiction, except as such plans and specifications may be changed by mutual consent.

(i) If the Borrower does not permit the Lender, or the Lender's representatives, to enter upon the Property to inspect the Building thereon at all reasonable times and examine all detailed plans, shop drawings, and specifications which are kept at the work, or fails to furnish to them, when requested, copies of such plans, drawings, and specifications.

(j) If the construction of the Building is not carried on with reasonable dispatch, in the judgment of the Lender.

(k) If the Borrower executes any security agreement, except to the Lender, covering any materials, fixtures, or articles used in the construction of the Building or covering articles of personal property placed in the Building, or grants any security interest in the foregoing, except to the Lender, or if any of such materials, fixtures, or articles is not purchased so that the ownership thereof will vest unconditionally in the Borrower, free from encumbrance, on delivery at the Property.

(l) If the Borrower fails to comply with any requirement of any governmental authority having jurisdiction within 30 days after notice in writing of such requirement shall have been given to the Borrower, or fails to furnish to the Lender, when requested, departmental searches made by governmental authorities having jurisdiction.

(m) If the Borrower does not disclose to the Lender, upon demand, the names of all persons with whom the Borrower contracted or intends to contract for the construction of the Building or the furnishing of labor or materials therefor.

13. *Application of proceeds.* The Borrower shall receive the advances to be made hereunder and to be secured by the Deed of Trust as a trust fund to be applied, first, for the purpose of paying the cost of improvement of the Property before using any part of such advances for any other purposes; provided that nothing herein shall impose upon the Lender any obligation to see to the proper application of such advances by the Borrower.

14. *Effect of agreement on note and deed of trust.* The note and Deed of Trust to be executed, acknowledged, and delivered pursuant to this agreement shall be subject to all the conditions, stipulations, agreements, and covenants contained in this agreement to the same extent as if the agreement were fully set forth and made part of such note and Deed of Trust, until this agreement is terminated by the completion of the Building described herein and the making of the final advance hereunder as provided for herein.

15. *Affidavits by borrower's officers.* The Borrower shall deliver to the Lender, and the Long-Term Lender, upon demand, and so often as called upon, an affidavit of the president or the secretary or other principal officer of the Borrower to the effect that all the chattels, fixtures, attachments, and equipment and all other personal and other

property now or hereafter delivered upon, attached to, or used in connection with the construction of the Building or the operation thereof, except owned or installed by tenants of the Borrower, are free and clear of all security interests and from all liens and encumbrances whatsoever, except the security interest given to the Lender, and that the Borrower is the absolute owner of such chattels, fixtures, attachments, and equipment.

16. *Discovery of adverse environmental conditions.* In the event that an adverse environmental condition is discovered or occurs upon the premises described in Schedule A, annexed hereto, Lender shall be under no obligation to make further advances to Borrower until such time as the adverse condition is satisfactorily remediated by Borrower or its agents. The determination of whether an adverse environmental condition exists shall be made in the sole discretion of Lender. Lender shall have the right to inspect the site and perform any tests Lender or its consultants may deem necessary or appropriate. The determination of whether the adverse condition has been satisfactorily remediated shall be made by Lender, in its sole discretion. Lender shall be entitled to require Borrower to meet all federal, state and local laws, regulations and policies pertaining to remediation.

Borrower shall also have a fiduciary duty to report to Lender any information in the possession of Borrower, its employees or agents, regarding environmental conditions on the real property described in Schedule A, annexed hereto. Failure to report such information shall be an event of default under the terms of this loan agreement.

17. *Right to receive advances.* The obligation of Lender to make advances hereunder shall be subject to the obligation of Borrower to comply with all of the terms of this agreement. In the event that Borrower is in default in any manner, Lender shall be under no obligation to make further advances until the default is fully cured.

18. *Amendment to agreement.* This agreement may not be changed orally, but only by an agreement in writing and signed by the party against whom enforcement of any waiver, change, modification, or discharge is sought.

19. *Title insurance.* No advance shall be due unless the Borrower furnishes to the Lender before the execution of this agreement title insurance policies in the amount of the loan, issued by title insurance companies satisfactory to the Lender, insuring the interest of the Lender as a valid first lien on the Property, free and clear of all prior liens, encumbrances, and exceptions to title whatsoever, other than those previously approved in writing by the Lender and the Long-Term Lender. It shall be a condition precedent to each advance that such title companies will continue their searches to the date of each advance and shall certify to the Lender in writing that such continuations disclose no liens, encumbrances, or exceptions to title.

20. *Application of agreement.* This agreement is made for the sole protection and benefit of the Borrower, the Lender, and the Long-Term Lender, and no other person shall be deemed to have a right of action of any kind hereunder.

21. *Architect.* The supervising architect for the erection of the Building shall be Philip Adams of 55 Connecticut Avenue NE, Washington, D.C. If Philip Adams shall be, or for any reason may become, disqualified or unable to act or to continue to act as supervising architect, the supervising architect to be named in his place, and any succeeding supervising architect, shall be satisfactory to, and approved by, the Lender and the Long-Term Lender.

22. *Long-term loan.* The Borrower represents that it has a commitment from the Long-Term Lender to make a long-term loan of \$3,000,000 to the Borrower and the Borrower understands that the Lender is willing to make this loan for the term recited because of such commitment. The Borrower, by its proper officers, shall be present at the closing of the loan provided for in the Long-Term Lender's commitment of January 2, 1994, and shall execute all such documents and otherwise perform and meet all requirements, conditions, and provisions of such commitment to the end that the loan provided for therein shall be consummated and the proceeds thereof used solely, to the extent required, fully to satisfy and fully to pay the principal and interest of the loan herein provided for. The Borrower shall notify the Lender ten days in advance of the time and place of its closing with the Long-Term Lender.

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23. *Notice.* Notices from the Lender to the Borrower may be given by mailing the same to the Borrower at 101 Massachusetts Avenue NE, Washington, D.C., and any notice so given shall be deemed to be sufficient for all purposes.

24. *Entire agreement.* This agreement supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

25. *Non-waiver.* No delay or failure by either party to exercise any right under this agreement, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

26. *Headings.* Headings in this agreement are for convenience only and shall not be used to interpret or construe its provisions.

27. *Governing law.* This agreement shall be construed in accordance with and governed by the laws of the State of Virginia.

28. *Counterparts.* This agreement may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

29. *Binding effect.* The provisions of this agreement shall be binding upon and inure to the benefit of each of the parties and their respective legal representatives, successors, and assigns.

In witness whereof the parties hereto have caused this instrument to be signed in their respective corporate names and to be attested under their respective corporate seals.

Attest:	Sandy Point Builders, Inc.
_____	by _____
Secretary	President
Attest:	Spring Lake Trust Company
_____	by _____
Secretary	President

E.12 Commercial note and mortgage

COMMENT

Traditionally, the lender's first preference in securing a commercial loan has been a mortgage on the property that will benefit from the loan. However, the fondness for this arrangement has diminished somewhat in recent years as commercial and residential real estate values across the nation have dropped--in some cases by very large percentages.

Despite this and other problems in collateralizing a loan using the underlying real property as security, most lenders still require a mortgage on the premises being built by the developer. The material that follows includes both a commercial mortgage and a promissory note.

Promissory note:

The note provides for an adjustable interest rate that is tied to the prime lending rate. The interest rate adjusts immediately in response to fluctuations in the prime. The borrower "draws down" (i.e., receives gradual disbursements of loan funds) on the note pursuant to a building loan agreement already executed by the lender and the borrower.

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Until the loan is fully disbursed, only interest payments are made by the borrower. After full disbursement of the loan proceeds occurs, amortizing payments of the principal begin.

The lender should carefully review the developer's title to the property before each disbursement is made in order to be certain that no intervening liens have been filed against the property. Such liens would take precedence over the lender's right to be repaid for any disbursements made after the liens were filed.

Mortgage:

The mortgage contains an interesting provision allowing the release of a lot from the terms of the mortgage upon payment of a specified sum. (See Paragraph 30.) This permits the construction and sale of individual dwelling units upon the released lots. The mortgage provides that the developer must not be in default at the time a release is granted. In the event that a default has already occurred, it must be fully cured before the developer is entitled to a release.

For further information, see Chapters 11, 12, and 19.

FORM

NOTE

_____, \$ _____
 __, 20 ____
 [insert amount of note]

The undersigned, _____ [_____ insert name of borrower], hereby promises to pay the sum of \$ _____, together with interest thereon at an annual rate which is _____ percent (_____ %) greater than the Lender's prime rate, to the order of Lender at _____ [insert lender's address], or at such other place as Lender may designate, as follows:

By paying interest only on the sums advanced pursuant to the terms of a certain building loan agreement of even date herewith until the earlier of the complete disbursement of the loan proceeds or _____, 20 _____. Thereafter, the payment of _____ [insert number] monthly installments of principal and accrued interest in an amount necessary to amortize the loan evidenced hereby for a term of _____ years, commencing _____, 20 _____, and continuing on the first day of each successive month thereafter to and including _____, 20 _____, when the entire unpaid principal balance and accrued interest, in any, shall be due and payable in full.

Changes in the interest rate resulting from changes in the prime rate shall be effective immediately. Upon any change in the interest rate, the amount of the monthly payment of principal and interest shall be adjusted to amortize the remaining balance over the remaining term of the loan at the adjusted rate. Notwithstanding the foregoing, Borrower, at his option, may draw down on the loan in amounts of not less than \$100,000 each.

Borrower shall give five (5) days' notice to Lender before each draw down. Lender shall be entitled to make a review of the title to the premises before each draw down. If any liens of any nature are placed against the premises, or if any conveyances have occurred without permission of Lender, Borrower shall not be entitled to further draw downs, and the

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amortization of the loan shall begin on the first day of the next month.

All payments shall be applied first to late charges, then to accrued interest, and then to principal. Interest shall continue to accrue until the entire balance is paid in full. Notwithstanding any provision contained herein, the interest rate to be paid hereunder shall not exceed the maximum rate allowed by law.

Presentment for payment, notice of dishonor, protest and notice of protest are hereby waived.

As used herein, the term "prime rate" shall mean the rate of interest publicly announced by Lender, from time to time, as its prime rate.

Borrower shall have the right to prepay the whole or any part of the principal at any time without penalty.

In the event that any payment shall not be paid within ten (10) days of its due date, an additional charge of six cents (6cent(s)) for each dollar so due shall be assessed to offset the additional costs and expenses of Lender due to such late payment.

This Note shall be secured by a mortgage. The terms of the mortgage shall be deemed a part of this Note as if fully set forth herein. A default in the terms of the mortgage or building loan agreement shall be deemed a default under the terms of this Note and shall entitle the holder to declare the entire sum immediately due and payable.

The terms of this note shall not be changed or terminated orally.

The failure of Lender to require strict performance of any of the terms or provisions of this Note shall not act as a waiver or release of such terms or provisions.

Borrower

MORTGAGE

This MORTGAGE, made the _____ day of _____, 20____, between _____ INC., a corporation formed under the laws of the State of _____ with offices for the conduct of business located at _____ (hereafter known as the Borrower), and _____, a banking corporation organized and existing under the laws of the State of _____, having its principal place of business at _____, in the City of _____, County of _____, and State of _____ (hereafter known as Lender)

WITNESSETH, that in order to secure the payment of an indebtedness in the principal sum of _____ Dollars (\$ _____), lawful money of the United States of America, with interest thereon, all to be paid according to a certain bond or note and building loan agreement bearing even date herewith, and also any and all further loans or indebtedness owed or to be owed by the Borrower, or any subsequent owner of the mortgaged premises, to the Lender, the Borrower hereby mortgages to the Lender

ALL THAT CERTAIN PARCEL OF LAND, with the buildings and improvements thereon erected, commonly known as Street No. _____, City of _____, State of _____, and more

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particularly described in "Schedule A", annexed hereto and made a part hereof, being the same premises conveyed to the Borrower herein by deed dated _____, 20 _____, and recorded in the office of the _____ County Clerk, in book number _____, at page _____.

TOGETHER with all right, title and interest of the Borrower, of, in, and to any land lying in the bed of any street, road or highway, in front, behind, or adjacent to the premises above described:

TOGETHER with all fixtures and articles of personal property, now or hereafter affixed to, or used in connection with, the premises or Borrower's business, all of which are covered by the lien of this Mortgage;

TOGETHER with the appurtenances, and all the estate and rights of the Borrower in and to said premises;

And the Borrower covenants and agrees with the Lender as follows:

1. *Mortgage subject to building loan agreement.* This mortgage is subject to the terms of a certain building loan agreement of even date herewith, to be filed with the County Clerk simultaneously herewith.

2. *Borrower to pay back loan.* The Borrower will pay the indebtedness, as provided in the accompanying bond or note, in a timely fashion. The terms, conditions and covenants of the bond or note secured hereby are made a part of this Mortgage. Said terms, conditions and covenants are incorporated by reference, with the same legal effect as if fully set forth hereat.

3. *Borrower to keep mortgaged premises insured.* The Borrower will keep the buildings and other improvements located on the premises, together with all fixtures and personalty covered hereby, insured for the benefit of the Lender against loss by fire and such other casualties as may be required by the Lender, by such companies as are acceptable to the Lender. Said insurance will be in the amount of the remaining principal balance of the Mortgage or the full replacement value of the buildings, other improvements, fixtures and personalty, and building materials stored on site covered by the lien of this Mortgage, whichever is greater. Borrower will assign and deliver the policies to the Lender, and he will reimburse the Lender for any premium payments for insurance made by the Lender because of the Borrower's failure to so insure as required herein or because of Borrower's failure to so assign and deliver the said insurance policies.

4. *Borrower warrants title to premises.* The Borrower hereby warrants title to the premises, fixtures and personal property mortgaged hereby and will defend and maintain the lien of this Mortgage as a valid first lien on the premises.

5. *Borrower to maintain mortgaged premises in good state of repair.* The Borrower affirmatively covenants to maintain the buildings on said premises in good repair. Borrower will not alter, demolish or remove any building, fixture or personal property mortgaged hereby, or any part thereof, without obtaining the written consent of the Lender in advance. Borrower will not suffer or permit any waste on the premises. Borrower will comply with all statutes, orders, and requirements of the federal, state, and municipal governments, or any departments or bureaus thereof, having jurisdiction over the premises covered by the lien of this Mortgage. The holder of this Mortgage, its successors, assigns, officers or agents, shall have the right to inspect the mortgaged premises from time to time at any reasonable hour of the day without advance notice to the Borrower.

6. *Default and acceleration of loan repayments.* The whole of said principal sum and interest shall become due and payable at the option of the Lender: after default in the payment of any installment of principal and/or of interest for thirty (30) days; or after default for thirty (30) days in the payment of any other sum required to be paid by the Borrower to the Lender under this Mortgage or under the terms of the bond or note secured hereby; or after default in the payment of any tax, special assessment, water rent, sewer rent or other assessment, which may become a lien against the property covered by the lien of this Mortgage, for thirty (30) days after the same becomes due and payable; or after

default (following notice and demand) either in assigning and delivering the policies of insurance for the buildings and improvements which insure Lender against loss by fire or other casualty, or in reimbursing the Lender for premiums paid on such insurance, as herein before provided; or after default (following request) in furnishing a statement of the amount due on the Mortgage and whether Borrower has any claim of offsets or defenses against the Mortgage debt, as hereinafter provided; or after any other default under the terms, covenants or conditions of this mortgage, or of the bond or note secured hereby, or upon the commencement by any party of an action or proceeding for the foreclosure or enforcement of any lien alleged to be filed against the mortgaged premises.

7. Receiver of rents to be appointed following institution of action to foreclose. The holder of this mortgage, in any action to foreclose this Mortgage, shall be entitled to the appointment of a receiver of rents without notice to the Borrower and without regard to the adequacy of any security for the debt.

8. Borrower to surrender possession of mortgaged premises after default. After any default hereunder, the Borrower shall, upon demand, surrender possession of the premises to the Lender. After any such default, the Lender may enter upon the premises or any part thereof. Lender may lease the same to third parties and collect the rents, income and profits therefrom, which are due or become due, and apply the same, after payment of all charges and expenses of entry and management, to the account of the Borrower. The Borrower hereby assigns to the Lender all of the said rents, income and profits and all the leases existing at the time of such default. This assignment shall act as further security for the payment of the indebtedness. Such entry, by or on behalf of the Lender, shall not be deemed to constitute the Lender a "Lender in possession." If the Borrower remains in possession thereof after any such default, the Borrower shall be a tenant of the Lender. In such case, the Borrower agrees to pay upon demand and in advance to the Lender a reasonable monthly rental fee for the premises or the portion so occupied by Borrower. The Lender may also dispossess, by summary proceedings or otherwise, any tenant of the Borrower, if such party fails to pay the rental fee as herein described. This provision shall, at the option of the Lender, become operative immediately after the happening of any event of default and without regard to whether foreclosure proceedings have been instituted and without application for the appointment of a receiver. In the event that a receiver of such rents, income or profits is so appointed, this provision shall inure to the benefit of such receiver.

9. Borrower to pay lender's attorneys' fees and other related costs in event of foreclosure. If any action or proceeding is commenced by the Lender to foreclose this Mortgage or to collect the indebtedness, the Borrower agrees to pay to the Lender statutory costs, expenses and reasonable attorneys' fees in connection with such action or proceeding. The said costs, expenses and attorneys' fees shall be deemed to be secured by the lien this Mortgage. The said costs, expenses and attorneys' fees may be collected as part of the foreclosure or as part of some other action or proceeding. The said costs, expenses and attorneys' fees shall be a lien on the premises covered by this Mortgage, existing prior to any right or title to, interest in, or claim upon, the premises attaching or accruing subsequent to the lien hereof.

10. Following foreclosure, premises may be sold in one or more parcels. If the lien of this Mortgage is foreclosed, the premises covered hereunder may be sold in one or more parcels, at the option and discretion of the Lender, subject to any provision of the law.

11. Borrower to reimburse lender for expenses arising from certain types of litigation. If any action or proceeding is commenced to which the Lender, by virtue of being Lender hereunder, becomes a party, the Borrower will reimburse the Lender for its expenses in connection therewith, including, but not limited to, legal fees and court costs.

12. Borrower to pay all taxes, assessments, water rents, etc. The Borrower will pay all taxes, assessments, water rents or sewer rents when due. If Borrower fails to do so, the Lender may pay the same. Borrower shall reimburse Lender therefor upon demand, together with interest at the note rate.

13. Upon request, borrower will furnish lender with statement of amount due on mortgage. The Borrower, within five (5) days of request made in person, or within ten (10) days of request made by mail, will furnish a written statement,

duly acknowledged before a notary public, of the amount due on this mortgage, and whether any offsets or defenses to payment of the mortgage debt exist.

14. *Notice and demand must be in writing.* Any notice and demand permitted or required hereunder shall be in writing and shall be served in person or by certified mail, return receipt requested.

15. *Abandonment of mortgaged premises by borrower.* If the premises covered by the lien of this Mortgage, or any part thereof, shall be abandoned or vacated by the Borrower, or by the then-owner thereof, the Lender shall have the right to enter upon and take possession of the premises to protect and conserve its security. Lender shall be vested with all usual powers of a Lender in possession.

16. *Borrower covenants that it has made no pledge or assignment of any rents, issues or profits.* Borrower has made no pledge or assignment of any of the rents, issues or profits of the said mortgaged premises, or any part thereof. Borrower has not accepted prepayment of rents. Borrower will not further pledge or assign such rents, or any part thereof, during the term of this Mortgage without the written consent of the Lender, in advance.

17. *Tax law changes.* In the event that any law is passed which changes in any way the laws for the taxation of mortgages or debts secured by mortgages, the Lender shall have the right to give thirty (30) days' written notice to the Borrower and require the payment of the indebtedness in full. If such notice is given, the indebtedness secured by the lien of this Mortgage shall become immediately due and payable at the expiration of said thirty (30) days.

18. *Failure of lender to require strict performance is not waiver or release of its rights.* If Lender fails at any time to require the strict performance of any of the terms or covenants of this Mortgage, said failure shall not act as a waiver or release of such terms or covenants.

19. *Modifications of terms contained in accompanying note or bond.* Any of the terms of the bond or note secured hereby may, at any time, be modified or altered by the Lender with the consent of the Borrower or the then-owner of the mortgaged premises, without impairing or affecting the priority of the lien of this Mortgage with respect to any subsequent lien or encumbrance.

20. *Release of portion of mortgaged premises.* The Lender may, at any time, release any portion of the mortgaged premises, or any fixtures or other personal property pledged or assigned to it as additional security for the payment of the bond or note and indebtedness secured by this Mortgage, without regard to the consideration for such release. Lender may accept other securities or other personal property in place thereof without being accountable to any other lienholder.

21. *Certain other events that will accelerate repayment of loan.* In the event that the premises subject to the lien of this Mortgage are sold, transferred, made subject to a "land sale" contract, or leased for a period exceeding two (2) years, or are otherwise conveyed, voluntarily or involuntarily, while this Mortgage shall remain a lien thereon, this Mortgage and the bond or note secured thereby shall, at the option of the Lender, become immediately due and payable. A transfer of stock ownership of the Borrower to another entity or to other principals to such an extent as would place the control of the Borrower in other than the current two (2) principal shareholders, or a change in ownership of shares constituting more than ten (10) percent of the outstanding and issued shares of the Borrower, shall be deemed a sale of the premises and will entitle Lender to demand payment in full of the outstanding balance.

22. *Copy of annual operating statement for lender.* The Borrower will furnish to the Lender the annual operating statement for the premises and/or financial statements of the Borrower in a form satisfactory to Lender within thirty (30) days after the close of Borrower's fiscal year, together with copies of Borrower's state and federal income tax returns.

23. *Borrower is corporation.* Borrower represents that it is a corporation. Neither its certificate of incorporation, any

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amendment thereto, nor its by-laws requires the consent of shareholders to the execution and delivery of this Mortgage. The execution and delivery of this Mortgage and the note or bond secured thereby have been duly authorized by its Board of Directors at a duly-called meeting.

24. *Terms in mortgage pertaining to number and gender of parties.* If more than one person joins in the execution of this Mortgage, the relative words herein shall be read as if written in the plural. If any Borrower be of the female gender, the relative words herein shall be read as if written in the feminine gender. If more than one person joins in the execution of this Mortgage, all the obligations herein contained shall be construed to be the joint and several obligations of all the said persons. If the Borrower is a corporation, all relative words shall be read as if written in the neuter gender.

25. *Maximum amount of mortgage.* The maximum amount secured by this Mortgage is the sum of \$ _____. This maximum amount shall be increased by the amount of any statutory costs, expenses and legal fees incurred by the Lender in any foreclosure or lawsuit. The maximum amount shall also be increased by the amount of any taxes or insurance premiums paid by Lender hereunder.

26. *Flood insurance.* The Borrower, its heirs, successors and assigns will, if required, keep the mortgaged premises insured against loss by flood under the provisions of the *Federal Flood Disaster Protection Act of 1973* for the benefit of Lender, up to the amount of the Mortgage debt or the maximum amount of coverage available. In the event of failure to obtain such insurance, the holder of the Mortgage may, at its option, insure the premises in the above manner and add the premiums therefor to the principal debt secured by this Mortgage.

27. *Agreement may not be orally amended, terminated or changed.* The terms of this Mortgage may not be amended, terminated or otherwise changed orally. The covenants contained in this Mortgage shall run with the land and bind the Borrower, the heirs, personal representatives, successors and assigns of the Borrower, and all subsequent owners, encumbrancers, tenants and subtenants of the premises. The covenants contained herein shall inure to the benefit of the Lender, its successors, assigns and all subsequent holders of this mortgage.

28. *Mortgage secures note.* This mortgage secures a note which has a variable interest rate.

29. *Sale of portion of mortgaged premises.* Notwithstanding anything to the contrary above stated, nothing herein shall be construed as preventing the sale of a portion of the premises described in Schedule "A", annexed hereto, provided a release is first obtained as herein provided below.

30. *Lender agrees to release sections of mortgaged premises.* The Lender agrees to release sections of the mortgaged premises described in Schedule "A" in one-acre units. Each unit will be released upon the payment of the sum of \$ _____ to Lender. The sum is determined by dividing the loan amount by the number of acres contained in Schedule "A." The payment for each release shall be applied to the indebtedness owed by the Borrower, as evidenced by the note and secured by this Mortgage in the manner provided in the note.

All costs and expenses incurred in connection with each release, including Lender's reasonable attorneys' fees for the preparation of the release and the recording fee will be the sole responsibility of Borrower and shall be paid in full upon the delivery of each release.

Notwithstanding the foregoing, Lender shall not be required to accept tender of payment for release or provide a release when Borrower shall be in default under any of the terms of this Mortgage or the note of even date which it secures.

IN WITNESS WHEREOF, this Mortgage has been duly signed and executed by the Borrower.

_____, INC.

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By: _____

*[insert title of signer]***ACKNOWLEDGEMENT: BORROWER**

STATE OF _____)
COUNTY OF _____) ss:

On this _____ day of _____, 20 _____, before me, the subscriber, personally appeared _____, the Borrower, to me personally known and known to me to be the same person described in and who executed the foregoing instrument, and (s)he acknowledged to me that (s)he executed the same.

Notary Public

STATE OF _____)
COUNTY OF _____) ss:

On this _____ day of _____, 20 _____, before me personally came _____, to me known, who by me being duly sworn, did depose and say that (s)he resides at _____; that (s)he is the _____ *[insert title of officer]* of _____, INC., the corporation described in and which executed the foregoing instrument; that (s)he knows the seal of said corporation; that the seal affixed to said instrument is such corporate seal; that it was so affixed by order of the Board of Directors of said corporation; and that (s)he signed her/his name thereto by like order.

Notary Public

E.13 Commitment for long-term financing--loan to be closed upon completion of construction--provision for interest contingent upon earnings--liquidated damages

COMMENT

The availability of a construction loan is often dependent upon whether the prospective borrower has been able to obtain a commitment for long-term financing. This form illustrates the long-term lender's commitment letter which sets forth the promise to make the loan and the obligation to which the borrower will be bound upon countersigning the document.

When the improvement which will constitute the security for the loan is not yet in existence, and when the loan is not to be consummated until the completion of the improvement, the lender must be protected with respect to both the quality and the time of completion of construction. In order to insure the quality

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of construction, the lender has the right, before being required to close the loan, to approve final plans and specifications, and to verify that the completed structure conforms to such plans and specifications and to the requirements of applicable law. In addition, the lender may establish that the land and prospective building will have a specified minimum value by obtaining an appraisal report with respect to the final plans and specifications. Before the loan is closed, the appraiser is entitled to make certain that the improvements as constructed conform to the information from which his original appraisal was derived.

Since the lender must arrange to make funds available for an expected closing date, any delay in the completion of construction or other default of the borrower which postpones or cancels consummation of the loan will cause the loss of investment income and other damages to the lender. The letter specifies that upon such postponement or cancellation the lender may receive (a) a specified amount of liquidated damages, and (b) an additional amount for each month of delay between the scheduled closing date and final consummation or cancellation. The borrower must also pay the lender's fees and other expenses incurred in connection with the loan if it is not consummated.

This instrument also affords the lender protection against inflation over the extended period of the loan. The borrower must pay as "contingent interest" a certain percentage of earnings in excess of a specified amount.

Aside from these special features, the commitment letter covers the following essential points: (1) the amount and term of the loan, (2) the deadline for completion of construction, (3) criteria for determining completion of construction, (4) requirement for execution and approval of deeds of trust, including coverage of personal property, (5) assignment rights, and (6) prepayment privileges. An institutional lender in the business holding lucrative long-term investments is more likely to impose a penalty for prepayment than a seller holding a purchase money mortgage. In this case, prepayment is permitted only after the tenth loan year and a penalty is assessed thereafter according to a schedule of percentages of loan principal which decrease throughout the remainder of the term.

For further information, see Chapters 11, 12, and 19.

FORM

East Side Life Insurance Company
20 Madison Avenue
New York, New York 10016

January 15, 2002

Bostwick Builders, Inc.
40 Castleton Avenue
Staten Island, New York 10314

Gentlemen:

You have inquired as to the willingness of this Company to make a permanent first mortgage loan to you upon the security hereinafter mentioned and, in connection therewith, you have warranted and represented to us as follows:

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(a) Bostwick Developers, Inc., is a corporation duly organized and validly existing under the laws of the State of New York, and has its principal place of business in New York, New York.

(b) You hold fee simple title to a parcel of land described in Exhibit A annexed hereto and made a part hereof (the "Land").

(c) You shall cause a 12-story office building, hereinafter more fully described (the "Building"), to be constructed upon the Land in full compliance with all applicable zoning and other legal requirements of the State of New York, pursuant to detailed plans and specifications to be prepared by Paul L. Burns, A.I.A. (the "Architect").

You have submitted to us certain preliminary architectural drawings and memoranda specifications prepared by the Architect to aid us in arriving at a fair valuation of the Land and the proposed improvements for long-term investment purposes. This material does not contain sufficient detail to enable us to make a definitive valuation, but you have stated to us that the Building will contain approximately 1,100,000 square feet and approximately 12,000,000 cubic feet.

We are pleased to advise you that, relying on the foregoing, and subject to our approval of all proceedings to be taken in connection with the transaction herein contemplated, and the form and substance of all documents incident thereto, and subject further to the terms and conditions hereinafter set forth, our Finance Committee has authorized a first lien mortgage loan to be made to you to be evidenced by your note (the "Note"), and secured by a first lien mortgage (the "Mortgage"), upon a good and marketable fee simple title to the Land and the improvements to be erected thereon, and by a security agreement (the "Security Agreement"), on the personal property hereinafter referred to.

1. *Borrower.* The Borrower shall be Bostwick Developers, Inc.

2. *Amount and term of loan.* The loan shall be in the amount of \$9,000,000. The term of the loan shall be 20 years from the date of closing, as defined in paragraph 15 hereof. The loan shall be repaid by monthly payments of \$64,479, to be applied first to interest at the rate of 8 percent per year, and the balance to principal.

3. *Contingent interest payments.* Within 90 days after the close of each "operating year" (as the same shall be defined in the Mortgage) during which the loan herein contemplated shall be outstanding, and within 90 days after the close of the operating year during which such loan shall have been fully paid and discharged (other than by prepayment), you shall deliver to us a statement, prepared in accordance with sound and generally accepted accounting practice and certified as true and correct by one of the firms of accountants listed in Exhibit B attached hereto. Such statement shall set forth, in reasonable detail, the "net earnings" from the Building, as the same are defined in Exhibit C attached hereto, during and with respect to such operating year. Simultaneously with the delivery of each such statement, and in addition to and over and above the required constant monthly payments of fixed interest and amortization and the required monthly deposits in respect of real estate taxes, as herein set forth, the Borrower shall pay to us, as additional interest, an amount equal to 15 percent of the amount, if any, by which the "net earnings" from the Building for such operating year, as shown by such statement, shall exceed \$1,750,000 (or, in the case of any partial yearly period, the proportionate part of \$1,750,000). We shall have the right, through such agents or employees as we may determine, to examine your books of account and records for the purpose of verifying the amount of such "net earnings."

4. *Tax deposits.* Monthly noninterest bearing deposits of one-twelfth of the annual real estate taxes, as estimated by this Company, shall be made to this Company to accumulate for the payment of such taxes when due.

5. *Prepayment privilege.* The Note shall grant the privilege to pay the loan in full prior to maturity on any interest date after the end of the tenth loan year, upon giving not less than 30 days' prior written notice of intention to prepay, and upon paying, in addition to principal then owing, accrued fixed interest, and accrued contingent interest (as estimated, subject to adjustment) a sum equal to 3 percent of such principal if prepayment is made in the eleventh loan year, 2.5

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percent if the prepayment is made in the twelfth loan year, 2 percent if prepayment is made in the thirteenth loan year, 1.5 percent if prepayment is made in the fourteenth loan year, 1 percent if prepayment is made in the fifteenth loan year, 1/2 of 1 percent if prepayment is made in the sixteenth loan year, and without prepayment charge thereafter.

6. *Security.* The following shall constitute security for the loan:

(a) The Land.

(b) The 12-story office Building, fireproof and fully air conditioned, to be constructed in accordance with detailed plans and specifications to be prepared by the Architect and approved by us, and which shall contain retail stores on the ground floor, offices on the remaining floors, and off-street parking facilities for not less than 650 automobiles.

(c) All furniture, furnishings, fixtures, equipment, and articles of personal property (collectively, the Personal Property) required for the operation of the Building, and all future additions thereto and replacements thereof. All of such Personal Property shall be acquired by you and remain your exclusive property, free and clear of any and all liens and encumbrances thereon and security interests therein except the lien of the Mortgage and the Security Agreement to be executed and delivered to this Company pursuant hereto.

7. *Plans and specifications.* You shall retain the Architect for the purpose of preparing detailed plans and specifications (the "Plans"), which shall be consistent with, and conform in all material respects with, the preliminary plans and memoranda specifications. We reserve the right to retain, at your expense, an architect or engineer, or both (the Mortgagee's Architect), for the purpose of passing on such detailed Plans. Prior to the commencement of construction of the Building, you shall submit copies of the Plans both to us and to the Mortgagee's Architect and shall have obtained our prior written approval thereof, which approval shall not unreasonably be withheld.

8. *New appraisal.* After we have approved the Plans, we are to receive from our Chief Appraiser a new appraisal report (the New Appraisal) which shall show that the fair value of the Land and of the improvements contemplated thereon, as evidenced by the Plans (exclusive of any value attributable to the Personal Property), is not less than \$13,500,000. You are to furnish our Chief Appraiser with all information which he may deem necessary for the purpose of such New Appraisal.

9. *Construction of building.* Subject to unavoidable delays, as hereinafter defined, construction of the Building shall be commenced not later than July 1, 2002, and construction of the Building shall be completed not later than December 31, 2003. If, by reason of such unavoidable delays, construction of the Building shall not be completed by December 31, 2003, the time for such completion shall be extended by a period equal to the period of such delays, but in no event beyond July 1, 2004, unless we shall have otherwise agreed in writing. Wherever in this letter the term "unavoidable delays" appears, it shall be construed to mean only delays due to strikes, lockouts, acts of God, inability to obtain labor or materials, governmental restrictions, enemy action, civil commotion, fire, unavoidable casualty, or similar causes, provided such similar causes are beyond your control.

Promptly following completion of the foundations and footings for the Building, you shall furnish us with a survey in form, and prepared by a licensed surveyor, satisfactory to us and to the title insurance companies hereinafter referred to, showing that no part of any foundation or footing encroaches upon any adjoining street or property.

For the purposes of this letter, construction of the Building shall be deemed to have been completed upon the earliest date (the Completion Date) when all of the following conditions shall have been fulfilled:

(a) The Architect and, provided we shall have determined to retain such architect or engineer, the Mortgagee's Architect each shall have certified to us that all work in connection with the Building has been substantially completed in substantial accordance with the Plans as approved by us, or in accordance with any modifications thereof which we

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shall have approved, and that all such work has been done in accordance with all applicable requirements of law, including, but without limitation, all applicable zoning requirements.

(b) Our Chief Appraiser shall have certified to us that the Building, as completed, and the Personal Property, substantially conform in all material respects to a building of the size and character, and personal property of the character and quality, which our Chief Appraiser projected in arriving at the valuation set forth in the New Appraisal.

(c) We shall have been furnished with a copy of the permanent or temporary certificate of occupancy, certificates of electrical inspection, certificates of the Board of Fire Underwriters, and such other certificates as are normally and customarily required and issued by the Department of Buildings of the City of New York, or other city, county, and state departments having jurisdiction thereover, in connection with a new building.

(d) The Building shall have been formally opened as an operating office building.

10. *Leases and occupancy agreements.* All leases and other occupancy agreements in existence at the time of the closing with respect to garage and office space and space for sales and service facilities shall have been approved by this Company and its special counsel and shall contain such attornment and other provisions as this Company may require, and your right, title, and interest therein shall be assigned to this Company as collateral security to such extent as we may require.

11. *Security agreement.* This Company shall receive a Security Agreement creating a security interest in the Personal Property together with the certificate of the title companies referred to in paragraph 12 hereof and a certificate of the Secretary of State of the State of New York that the Security Agreement constitutes a good and valid first lien on the Personal Property.

12. *Documents and title.* The form and substance of all documents to be delivered to or received by us at or prior to the closing, including, but not by way of limitation, the Note, Mortgage, and Security Agreement, all leases and other occupancy agreements, and the assignments to this Company of your interest therein, surveys, title and other insurance policies, and certifications, shall in all respects be satisfactory to this Company and its special counsel. The title and the evidence thereof shall be satisfactory to this Company and its special counsel and, at the time of closing, there shall have been delivered to us title insurance policies distributed both as to companies and amounts in a manner satisfactory to us, providing for joint and several insurance, or coinsurance if we so require, by such companies, in the aggregate amount of \$9,000,000, insuring that the Mortgage constitutes the valid, direct first lien which it purports to create upon your good and marketable fee simple title in and to the Land and the Building subject only to such liens, charges, and encumbrances as shall have been previously approved by us in writing. You agree to use your best efforts to reach agreement with us, as soon as reasonably possible following your acceptance hereof, upon the provisions of the Note, the Mortgage, and the Security Agreement and of such other instruments incident to the transaction contemplated hereby as are presently determinable. It is understood that, without limiting the generality of the first sentence of this paragraph, the Note or the Mortgage shall contain, among other provisions, mutually satisfactory provisions with respect to the several types and amounts of insurance coverages to be maintained by you; the application of insurance and condemnation proceeds; the maintenance of working capital; the furnishing of financial and other statements by you, restrictions on the creation of junior liens, creation of additional indebtedness, declaration and payment of dividends, and creation of subsidiaries by you, your other business activities, merger and consolidation by or with you, the sale, conveyance, or other transfer of the Building, the leasing of the Building, and the modification and termination of leases, licenses, concessions, and other occupancy agreements made with respect to any space in the Building.

13. *Environmental site assessment.* Prior to the closing, you shall provide us with a phase I environmental site assessment, which shall state that there is no evidence of any adverse environmental condition existing on the real property which is to secure this loan. The site assessment shall be performed by an experienced environmental engineer who is acceptable to us. Acceptance shall not be unreasonably withheld. In the event that the site assessment does not

provide as required above, we shall be under no obligation to lend any sum to you.

14. *Legal opinions.* At the time of closing, we shall have received from Messrs. Downs and Liberty, who are acting as special counsel for us in connection with this transaction, an opinion in scope and substance satisfactory to us, as to the following:

(a) The due incorporation and existence of Bostwick Developers, Inc., as a New York corporation and its corporate power to own and operate the Building, and to borrow the moneys and otherwise assume and perform the obligations on its part to be assumed and performed, as contemplated herein.

(b) The due authorization, execution, and delivery by you of this agreement, and the legality, validity, and enforceability of this agreement in accordance with its terms.

(c) The due authorization, execution, and delivery of the Note, and the legality, validity, and enforceability thereof in accordance with its terms, and the availability to the holder thereof of the benefits and security afforded by the Mortgage and the Security Agreement in accordance with the terms of such Mortgage and such Security Agreement.

(d) The due authorization, execution, and delivery of the Mortgage, the legality, validity, and enforceability thereof in accordance with its terms, and the creation by the Mortgage of the valid lien which it purports to create upon your interest in the Land and the Building.

(e) The due authorization, execution, and delivery of the Security Agreement, the legality, validity, and enforceability thereof in accordance with its terms, and the creation by the Security Agreement of the valid lien which it purports to create upon your interest in the Personal Property then owned by you.

(f) The due filing for record and recording of the Mortgage and of the Security Agreement in the appropriate filing office or offices in order to perfect and preserve the liens thereof on the respective properties intended to be covered thereby, the due payment of all taxes, recording fees, and other charges in connection therewith, and the necessity of any periodic re-recording or re-filing of the Mortgage or of the Security Agreement in order to preserve and protect such liens.

(g) Such other matters incident to the transaction hereby contemplated as this Company may reasonably request.

None of the opinions required by this paragraph 14 need express any opinion as to your title to any of the property intended to be subjected to the lien of the Mortgage or of the Security Agreement, or as to the existence of any liens, charges, or encumbrances thereon other than the Mortgage or the Security Agreement.

15. *Closing date.* Subject to unavoidable delays, as defined in paragraph 9 hereof, the closing of the loan shall take place at this Company's home office at 20 Madison Avenue, New York, New York, on a date (the "Closing Date"), subsequent to the Completion Date which shall be fixed by the parties. Unless this Company, in its sole and absolute discretion, shall otherwise agree in writing, the Closing Date shall not be later than the earlier of (a) March 1, 2004, or (b) the date which is 60 days subsequent to the Completion Date. In the event of unavoidable delays, the Closing Date shall be such date, subsequent to the Completion Date of the Building, as shall be fixed by the parties and, unless this Company, in its sole and absolute discretion, shall otherwise agree in writing, shall not be later than the earlier of (c) September 1, 2004, or (d) the date which is 60 days subsequent to the Completion Date. In no event shall the Closing Date be earlier than January 1, 2004, unless this Company, in its sole and absolute discretion, shall otherwise decide and so notify you in writing.

16. *Payment of fees and expenses.* Your acceptance hereof shall constitute your unconditional agreement, whether or not the transaction contemplated hereby shall be consummated, to pay or reimburse us for all costs and expenses paid or

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incurred by us or on our behalf in connection with such transaction, including, but not limited to, the reasonable fees and disbursements of Messrs. Down and Liberty for their services to us with relation to this agreement, including the furnishing of the opinions referred to herein and all other opinions which we may request on questions incident to the proposed transaction, the fees and expenses of the Mortgagee's Architect, printing costs, charges for title examination, and insurance, surveys, recording and filing fees, revenue stamp, mortgage, and other taxes, if any are required, and all other actual out-of-pocket expenses in connection with such transaction. This Company shall not be obligated to pay any premium or other charge, or any brokerage fee or commission, in connection with such transaction and your acceptance hereof shall constitute your further unconditional agreement to pay, and to hold this Company harmless against, any and all claims in connection with the foregoing and with such transaction.

17. *Cancellation of commitment.* This Company reserves the right to cancel this commitment and to terminate its obligations hereunder, in any of the following events:

- (a) Failure to conform to the respective time limits specified in paragraphs 9 and 15 hereof.
- (b) Failure to comply with any of the requirements of paragraphs 7 to 14, inclusive, hereof.
- (c) Failure to construct the Building substantially in accordance with the Plans as they, including any changes therein, shall have been approved by this Company.
- (d) Nonreceipt by this Company of the Architects' certificates provided for in paragraph 9(a) hereof and satisfying the requirements of such paragraph.
- (e) Nonreceipt by this Company of the Chief Appraiser's certificate provided for in paragraph 9(b) hereof and satisfying the requirements of such paragraph.
- (f) Insufficiency of title or lack of approval by this Company or its special counsel of the title to the Land, or of any documents required hereunder to be delivered to this Company at or prior to the closing.
- (g) Substantial damage to the Building which shall not have been repaired or restored to the satisfaction of this Company at the time of closing, or insubstantial damage to the Building, as to which provision for repair or restoration, satisfactory to this Company, shall not have been made at the time of closing.
- (h) If any part of the Land or the Building shall have been taken in condemnation or other like proceedings.
- (i) If there shall be filed by or against you any petition in bankruptcy or insolvency or for reorganization or for the appointment of a receiver or trustee, or if you shall make an assignment for the benefit of creditors, or shall file a petition for arrangement, or shall enter into an arrangement, and if, in any such case, such petition is not withdrawn or dismissed or such appointment, assignment, or arrangement is not cancelled and terminated within 30 days after the filing of such petition or the entry into of such arrangement.
- (j) Failure to make any payment required to be paid to or for the account of this Company pursuant to paragraph 16 hereof.
- (k) Failure to comply with any requirement of law applicable to the construction of the Building, including, without limitation, any zoning requirement or any condition with respect to such construction.
- (l) Nonreceipt by this Company of the New Appraisal as provided in paragraph 8 hereof and satisfying the requirements of such paragraph.

This Company may exercise the foregoing right of cancellation and termination by giving you written notice thereof, by registered or certified mail addressed as provided in paragraph 20. Upon the giving of such notice all obligations of this Company hereunder shall come to an end as of the date of such notice. The issuance of such notice shall relieve you of all obligations hereunder except for the payment of the fees, expenses, and other disbursements mentioned in paragraph 16 hereof which shall have been paid or incurred by us, any amount which may have become payable under paragraph 18 hereof, and the liquidated damages provided for in paragraph 19 hereof.

18. *Compensation for loss of investment income.* In the negotiations preliminary to the delivery of this commitment, you indicated to us your expectation that the Building would be completed by December 31, 2003, and that it was your desire that the funds for the permanent financing of the Building should be available at that time. By reason of this commitment, it will be necessary for us to schedule our funds available for investment accordingly. In consideration of the agreement on our part to continue to make such funds available to the Borrower beyond March 1, 2004, as, and subject to the conditions, set forth herein, and in recognition of the loss of investment income which would accrue to this Company if the consummation of the loan were to be delayed beyond such date, you agree that if, for any reason whatsoever, including specifically, but not limited to, unavoidable delays as defined in paragraph 9 hereof, the closing of such loan shall not have been consummated by March 1, 2004, and if, and so long thereafter, as such loan shall not have been consummated or this commitment shall not have been terminated by this Company pursuant to the provisions of paragraph 17 hereof, you shall pay to this Company, commencing April 1, 2004, and monthly thereafter, as compensation for the loss of investment income which we would sustain in such event, during and with respect to the period from March 1, 2004, to the date of closing or the date of termination of this commitment, the sum of \$22,500 for each month that shall elapse between March 1, 2004, and the date of the actual closing of the loan or the date, if any, upon which we shall have notified you of our determination to cancel and terminate this commitment. If the closing of the loan shall be consummated, or if the date upon which we shall have notified you of any determination on our part to cancel and terminate this commitment, shall be any day other than the first or last day of the month, such monthly sum for the month in which such closing or such notification shall occur shall be prorated, on a per diem basis, from the first day of such month up to and including the actual date of closing or the date of such notification, and shall be payable on such date. Your obligation for the payments referred to in this paragraph shall be over and above your obligation for payment of the fees and expenses referred to in paragraph 16 hereof, and for the payment of liquidated damages, if any, as provided for in paragraph 19 hereof.

19. *Liquidated damages.* In consideration of the substantial services and the expense thereof heretofore and which will hereafter necessarily be rendered and incurred by this Company in processing and preparing for the closing of the loan contemplated hereby; the substantial long-term loss of investment income which this Company would sustain, in the event of your failure to consummate such loan, above and beyond the portion of such loss, if any, as might be recovered by this Company pursuant to the provisions of paragraph 18 hereof; the uncertainty, in the event of such failure to consummate such loan, as to the then availability to this Company of other investment opportunities having investment qualities and characteristics, and upon terms, comparable with those represented by the loan contemplated hereby; and in recognition of the difficulty of accurately ascertaining the amount of damages which this Company would sustain in the event of any such failure by you to take or cause to be taken all action necessary to cause such loan to be consummated, the acceptance hereof by you shall constitute your unconditional agreement to pay this Company, as liquidated damages, the sum of \$180,000 if for any reason other than the cancellation of this commitment by this Company pursuant to paragraph 17(h) hereof the transaction hereby contemplated is not consummated and the loan is not closed within the time hereby set for consummation and closing.

20. *Notices.* Any notice required or desired to be given hereunder shall be deemed to have been properly given if sent by registered or certified mail addressed, if to this Company, to Vice President, Real Estate Department, East Side Life Insurance Company, 20 Madison Avenue, New York, New York, or, if to you, to the address to which this letter is addressed. Either party hereto may from time to time designate another address in the City of New York, New York, for the receipt of future notices by a notice given as herein provided.

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21. *Nonassignability.* This commitment may not be assigned by you without our written consent.

22. *Entire agreement.* This commitment supersedes all agreements previously made between us relating to its subject matter. There are no other understandings or agreements between us.

23. *Non-waiver.* No delay or failure by either of us to exercise any right under this commitment, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

24. *Headings.* Headings in this commitment are for convenience only and shall not be used to interpret or construe its provisions.

25. *Governing law.* This commitment shall be construed in accordance with and governed by the laws of the State of New York.

26. *Counterparts.* This commitment may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

27. *Binding effect.* The provisions of this commitment shall be binding upon and inure to our benefit and that of our respective legal representatives, successors, and assigns.

If the foregoing is satisfactory to you, will you please so indicate by signing and returning to us the enclosed copy of this letter agreement within ten days from the date hereof, whereupon it shall become a binding agreement between us in accordance with its terms. Until the receipt thereof within such ten-day period, there shall be no obligation on our part hereunder.

Very truly yours,

East Side Life Insurance Company

by _____

President

Accepted:

Bostwick Builders, Inc.

by _____

President

E.14 Construction loan--agreement between construction lender and long-term lender

COMMENT

In certain circumstances, the commitment for permanent long-term financing will precede the obtaining of a loan for commercial construction. Where no immediate sale of the completed building is contemplated the funds required to repay the construction loan will come from the long-term lender. In the situation anticipated by the agreement illustrated here, the borrower has obtained such a long-term loan commitment. Under this agreement, when the conditions of the long-term loan agreement have been met or waived or modified by the borrower the long-term lender agrees to purchase the note given by the borrower to the interim lender in connection with the construction loan.

For further information, see Chapters 11, 12, and 19.

FORM

November 26, 2002

Garden State Life Insurance Company
100 Madison Avenue
Trenton, New Jersey

Re: Premises 150 Central Avenue
Toms River, New Jersey

Gentlemen:

With reference to your commitment dated September 10, 2002, issued to Spargo Investing Corp., we propose to act as interim lender for the construction loan of \$3,000,000 on this property (reserving to ourselves the right to increase the same to \$3,500,000). Such loan shall be secured by a first mortgage lien affecting the property in the sum of \$3,500,000.

We understand that in consideration of our making a construction loan to the Borrower in an amount of \$3,000,000 and of incorporating in the construction loan documents certain provisions which will obligate the Borrower to execute an extension agreement with you under the terms of the permanent loan, as provided in your commitment, you do hereby agree to purchase the note of the Borrower from us when the requirements of your commitment have been met, on or before October 1, 2003, or within the extended period of the commitment, if any, as hereinafter provided; subject, however, to our agreement to the following conditions, and the assent thereto of the Borrower.

1. *Assignment of construction loan note and mortgage by interim lender.* At such time as the conditions of your commitment have been met, or such conditions shall have been waived or modified by you, on or before October 1, 2003 (or within the extended period of the commitment, if any, as hereinafter provided), we agree to sell and assign to you (by endorsement of the note to your order, without recourse, and by assignment of the construction loan mortgage), and you agree to purchase, the note and mortgage of the Borrower, for the amount of principal advances made by us thereon (the Borrower to pay us, at the time of such sale, all interest accrued thereon and unpaid up to, but not including, the date of purchase). We agree that all papers regarding the purchase will be forwarded to your home office, upon your request, prior to endorsement for transfer thereof, with allowance of a reasonable time to permit your final examination of such papers and the taking of other actions incidental to the purchase by you and all other persons concerned.

2. *Enforcement of borrower's obligations under construction loan.* If the Borrower shall default in performing its obligations to us, under the loan documents or any collateral documents, prior to October 1, 2003 (or within the extended period of the commitment, if any, as hereinafter provided), we reserve the right in our sole discretion and without your prior consent to enforce the obligations of the note, mortgage, and construction loan agreement in accordance with the terms of such instruments, but we shall promptly notify you of the nature of such default and of any action we have taken.

3. *Extension of construction loan.* If, on October 1, 2003, the Borrower shall not have met the requirements of the commitment on which the permanent loan is conditioned, you shall have the option, for 20 days thereafter, either (a) to purchase the note of the Borrower from us, or (b) to extend the period of the commitment for a reasonable period of time, not to exceed a period of 60 days from the date such option is exercised, by written notice delivered to us and the

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Borrower. In the event of such extension, the parties hereto agree that the date on which payment of the note to us is due will be extended for a period equal to the period of such extension; that during such extended period the Borrower will not offer to pay the note held by us, and we will not voluntarily accept payment of the note, either with or without interest to maturity; and that we will take no action to foreclose the lien of the mortgage securing the note, nor voluntarily sell or assign the note to any other person or institution without your assent, during such extended period of the commitment. You, in turn, agree to purchase the note from us, within such extended period of the commitment, when the terms and conditions of the commitment as modified have been fully complied with by the Borrower or waived by you.

4. *Acceptance by borrower.* Our agreement to the terms outlined herein is subject to the acceptance of those terms by the Borrower, as to such obligations as these terms impose upon it, and upon an understanding that these obligations of the Borrower will be binding upon it, its successors, and assigns.

5. *Execution of agreement.* We request that you indicate your assent to this agreement by your endorsement of a copy of this agreement and returning such copy to us, with a copy to the Borrower, and that the Borrower indicate its assent to the terms hereof by its endorsement of a copy of this agreement and returning such copy to us.

Yours very truly,

Central Bank of New Jersey

by _____

President

In consideration of your undertakings in the foregoing agreement, we are pleased to accept the terms thereof and agree to be bound by the obligations imposed on us therein.

Dated: December 15, 2002

Garden State Life Insurance Company

by _____

President

Spargo Investing Corp.

by _____

President

E.15 Construction loan mortgage--New York title company form--property to be leased

COMMENT

Although state statutes applicable to mortgages vary considerably, the following protections for the mortgagee are generally included in a mortgage, regardless of where the real property is located: (1) insurance against fire losses must be carried by the mortgagor; (2) the mortgagor must pay taxes, assessments, sewer or water rents, and all other charges levied by governmental authorities; (3) buildings on the premises may not be altered, removed, or demolished without the mortgagee's consent; (4) awards for taking by eminent domain are to be applied first to reduce the mortgage debt; (5) personal property on the premises is subject to the mortgage; (6) upon a default in the payment of the mortgage debt or in the performance of other conditions of the mortgage, the full amount of principal and interest is to

become due; and (7) expenses incurred by the mortgagee to defend or uphold the lien of the mortgage are to be paid by the mortgagor.

If the property is to be leased, an additional protection for the mortgagee is an assignment of rents in the event of a default under the mortgage. There should also be a limitation on the right of the mortgagor to receive advance rentals which diminish the value of the leases as security for the debt.

Regardless of whether the mortgagee's interest is equitable, as under this mortgage, or whether the mortgagor has conveyed legal title to the mortgagee, the mortgagee is subject to the same treatment for tax purposes. The mere possession of a mortgage interest, whether legal or equitable, does not entitle the mortgagee to take any of the deductions arising in connection with the property, such as depreciation and taxes. Such items are deductions of the mortgagor. Even if the rents are assigned to the mortgagee in satisfaction of defaulted payments of the mortgage debt, the rents would nevertheless be treated as having been paid first to the mortgagor. That is, the rents would constitute ordinary income to the mortgagor, and the mortgagee would be considered to have received a nontaxable payment of a debt.

For further information, see Chapters 11, 12, and 19.

FORM

THIS MORTGAGE, made December 3, 2002, between Ashwood Shopping Center, Inc., a domestic corporation having its place of business at 148 Forest Avenue, in the Borough and County of Richmond, City and State of New York (the "Mortgagor"), and First Federal City Bank, a banking association created and existing under the laws of the State of New York, and having an office at 99 Park Avenue, in the Borough of Manhattan, City and County of New York (the "Mortgagee"), to secure the payment of an indebtedness in the sum of \$500,000, lawful money of the United States, or so much thereof as may be advanced, to be paid according to a certain bond, note, or obligation bearing even date herewith. The Mortgagor hereby mortgages to the Mortgagee all that certain plot, piece, or parcel of land, with the buildings and improvements thereon erected, situate, lying, and being in the Borough and County of Richmond, City and State of New York, bounded and described as follows:

(Insert description)

Together with all right, title, and interest of the Mortgagor in and to the land lying in the streets and roads in front of and adjoining such premises;

Together with all fixtures and articles of personal property now or hereafter attached to or used in connection with such premises, including, but not limited to, furnaces, boilers, oil burners, radiators, and piping, coal stokers, plumbing and bathroom fixtures, refrigeration, air conditioning and sprinkler systems, washtubs, sinks, gas and electric fixtures, stoves, ranges, awnings, screens, window shades, elevators, motors, dynamos, refrigerators, kitchen cabinets, incinerators, plants and shrubbery, and all other equipment and machinery, appliances, fittings, and fixtures of every kind in or used in the operation of the buildings standing on such premises, together with any and all replacements thereof and additions thereto;

Together with all awards heretofore and hereafter made to the Mortgagor for taking by eminent domain the whole or any part of such premises or any easement therein, including any awards for changes of grade of streets, which awards are hereby assigned to the Mortgagee, who is hereby authorized to collect and receive the proceeds of such awards and to give proper receipts and acquittances therefor, and to apply the same toward the payment of the mortgage debt, notwithstanding the fact that the amount owing thereon may not then be due and payable; and the Mortgagor hereby

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agrees, upon request, to make, execute, and deliver any and all assignments and other instruments sufficient for the purpose of assigning such awards to the Mortgagee, free, clear, and discharged of any encumbrances of any kind or nature whatsoever.

The Mortgagor covenants with the Mortgagee as follows:

1. *Payment.* That the Mortgagor shall pay the indebtedness as hereinbefore provided.
2. *Insurance.* That the Mortgagor shall keep the buildings on the premises insured against loss by fire for the Mortgagee's benefit; that he shall assign and deliver the policies to the Mortgagee; and that he shall reimburse the Mortgagee for all premiums paid for insurance made by the Mortgagee on the Mortgagor's default in so insuring the buildings or in so assigning and delivering the policies.
3. *Alterations.* That no building on the premises shall be altered, removed, or demolished without the Mortgagee's consent.
4. *Default in payment of principal or interest.* That the whole of such principal sum and interest shall become due at the option of the Mortgagee: after default in the payment of any installment of principal or of interest for 15 days; or after default in the payment of any tax, water rate, sewer rent, or assessment for 30 days after notice and demand; or after default after notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire or in reimbursing the Mortgagee for premiums paid on such insurance, as hereinbefore provided; or after default upon request in furnishing a statement of the amount due on the mortgage and whether any offsets or defenses exist against the mortgage debt, as hereinafter provided. An assessment which has been made payable in installments at the application of the Mortgagor or lessee of the premises shall nevertheless, for the purpose of this paragraph, be deemed due and payable in its entirety on the day the first installment becomes due or payable or a lien.
5. *Receiver.* That the holder of this mortgage, in any action to foreclose it, shall be entitled to the appointment of a receiver.
6. *Taxes, assessments, etc.* That the Mortgagor shall pay all taxes, assessments, sewer rents, or water rates, and in default thereof, the Mortgagee may pay the same.
7. *Mortgage debt.* That the Mortgagor, within five days upon request in person or within ten days upon request by mail, shall furnish a written statement duly acknowledged of the amount due on this mortgage and whether any offsets or defenses exist against the mortgage debt.
8. *Notice.* That notice and demand or request may be in writing and may be served in person or by mail.
9. *Warranty of title.* That the Mortgagor warrants the title to the premises.
10. *Extended coverage on fire insurance.* That the fire insurance policies required by paragraph 2 above shall contain the usual extended coverage endorsement; that in addition thereto the Mortgagor, within 30 days after notice and demand, shall keep the premises insured against war risk and any other hazard that may reasonably be required by the Mortgagee. All of the provisions of paragraphs 2 and 4 above relating to fire insurance and the provisions of Section 254 of the Real Property Law construing the same shall apply to the additional insurance required by this paragraph.
11. *Foreclosure sale.* That, in case of a foreclosure sale, such premises, or so much thereof as may be affected by this mortgage, may be sold in one parcel.
12. *Expenses of foreclosure sale.* That if any action or proceeding be commenced (including an action to foreclose this

mortgage or to collect the debt secured thereby), to which action or proceeding the Mortgagee is made a party, or in which it becomes necessary to defend or uphold the lien of this mortgage, all sums paid by the Mortgagee for the expense of any litigation to prosecute or defend the rights and lien created by this mortgage (including reasonable counsel fees) shall be paid by the Mortgagor, together with interest thereon at the rate of nine (9) percent per year or the note rate, whichever is greater. Any such sum and the interest thereon shall be a lien on such premises, prior to any right or title to, interest in, or claim upon such premises attaching or accruing subsequent to the lien of this mortgage, and shall be deemed to be secured by this mortgage. In any action or proceeding to foreclose this mortgage, or to recover or collect the debt secured thereby, the provisions of law respecting the recovering of costs, disbursements, and allowances shall prevail unaffected by this covenant.

13. *Assignment of rents.* That the Mortgagor hereby assigns to the Mortgagee the rents, issues, and profits of the premises as further security for the payment of such indebtedness, and the Mortgagor grants to the Mortgagee the right to enter upon the premises for the purpose of collecting the same and to let the premises or any part thereof, and to apply the rents, issues, and profits, after payment of all necessary charges and expenses, on account of such indebtedness. This assignment and grant shall continue in effect until this mortgage is paid. The Mortgagee hereby waives the right to enter upon such premises for the purpose of collecting such rents, issues, and profits, and the Mortgagor shall be entitled to collect and receive such rents, issues, and profits until default under any of the covenants, conditions, or agreements contained in this mortgage, and agrees to use such rents, issues, and profits in payment of principal and interest becoming due on this mortgage and in payment of taxes, assessments, sewer rents, water rates, and carrying charges becoming due against such premises. The Mortgagee, however, may revoke such right of the Mortgagor upon any default, by giving five days' written notice. The Mortgagor shall not, without the Mortgagee's written consent, receive or collect rent from any tenant of such premises or any part thereof for a period of more than one month in advance. In the event of any default under this mortgage the Mortgagor shall pay monthly in advance to the Mortgagee, or to any receiver appointed to collect such rents, issues, and profits, the fair and reasonable rental value for the use and occupation of such premises or of such part thereof as may be in the Mortgagor's possession. Upon default in any such payment the Mortgagor shall vacate and surrender the possession of such premises to the Mortgagee or to such receiver, and in default thereof may be evicted by summary proceedings.

14. *Default in observation of conditions.* That the whole of such principal sum and the interest shall become due at the option of the Mortgagee if any of the following events shall occur: (a) failure to exhibit to the Mortgagee, within ten days after demand, receipts showing payment of all taxes, water rates, sewer rents, and assessments; (b) the actual or threatened alteration, demolition, or removal of any building on the premises without the Mortgagee's written consent; (c) the assignment of the rents of the premises or any part thereof without the Mortgagee's written consent; (d) if the buildings on such premises are not maintained in reasonably good repair; (e) failure to comply with any requirement or order or notice of violation of law or ordinance issued by any governmental department claiming jurisdiction over the premises within three months from the issuance thereof; (f) if on application of the Mortgagee two or more fire insurance companies lawfully doing business in the State of New York refuse to issue policies insuring the buildings on the premises; (g) in the event of the removal, demolition, or destruction in whole or in part of any of the fixtures or articles of personal property covered hereby, unless the same are promptly replaced by similar fixtures and articles of personal property at least equal in quality and condition to those replaced, free from any security interests or other encumbrances thereon and free from any reservation of title thereto; (h) after 30 days' notice to the Mortgagor, in the event of the passage of any law deducting from the value of land for the purposes of taxation any lien thereon, or changing in any way the taxation of mortgages or debts secured thereby for state or local purposes; or (i) if the Mortgagor fails to keep, observe, and perform any of the other covenants, conditions, or agreements contained in this mortgage or of those contained in the building loan contract hereinafter mentioned.

15. *Advances.* That the Mortgagor shall, in compliance with Section 13 of the Lien Law, receive the advances secured hereby and shall hold the right to receive such advances as a trust fund to be applied first for the purpose of paying the cost of the improvement and shall apply the same first to the payment of the cost of the improvement before using any part of the total of the same for any other purpose.

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16. *Building loan contract.* This mortgage is made pursuant to a certain building loan contract between the Mortgagor and the Mortgagee dated December 3, 1994, and intended to be filed in the office of the Clerk of the County of Richmond on or before the date of the recording of this mortgage, and is subject to all the provisions of such contract as if they were fully set forth herein and made part of this mortgage.

17. *Performance.* That the Mortgagor shall observe and timely perform all covenants, conditions, and agreements contained in any lease now or hereafter affecting the premises or any portion thereof on the part of the landlord to be observed and performed.

18. *Modification of leases.* That, pursuant to the provisions of Section 291-f of the Real Property Law, the Mortgagor shall not cancel, abridge, or otherwise modify any lease of such premises or of any part thereof.

19. *Corporate authority.* That the Mortgagor represents that: (1) the Certificate of Incorporation of the Mortgagor does not require a vote or consent of the shareholders to authorize the execution and delivery of this mortgage, and (2) the Mortgagor's Board of Directors has by proper action, which has not been revoked or modified, duly authorized the execution and delivery of this mortgage by the officer or officers who have executed the same.

20. *Schedule of leases.* That, within 15 days after demand, the Mortgagor shall furnish to the Mortgagee a schedule, certified to by the Mortgagor, setting forth all leases of space in the premises then in effect, including in each case the name of the tenant, a description of the space occupied by such tenant, the annual rental payable by such tenant and such other pertinent information with respect to such leases as the Mortgagee may reasonably request. As additional and collateral security for the payment of the principal sum and interest secured hereby, the Mortgagor, within ten days after demand by the Mortgagee, shall assign to the Mortgagee all right, title, and interest of the Mortgagor, as landlord, in and to each lease of space in the premises. Each such instrument of assignment shall provide, among other things, that the assignor shall be permitted to collect, use, and enjoy the rents payable under each such lease as such rents become due so long as there is no default under this mortgage.

21. *Prepayment privilege.* That the Mortgage shall, after completion of the improvements, have the privilege of prepaying the principal, in whole or in part, at any time without penalty.

22. *Modification; binding effect.* This mortgage may not be changed or terminated orally. The covenants contained in this mortgage shall run with the land and bind the Mortgagor, the the heirs, personal representatives, successors, and assigns of the Mortgagor and all subsequent owners, encumbrancers, tenants, and subtenants of the premises, and shall inure to the benefit of the Mortgagee, the personal representatives, successors, and assigns of the Mortgagee and all subsequent holders of this mortgage.

In witness whereof this mortgage has been duly executed by the Mortgagor.

In presence of:

Ashwood Shopping Center, Inc.

by _____

President

(Acknowledgment)

E.16 Construction loan deed of trust

COMMENT

In jurisdictions where the deed of trust rather than a mortgage is utilized to provide a security interest in real property, the lender should be afforded the same kinds of protection as those afforded a mortgagee in jurisdictions where a mortgage is the customary security device. The technique for establishing a deed of trust as the security interest is by a conveyance of the fee title by the owner of the fee to trustees designated by the lender. The terms of the trust are set forth in the deed of trust and are fundamentally the same as those contained in a mortgage. The lender retains the power to appoint substitute trustees. While this deed of trust secures a construction loan, the provisions necessarily included in the instrument in order adequately to protect the lender would be appropriate for a long-term security instrument as well. It should be noted that the deed of trust is not the most common form of encumbrance that is used and the practitioner should ascertain the form that is proper for the jurisdiction in which the property is located.

For further information, see Chapters 11, 12, and 19.

FORM

DEED OF TRUST made November 25, 2002, between Boswell Developers, Inc., a corporation organized and existing under the laws of the State of New York (the "Borrower"), and Paul Nielsen and James Crabtree (the "Trustees").

Whereas the Borrower is indebted to Municipal Trust Company, a New York corporation, in the principal sum of \$2,500,000, for money loaned, for which amount the Borrower has made and delivered a promissory note of even date herewith (the "Note"), payable to Municipal Trust Company, or order, on April 1, 2006, at its office at 20 Fifth Avenue, New York, New York, or at such other place as the holder may in writing direct, together with interest on the principal sum or so much thereof as shall at any time be advanced, at the rate of 6 percent per year, payable monthly on the first day of each month until the Note is paid in full, except that if any interest payment shall be due on a Saturday, Sunday, or public holiday the maker shall pay interest thereon to the next succeeding business day; and

Whereas the Note provides that the principal sum evidenced by the Note shall become due and payable at the option of the holder thereof on the happening of any default or event by which, under the terms of this Deed of Trust or under the terms of the Construction Loan Agreement hereinafter referred to, such principal sum may or shall become due and payable; and that in any event such principal sum or so much thereof as shall have been advanced with interest thereon shall become immediately due and payable at the sole option of Municipal Trust Company, its successors and assigns, at any time subsequent to the earlier of (1) April 1, 2006, or (2) 60 days subsequent to the date of issuance of a permanent Certificate of Occupancy or an irrevocable temporary Certificate of Occupancy permitting use of the entire building to be erected pursuant to such Construction Loan Agreement; and

Whereas the Borrower desires to secure the prompt payment of such principal and interest and the full performance of the covenants herein contained, as well as the prompt payment of principal and interest on any renewal, extension, or change of such Note, and any note given in substitution thereof, which renewal, extension, change, or substitution shall not impair in any manner the validity or priority of this Deed of Trust; and also to secure reimbursement to any Trustee acting hereunder and to any purchaser or grantee under any sale under the provisions of this Deed of Trust for all money which may be advanced as herein provided, and for all costs and expenses, including reasonable attorneys' fees, incurred or paid on account of any litigation at law or in equity which may arise in respect of this Deed of Trust, or the indebtedness, or the property herein mentioned, or obtaining possession of the property after any sale which may be made as hereinafter provided;

Now, therefore, under this Deed of Trust, the Borrower in consideration of the premises and One Dollar in lawful money to it in hand paid by the Trustees, the receipt of which, before the signing and delivery of these presents, is hereby acknowledged, does hereby grant and convey unto the Trustees, their successors and assigns, in trust in fee

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simple, the following described land and premises, with the improvements, including any building hereafter constructed or placed thereon, easements, rights, ways, and appurtenances, now or hereafter belonging thereto, hereinafter called the Property, situated in the District of Columbia:

(Insert description)

together with all right, title, and interest of the Borrower in and to all machinery, apparatus, equipment, fittings, and fixtures of every kind and nature whatsoever, now owned or hereafter acquired by the Borrower and now or hereafter placed in, affixed to, or used in connection with the operation of, the Property. Such machinery, apparatus, equipment, fittings, and fixtures shall include, but not be limited to, all engines, furnaces, boilers, stokers, pumps, heaters, tanks, dynamos, motors, generators, fans, blowers, vents, switchboards, electrical equipment, heating, plumbing, lifting and ventilating apparatus, air cooling and air conditioning apparatus, gas and electrical fixtures, elevators, escalators, shades, awnings, screens, radiators, partitions, ducts, compressors, vacuum cleaning systems, call systems, and fire prevention and extinguishing apparatus. All of such machinery, apparatus, equipment, fittings, and fixtures are hereby understood and agreed to be part and parcel of the Property and appropriated to the use of the Property, whether affixed or annexed or not, and shall for the purposes of this Deed of Trust be deemed to be fixtures and accessory to the freehold and a part of the realty as between the parties hereto, and shall be deemed to be a portion of the security for the indebtedness herein mentioned and to be subject to this Deed of Trust, in and upon the following uses and trusts:

1. *Borrower's rights absent default.* Until any default in the payment of any indebtedness hereby secured, or until the breach of any covenant herein contained, the Borrower, its successors and assigns, shall possess and enjoy the Property, and receive the rents, issues, and profits therefrom. Upon full payment of the Note, and any extension or renewal thereof, and interest thereon, and all sums advanced or expended as herein provided and all other proper costs, charges, expenses, commissions, and half-commissions, incurred at any time before a sale as hereinafter provided for, the Trustees shall release and reconvey the Property, at the Borrower's cost, to the Borrower, or to any party then claiming through or under it.

2. *Obligations of borrower.* The Borrower shall be required to do the following:

(a) In the event of the assessment or imposition of any tax, assessment, or other charge, not including income taxes, pursuant to any laws of the District of Columbia, or any subdivision thereof, upon any holder of the Note or such holder's interest in the Property by reason of such indebtedness, or upon this Deed of Trust, or the debt secured hereby, or the note evidencing such indebtedness, as well as any specific mortgage tax or intangible tax now or hereafter imposed by law in such jurisdiction, such holder shall have the right to give written notice to the Borrower requiring the Borrower to pay the debt secured hereby within 120 days after receipt of such notice. The Borrower shall not be required to pay the debt secured hereby if it or its successors or assigns, without violation of usury laws, pays any such tax, assessment, or charge in full as it becomes due and payable.

(b) The Borrower shall pay the indebtedness secured hereby and the interest thereon at the time and in the manner provided in the Note. Upon default in such payment, the holder of the Note shall have the option to cause the whole indebtedness to become immediately due and payable.

(c) The Borrower shall keep the Property and the fixtures thereon constantly insured against loss or damage by fire and the casualties included under extended coverage and against loss by other casualty including, without limitation, war risk or war damage, if available, in amounts and under types of policies in companies satisfactory to the holder of the Note with losses payable to the holder in such form as the holder may require. The Borrower shall deliver such policy or policies with evidence of the payment of premiums thereon to such holder. In the event the Borrower shall at any time fail to perform such requirements, then such holder may cause the Property to be insured and may pay the premiums for such insurance, and any premium paid or expense incurred in so doing shall be secured by this Deed of Trust and shall

2-Forms Federal Taxes Affecting Real Estate [E]

be repaid with interest at the rate of 6 percent per year by the Borrower within five days after demand. The right of such holder to cause the Property to be insured and to pay any such premium shall not be construed to prevent it from exercising an option to cause the whole indebtedness hereby secured to become immediately due and payable upon such default. If, however, such holder shall exercise the right to cause the Property to be insured or to pay any such premium, such holder shall have the option to cause the whole indebtedness to become immediately due and payable only if repayment is not made as above provided. Such holder may, at its option, apply any insurance proceeds received to the payment of the indebtedness secured hereby or make such proceeds available to the Borrower for the replacement and repair of the Property, under such terms and conditions as it shall see fit.

(d) The Borrower shall pay all taxes, assessments, and charges that may be levied or assessed on or against the Property as the same become due and payable, and deliver official receipts to the holder of the Note on demand showing such payment to have been made. Upon default in such payment, the holder may, at its option, pay or cause to be paid the amount due, and such amount, with any expenses of payment, shall be secured by this Deed of Trust, and shall be repaid with interest at the rate of 6 percent per year by the Borrower within five days after demand. No such right of payment by the holder of the Note shall prevent it from exercising its option to cause the whole indebtedness hereby secured to become immediately due and payable upon such default. If, however, such holder shall pay the amount due, it shall have the option to cause the whole indebtedness to become immediately due and payable only if repayment thereof is not made as above provided.

(e) The Borrower shall at all times maintain the Property and the fixtures thereon in good order and repair, and shall not commit any waste or injury to such an extent as to impair the value of the same as security for the debt. Upon the failure of the Borrower to perform this requirement, or upon actual or threatened demolition or removal of the building hereafter constructed or placed on the Property or the fixtures or any part thereof, the whole indebtedness hereby secured shall become immediately due and payable at the option of the holder of the Note.

(f) The Borrower shall comply with the requirements of all laws and regulations in force in the District of Columbia or any subdivision thereof and with all orders, decrees, or requirements of all governmental bodies having jurisdiction over, or with respect to, the Property. The Borrower may, however, after written notice to the holder of the Note, contest any such law, regulation, order, decree, or requirement, in any reasonable manner which will not affect the title of the Trustees to any part of the Property, or the lien of this Deed of Trust, or the maintenance of that standard of physical condition of the Property which is provided for in subparagraph (e) of this paragraph.

3. *Dispossession of borrower.* Upon default by the Borrower in the performance of any requirement provided for in this Deed of Trust or in the Note secured hereby which under this Deed of Trust gives the holder of the Note the option to cause the whole indebtedness to become immediately due and payable, the Trustees, at the written request of such holder, shall have the right forthwith, after any such default, to enter upon and take possession of the Property, to let the Property and to receive all the rents, issues, and profits therefrom which are overdue, due, or to become due, and to apply the same after payment of all necessary charges and expenses against the balance of the then remaining indebtedness hereby secured. For this purpose, such rents and profits are, in the event of any such default, hereby assigned as security to the Trustees. The Borrower or any subsequent owner of the Property shall in such event pay to the Trustees, in advance, a reasonable rent for the property occupied by them. In default of such payment, the Borrower or such subsequent owner may be dispossessed by the usual summary proceedings. Any tenant defaulting in the payment to the Trustees of any rent may be likewise dispossessed. This covenant becomes effective either without or with any action brought to foreclose this Deed of Trust and without applying at any time for a receiver of such rents. Such collection and application of rents shall in no manner be taken or held to interfere with or abridge the power of sale and disposition granted to the Trustees by this instrument, nor shall such collection and application of rents in any manner at law or in equity discharge or relieve the Borrower, its successors or assigns, from the full payment of the balance of the indebtedness hereby secured, in strict accordance with the terms hereof and of the Note hereby secured.

4. *Sale upon borrower's default.* Upon default by the Borrower in the performance of any requirement provided for in

this Deed of Trust or in the Note secured hereby which under this Deed of Trust gives the holder of the Note the option to cause the whole indebtedness to become immediately due and payable, the Trustees, at the written request of such holder, may sell the Property at public auction, at such time and place, upon such terms and conditions and after such previous public notice, and with such postponement of sale or resale as to the Trustees shall seem best for the interests of all parties concerned. The Trustees shall convey fee simple title to the purchaser in such sale, and the purchaser shall be discharged from all liability for the application of the purchase money. The Trustees shall apply the proceeds of the sale, after paying all expenses of the sale, all taxes and assessments thereon due, all sums advanced as herein provided for, with interest as above set forth, and a Trustees' commission of 1 percent on the gross amount of the sale, to the payment of the then remaining indebtedness hereby secured whether then due or not, and the interest thereon to the date of payment. Any proceeds of the sale in excess of the amount so applied, less the expenses, if any, of obtaining possession of the Property, shall be paid to the Borrower, its successors and assigns, upon the surrender and delivery to the purchaser of possession of the Property so sold and conveyed. If the Property shall be advertised for sale as provided in this paragraph and not sold, the Trustees shall be entitled to one-half of the above commission to be computed on the amount of the debt then remaining indebtedness.

5. *Trustees.* The irrevocable power to appoint a substitute Trustee or Trustees hereunder is expressly granted to the holder of the Note, to be exercised at any time, without notice and without specifying any reason therefor, by filing, for record in the office where this instrument is recorded, a deed of appointment. Such power of appointment of a successor Trustee or Trustees may be exercised as often and whenever such holder deems it advisable. Upon the recording of such deed or deeds of appointment, the Trustee or Trustees so appointed shall thereupon without any further act or deed or conveyance become fully vested with identically the same title and estate in and to the Property with all the rights, powers, trusts, and duties of their, his, or its predecessor hereunder, with like effect as if such Trustee or Trustees were originally named as trustee or trustees hereunder. Whenever in this Deed of Trust reference is made to the Trustee or Trustees, it shall be construed to mean the Trustee or Trustees for the time being, whether original or successor or successors in the trust.

6. *Condemnation.* Should all or any part of the Property conveyed hereby be condemned or taken through eminent domain proceedings, all such part of any award or proceeds derived from such proceedings, as the holder of the Note in its sole discretion may determine, shall be paid to such holder and applied against the then remaining indebtedness hereby secured, and all such proceeds are hereby assigned to such holder to the extent of the then remaining indebtedness hereby secured.

7. *Renewal, extension, waiver.* The holder of the Note, at its option, may at any time renew or extend this Deed of Trust or the Note secured hereby, or alter or modify the same in any way and (except to the detriment of the Borrower) may waive any of the covenants and conditions of the Note or this Deed of Trust in whole or in part either at the request of the Borrower or of any other person then having an interest in the Property or in any way liable on the indebtedness secured hereby; take other security for the indebtedness or release any portion of the Property, or release any party primarily or secondarily liable on the Note; grant such extensions or indulgences in relation to the Note and this Deed of Trust and the payment thereof; and apply to the principal or interest of the indebtedness secured hereby any part or all of the proceeds obtained by sale or otherwise as herein provided, without resort or regard to other security. Such waivers, renewals, extensions, or other indulgences may be granted without in any way releasing the Borrower from any covenant, agreement, or condition of the Note or this Deed of Trust, or affecting the lien of this Deed of Trust on all Property covered hereby and not specifically released.

8. *Subordinate liens.* If the Borrower shall grant any lien on the Property subordinate to this Deed of Trust, such subordinate lien shall be subject to the condition that the time for the payment of the indebtedness hereby secured and the manner and amount of payment thereof, and the benefits of the security afforded hereby and by the Note, or any obligation substituted for the Note, may, without the consent of such subordinate lienor, and without any obligation to give notice of any kind thereto, be extended, re-extended, or suspended on any terms whatsoever without in any manner affecting the priority of the lien hereby created, as security for the payment of the indebtedness secured hereby.

9. *Attornment.* If the Borrower has leased the Property or any part thereof, any such lease shall be subject to the condition that, in the event of any foreclosure sale hereunder, such lease shall continue in full force and effect and the tenant thereunder will, upon request, attorn to and acknowledge the foreclosure purchaser as landlord, unless the holder of the Note, or such foreclosure purchaser or the Trustees hereunder, shall, at or prior to the time of such sale or within 60 days thereafter, notify the tenant in writing to vacate and surrender the leased premises within 90 days from the date of sale. In the event of such notice, any such lease shall fully terminate and expire at the end of such 90-day period. The holder of the Note hereby consents to the creation of such leases subject to such condition.

10. *Incorporation of construction loan agreement.* This Deed of Trust and the Note secured hereby are executed and delivered to secure moneys advanced or to be advanced in accordance with a Construction Loan Agreement of even date herewith between the Borrower and Municipal Trust Company, which Construction Loan Agreement is incorporated herein by this reference. Failure by the Borrower to carry on or complete the construction of improvements in accordance with such Construction Loan Agreement or any other default by the Borrower under such Construction Loan Agreement shall constitute a default under this Deed of Trust and the holder of the Note may at its option cause the entire indebtedness secured by this Deed of Trust to become immediately due and payable. In the event of such default by the Borrower, and whether or not such holder shall cause the indebtedness secured hereby to become immediately due and payable, the Trustees at the written request of such holder, after due notice to the Borrower, may enter upon the Property, employ watchmen to protect the improvements thereon from theft or injury, continue all outstanding contracts for the erection and completion of improvements, enter into any further contracts and obligations wherever necessary, either in their own name as Trustees hereunder or in the name of the Borrower, and pay all debts, obligations, and liabilities incurred thereby. All sums so advanced by the Trustees or by such holder and all sums advanced under such Construction Loan Agreement shall be secured by this Deed of Trust and, to the extent they shall not be included in the principal amount of the indebtedness secured hereby, shall be due and payable on demand with interest at the rate of 6 percent per year.

11. *Deferral of tax payments.* Notwithstanding any other provisions of this Deed of Trust, the Borrower, upon giving to the holder of the Note written notice, shall have the right to defer payment of any tax or assessment levied or imposed against the Property so long as the Borrower shall in good faith and with due diligence at its own expense contest the validity thereof by appropriate legal proceedings. Pending any such legal contest, such holder shall not have the right to pay or discharge such taxes or assessments thereby contested unless such payment is necessary to protect the title to the Property. Such delay by the Borrower in paying the same until final determination of such disputed matter shall not be deemed a default in the performance of the conditions of this Deed of Trust; provided that upon such final determination the Borrower pays such tax or assessment as finally determined together with penalties and interest, if any, thereon; and provided further that on demand of such holder the Borrower shall furnish indemnity satisfactory to such holder against loss or damage on account thereof.

12. *Notice.* Any notice or demand that may be given or made hereunder or with reference to this Deed of Trust shall be sufficient notice or demand if mailed, postage prepaid, addressed to the Borrower at 35 Third Avenue, New York, New York, and to the Municipal Trust Company at 20 Fifth Avenue, New York, New York. Such notices shall be considered to have been given at the time they are deposited in any letter box or post office of the United States Government.

13. *Binding effect.* All provisions, covenants, and agreements contained in this Deed of Trust shall bind, inure to the benefit of, and equally relate to the Borrower, its successors and assigns, and any other succeeding owners of the Property jointly and severally, and the Trustees, the survivor of them or substituted Trustees or Trustee, or other successor or successors in trust and those claiming by, through, or under them. The provisions herein relating to the Municipal Trust Company shall equally relate to its successors and assigns or other holder or holders of the Note secured hereby, including any endorsee, assignee, or pledgee of the Note receiving title thereto by or through Municipal Trust Company, its successors or assigns.

14. *Warranty of title.* The Borrower warrants specially the Property hereby conveyed, and that it shall execute such further assurances with respect to the Property as may be requisite or necessary for vesting title in the Trustees or Trustee acting hereunder for the time being, in and upon the same trusts hereinbefore declared.

In witness whereof the Borrower has caused these presents to be executed in its corporate name as of the day, month, and year first hereinabove written.

Attest:

Boswell Developers, Inc.

by _____

Secretary

President

E.17 Commitment for permanent real estate loan

COMMENT

In this agreement the institutional lender offers, through the medium of its correspondent, to commit itself to the making of a permanent loan for the initial part of the development, as illustrated here.

Second state financing:

In this commitment, the lender's obligation to proceed with financing the second section is expressly conditioned upon the achievement of a satisfactory rent roll for the first section. In this manner, the institution's financial backing is tied to the demonstrated success of the project.

The long-term lender will issue a commitment for the next stage of the project (in this case, the third and last sections) when it is satisfied that the development has demonstrated its financial feasibility. The form of such commitment will be substantially the same as the commitment for the first two sections but will provide for consolidation of all four loans when the final advance is made for the last section.

Collateral:

The loan is collateralized, in part, by the borrower's granting a security interest in certain fixtures included among the improvements to be installed. Typically, the lender will advance the funds to the borrower so that the latter may acquire the specific assets. The lender obtains ultimate protection with respect to such items by creating a purchase money security interest in the fixtures. Filing of such a security interest will be necessary to perfect the lender's lien on the personalty.

Prepayment penalties:

Prepayment penalties, here labeled "surrender payments," are deemed compensation for the use of money for a shorter period than the period to maturity stated in the mortgage or loan instrument. In that sense, they are deemed interest, to which the general rules both of deductibility (by borrower) and taxability (to lender) would apply.

For further information, see Chapters 11, 12, and 19.

FORM

Atlantic Mortgage Company
40 Warren Avenue

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Newark, New Jersey

June 30, 2002

Horizon Gardens, Inc.

P.O. Box 123

Union, New Jersey

Re: Horizon Gardens, Inc.--Sections I and II
South Side of Allen Road
Borough of Claremont
Middlesex County, New Jersey

Gentlemen:

We have received a commitment from the Urban Life Insurance Company for a permanent mortgage loan covering the captioned property, containing the following provisions:

1. *Amount of loan.* The loan shall be in the total amount of \$3,035,000.
2. *Borrower.* The borrower is Horizon Gardens, Inc.
3. *Term of loan and repayment.* The term of the loan shall be 20 years from the date of final payment to the borrower. The loan shall be repaid in equal monthly installments of \$19,601.05 each, beginning on the first day of the third month after the date of final payment to the borrower, and each succeeding month thereafter, to be applied first to interest at the rate of 5.80 percent per year, and the balance on account of principal.
4. *Prepayment.* The borrower may pay the entire balance of the loan (a) on the first day of any month commencing five years from the date of the first monthly payment of principal and interest, by giving 30 days' written notice and by paying a surrender charge of 3 percent, computed on the balance prepaid, and (b) on the first day of any month commencing six years from the date of the first monthly payment of principal and interest, by giving 30 days' written notice and by paying a surrender charge of 2.5 percent, computed on the balance prepaid, and reducing 1.5 percent each year thereafter to a minimum of 1 percent.
5. *Location and size of lot.* The real property affected by the permanent mortgage loan is located at the south side of Allen Road on a plan of Horizon Gardens situated in the Borough of Claremont, Middlesex County, New Jersey, as revised May 13, 2002, and designated Sections I and II and which lies in the southwest corner of the plat consisting of approximately 800,000 square feet.
6. *Improvements.* The improvements on the property shall include 15 two-story, frame, brick veneer apartment buildings consisting of 376 apartments, 1,412 rooms, 376 bathrooms, and on-lot parking for 562 cars.
7. *Insurance value.* The insurance value of the property affected by the permanent mortgage loan shall be \$3,870,000,

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including fixtures valued at \$140,000. We shall be furnished with original fire insurance policies which must be based on the above insurable value, but in no event is the insurance to be less than \$3,035,000.

8. *Liability.* The note shall provide that the sole remedy of the holder shall be foreclosure of the mortgage on the real property in the event of default.

9. *Mortgage.* The note shall be secured by a mortgage which shall be a first lien on the unencumbered, marketable, fee simple absolute title to the real property, to easements appurtenant thereto (if any), and to all improvements to the property described in this commitment, free of the possibility of all (a) prior mechanics' liens, (b) prior materialmen's liens, or (c) special assessments for work completed or under construction on the date of the first payment on account of the loan. All title exceptions shall be subject to the approval of the Law Division of the Urban Life Insurance Company.

10. *Security interest.* (a) The borrower shall grant to us or our designee a security interest in fixtures consisting of 376 ranges, 376 refrigerators, and 376 sleeve air conditioning units, and all additions and accessions thereto, and all proceeds of their sale or disposition.

(b) The borrower shall execute alone or together with us or with our designee as the secured party any financing, continuation, or termination statement or other document or procure any document, and pay all connected costs, necessary to protect such security interest against the interest of third persons.

(c) The borrower shall not permit any other security interest to attach to any of such fixtures, permit such fixtures to be levied upon under any legal process, or permit anything to be done that may impair the value of such fixtures or the security intended to be afforded thereby.

11. *Survey.* We shall be furnished with a final survey from a licensed surveyor upon completion of all improvements. The survey shall show the dimensions and total square foot area of the plot, interior lot lines, if any, the dimensions and location of all improvements, parking areas, and easements, and the location of adjoining streets and the distance to and name of the nearest intersecting streets.

12. *Title policy.* We shall be furnished with a title policy for the loan amount insuring us as the holder of the mortgage from a title company acceptable to us.

13. *Taxes.* All taxes and assessments affecting the real property or any part thereof shall be paid when due, and the mortgage shall require the borrower to pay concurrently with each installment of principal and interest payable on the note such amount as in the mortgagee's discretion will enable it to pay (out of moneys so paid to the mortgagee), at least 30 days before due, all taxes, assessments, and similar charges affecting the real property. No interest shall be payable on such deposits.

14. *Certificate of occupancy.* We shall be furnished with a certificate of occupancy and other evidence satisfactory to us indicating that all improvements and their use comply with all applicable zoning, building, and other governmental laws and requirements.

15. *Leases.* All leases to be executed by tenants will contain no rental concessions, nor will the leases contain any provision which would cut off or impair the lien of the mortgage. This must be certified to by the closing attorney at the time of the closing of the permanent loan. In addition, all leases shall contain a clause, satisfactory to our attorney, subordinating the leases to the mortgage contemplated herein, together with any future advances or modifications thereof.

16. *Approval of documents.* Each document required in connection with this loan shall be delivered to, and shall be in form and substance acceptable to, the Law Division of the Urban Life Insurance Company. Without limiting the

generality of the foregoing, the detailed legal description of the real property set forth in the mortgage shall be acceptable to the Law Division of the Urban Life Insurance Company. The survey, title report, and drafts of all documents shall be submitted to the Law Division of the Urban Life Insurance Company for approval.

17. *Survival of representations.* Except as may be otherwise required by this commitment, the loan, the rental income of the real property, the credit of the borrower, and all other features of the transaction shall be as represented to us without material, adverse change. No part of the real property shall have been damaged and not repaired to our satisfaction nor taken in condemnation or other like proceeding, nor shall any such proceeding be pending. Neither the borrower nor any tenant nor any assignee of such tenant nor any subtenant, nor any guarantor of the loan or any such lease or sublease, shall be involved in any bankruptcy, reorganization, or insolvency proceeding.

18. *Plans and specifications.* The building or buildings and all other improvements contemplated by this commitment (including any grading, seeding, and landscaping and all other on-site and off-site improvements) shall be completed in accordance with plans and specifications to be approved in writing by our architect and shall be equipped and paid for to our satisfaction, and each such building shall be ready for occupancy. The representatives of the Urban Life Insurance Company shall have the right to inspect all such improvements periodically during and after construction. Periodic inspections during construction shall be made, and construction shall be approved, by the architect of the Urban Life Insurance Company or its designee. All corrections required by them must be complied with prior to the next construction advance. No changes are to be made in the original plans and specifications without our written approval.

19. *Signs.* By acceptance of this commitment, permission is granted by the owner for the erection of a sign during the construction period, indicating the source and origination of permanent financing.

20. *Adjoining streets.* Evidence is to be submitted that all streets adjoining the real property have been completed, dedicated, and accepted for maintenance and public use by the appropriate governmental authorities.

21. *Conditions of commitment.* The plans and specifications prepared by T. A. York, Architect, must be reviewed and approved by the Urban Life Insurance Company. In addition to all requirements of its architect, the following, including the use of the specified materials, are conditions of this commitment:

- (a) Compliance with all local codes and ordinances.
- (b) The Urban Life Insurance Company is to be furnished with final heating plans and specifications for its review and approval.
- (c) 235# asphalt shingle roof.
- (d) 1/2" sheetrock interior partitions.
- (e) Full ceramic tile baths.
- (f) #1 oak flooring.
- (g) 30" ranges and 12 c/f refrigerators.
- (h) Aluminum single-hung windows.

22. *Utility lines.* The necessary permanent easements, subject to the approval of the Law Division of the Urban Life Insurance Company, must be supplied with all utility lines which are necessary for the operation of the project. These

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utilities shall include, but not be limited to, gas, electricity, water, and sewerage.

23. *Zoning compliance.* Evidence, acceptable to the Law Division of the Urban Life Insurance Company, must be supplied confirming compliance with all local zoning requirements with regard to, but not limited to, the setbacks of all buildings.

24. *Swimming pool.* An additional parcel of land at the southerly end of the property shall be encumbered by the mortgage, and shall have constructed upon it a swimming pool of a minimum size of 5,000 square feet. At the time of the final disbursement of either section of this loan, we shall require permanent access to the pool.

25. *First section of loan.* The loan shall be made as Section I and Section II, in accordance with the market plot plan dated May 13, 2002. We shall not be obligated for the second section until the first section has been satisfactorily completed and occupied in accordance with the rental condition stated below. The following conditions shall apply to Section I only:

(a) *Amount of loan.* \$1,600,000.

(b) *Improvement.* Completion of construction of eight buildings consisting of 200 apartments, 748 rooms, 200 bathrooms, all the land designated as Section I and Section II, the additional land in the area of the swimming pool, and the completed swimming pool.

(c) *Term.* Twenty years after date of final payment to the borrower.

(d) *Interest rate.* 5.80 percent per year.

(e) *Conditions.* Equal monthly payments by the borrower of \$10,333.34 each, beginning on the first day of the third month after final payment to the borrower, and each succeeding month thereafter, which are to be applied first to interest and the balance on account of principal.

(f) *Mortgage.* The note shall be secured by a mortgage upon all of the land heretofore specified.

(g) *Insurance value.* \$2,000,000. We shall be furnished with the original fire insurance policies which must be based on the insurable policies which must be based on the insurable value, but in no event is the insurance to be less than \$1,600,000.

(h) *Expiration date.* The commitment in respect of Section I will expire April 30, 2003, by which time the final disbursement must be made and the loan assigned to the Urban Life Insurance Company.

26. *Second section of loan.* The following conditions shall apply to Section II only:

(a) *Amount of loan.* \$1,435,000.

(b) *Improvement.* Completion of seven additional buildings consisting of 176 apartments, 664 rooms, 176 bathrooms.

(c) *Term.* Twenty years after date of final payment to the borrower.

(d) *Interest rate.* 5.80 percent per year.

(e) *Conditions.* Equal monthly payments by the borrower of \$9,267.71 each, beginning on the first day of the third month after finally payment to the borrower, and each succeeding month thereafter, which are to be applied first to

interest and the balance on account of principal.

(f) *Mortgage.* The note shall be secured by a mortgage upon all of the land heretofore specified.

(g) *Insurance value.* \$1,870,000. We shall be furnished with the original fire insurance policies which must be based on the insurable value, but in no event is the insurance to be less than \$1,435,000.

(h) *Rental condition.* The eight buildings in Section I shall have a gross rental income from not more than 77 percent of the apartments in the buildings on an unfurnished basis of not less than \$214,000, and the space rented shall be rented on a basis so that if the building were 100 percent rented, the annual rental would be at least \$279,500. Such apartments shall be occupied by tenants on a current rent paying basis under written leases or rental agreements. Horizon Gardens, Inc., shall give us a rent roll certified to be correct indicating that apartments and the annual rental therefrom relied upon to satisfy this condition. No rental concession to tenants shall have been made, and the Horizon Gardens, Inc., certificate shall so state.

(i) *Consolidation.* At the time of the final disbursement on Section II of this loan, it will be consolidated with the loan made pursuant to Section I. The consolidated loan must be a first lien on the entire property, and the Urban Life Insurance Company must be furnished with title insurance, satisfactory to its Law Division, to this effect.

(j) *Expiration date.* The commitment in respect of Section II will expire April 30, 2004, by which time the final disbursement must be made, and the loan assigned to the Urban Life Insurance Company and consolidated with the loan made pursuant to Section I.

(k) *Interim subordination.* If necessary for construction loan purposes in connection with Section II of this commitment, only that portion of the land designated as Section II may be subordinated in order to provide the interim lender with a valid first lien. However, any such subordination shall be in such a manner as not to disturb any easements or other requirements as provided for in other sections of this commitment.

27. *Closing.* Howard Wood, Esq., shall be the closing and disbursing attorney in respect of this case and all legal expenses including survey costs, title costs, recording charges, etc., are to be without charge to this company. We shall receive a letter from the title company indicating that Mr. Wood is approved and bonded by such title company, if such a letter is not now in our files.

28. *Deposit.* Upon acceptance of this commitment, you shall deposit with us a check in the amount of 1 percent of the amount of the mortgage, as pertains to each section, which will be held in escrow until the time of the first construction advance, at which time this deposit will be considered income earned by us for services rendered. If for any reason this loan is not assigned to the Urban Life Insurance Company pursuant to the provisions hereof, this deposit must be remitted by us to the Urban Life Insurance Company as the consideration for the commitment's not having been fulfilled.

29. *Disbursements for material and labor.* We shall forward to Mr. Wood the permanent mortgage and mortgage note forms, to be drawn in accordance with the terms of our permanent mortgage commitment. The executed forms of the mortgage and mortgage note, together with the necessary title binder, survey, and other papers, as required, will be returned to us. We shall forward them to the Law Division of the Urban Life Insurance Company, and upon approval, we shall disburse against this mortgage from time to time an amount equal to 90 percent of the cost of material and labor in place and material on the site as certified by the Architect, and verified by us.

30. *Broker's fee.* In consideration of our arranging the construction financing on your behalf, we are to receive a fee of \$1,000 in respect of each section, payable at the time of our first construction advance on that section.

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31. *Anticipatory completion.* If at any time before the expiration of this commitment the improvements on the property, in the judgment of the Urban Life Insurance Company, have been sufficiently completed and you have otherwise complied with the terms of the commitment, the final disbursement is to be made, and amortization is to commence, in accordance with the terms of the commitment.

32. *Commencement of construction.* Construction must be started by August 1, 2003, or at our option the commitment will be terminated.

33. *Assignment.* This commitment is not assignable without our express written approval. In order that our records may be complete, we would appreciate your acknowledging your acceptance of the terms and conditions of this commitment on the duplicate copy enclosed.

Very truly yours,

Atlantic Mortgage Company

by _____

President

Horizon Gardens, Inc.

by _____

President

E.18 Land mortgage and note--guaranty by corporate principals

COMMENT

Illustrated here are a mortgage encumbering all the land except the portion which will be improved first and the promissory note of the borrower corporation guaranteed by the principals. The institutional lender usually requires its loan correspondent to participate in the land loan. Consequently, shortly after the note and mortgage have been delivered, they will execute a participation agreement setting forth their internal arrangements, such as the amounts of their respective participations, their respective rights in payments, and their separate rights if foreclosure of the mortgage should be undertaken. The participation may be recorded to put third parties on notice.

For further information, see Chapters 11, 12, and 19.

FORMS

(1) Land mortgage

THIS INDENTURE, made July 1, 2002, between Horizon Gardens, Inc., a corporation organized and existing under the laws of the State of New Jersey (the "Mortgagor"), and Atlantic Mortgage Company, a corporation organized and existing under the laws of the State of New Jersey (the "Mortgagee").

Whereas the Mortgagor has become justly indebted to the Mortgagee in the sum of \$260,000, with interest thereon at the rate of 8 percent per annum for which amount the Mortgagor has signed and delivered unto the Mortgagee a certain note bearing even date with these presents, the terms of which are incorporated herein by reference, the principal and interest to be payable at the office of the Mortgagee in Newark, New Jersey, or at such other place as the holder thereof

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may designate, in the following manner: interest, only, from the date of disbursement, to be paid in monthly installments of \$1,354.17 on the first day of each month thereafter, to and including the thirtieth month following the date of disbursement; the principal amount of \$260,000, plus accrued interest, shall become due and payable on the first day of the thirty-first month following the date of disbursement; and

Whereas the Mortgagor is desirous of securing the prompt payment of such note and the several installments of principal, interest, and the monthly payments hereinafter provided for, and any additional indebtedness accruing to the Mortgagee on account of all future payments, advances, or expenditures made by the Mortgagee as hereinafter provided.

1. *Grant of mortgage.* The Mortgagor, for the purpose of securing the prompt payment of the indebtedness as it becomes due, and also for and in consideration of the sum of One Dollar to it in hand paid by the Mortgagee, at or before the ensembling and delivery of these presents, the receipt whereof is hereby acknowledged, has granted, bargained, sold, aliened, released, conveyed, and confirmed, and by these presents does grant, bargain, sell, alien, release, convey, and confirm unto the Mortgagee forever, all that tract or parcel of land situate, lying, and being in the Borough of Claremont, County of Middlesex, and State of New Jersey, as more particularly referred to in the description annexed hereto and made part hereof.

Together with all and singular the tenements, hereditaments, and appurtenances thereunto belonging or in any wise appertaining, and the reversion or reversions, remainder and remainders, rents, issues, and profits thereof, and also all the estate, right, title interest, property, possession, claim, and demand whatsoever as well as in law as in equity of the Mortgagor, of, in, and to the same, and every part and parcel thereof. To have and to hold the herein granted and described premises unto the Mortgagee to its own proper use, benefit, and behoof forever; and the Mortgagor does covenant with the Mortgagee that it is seized of an indefeasible estate in fee simple in such premises and will warrant and forever defend the title thereof unto the Mortgagee, against all lawful claims whatever.

2. *Release of sections from lien of mortgage.* It is understood and agreed that the Mortgagee will release the respective sections of the mortgaged premises from the lien of this mortgage in the following order, and upon performance of the following conditions:

- (a) Section II, upon the payment of \$90,000;
- (b) Section III, upon the payment of \$90,000, and, at the option of the Mortgagee, the issuance and acceptance by the Mortgagor of a mortgage commitment for the permanent financing of the garden apartments to be built on such section;
- (c) Section IV, upon the payment of \$80,000, and, at the option of the Mortgagee, the issuance and acceptance by the Mortgagor of a mortgage commitment for the permanent financing of the garden apartments to be built on such section.
- (d) However, Mortgagee shall be under no obligation whatsoever to grant any release if any default by Mortgagor exists under the terms of the note and mortgage. Mortgagor must fully cure any such default(s) before any release goes forward.

3. *Payment of note.* These presents are upon the express condition that if the Mortgagor shall pay unto the Mortgagee the indebtedness according to the terms of the note hereinabove referred to, without deduction or credit for taxes, then these presents and the estate hereby granted shall cease, determine, and be void.

4. *Covenants of mortgagor.* The Mortgagor, in order more fully to protect the security of this mortgage, does hereby covenant and agree as follows:

- (a) That it shall pay all ground rents, taxes, assessments, water and sewer rates, and other governmental or municipal

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charges, fines, or impositions levied upon such premises or upon the interest of the Mortgagee in and to such premises for which provision has not been made heretofore, and shall deliver proper receipts therefor to the Mortgagee; and in default thereof, the Mortgagee may pay the same. All payments so made by the Mortgagee shall be a lien on the mortgaged property, and shall be added to the amount of the indebtedness secured by these presents.

(b) That it shall not claim or demand or be entitled to receive any credit or credits on the principal indebtedness to secure payment of which this mortgage is made, or on the interest payable thereon, for so much of the taxes assessed against such lands as is equal to the tax rate applied to the principal indebtedness due on this mortgage or any part thereof, and that no deduction shall be claimed from the taxable value of such lands and premises by reason of this mortgage; and that during the continuance of this mortgage the Mortgagor shall keep all the buildings subject to this mortgage in good and substantial repair, and that if the Mortgagor shall neglect to do so the Mortgagee may, at its option, enter upon the premises from time to time, in order to repair, and keep in repair, such premises, without thereby becoming liable to the Mortgagor, or any person holding under him in possession, and that the Mortgagee's expense of so repairing or keeping in repair shall be a lien on the mortgaged premises, added to the amount of the indebtedness secured by these presents.

(c) That it shall keep the improvements, now existing or hereafter erected on the mortgaged property, insured as may be required from time to time by the Mortgagee against loss by fire and other hazards, casualties, and contingencies in such amounts and for such periods as may be required by the Mortgagee, and shall pay promptly, when due, all premiums on such insurance. All insurance shall be carried in companies approved by the Mortgagee, and the policies and renewals thereof shall be held by the Mortgagee and have attached thereto loss payable clauses in favor of and in form acceptable to the Mortgagee. In the event of loss, the Mortgagor shall give immediate notice by mail to the Mortgagee, who may make proof of loss if not made promptly by the Mortgagor. Each insurance company concerned is hereby authorized and directed to make payment for such loss directly to the Mortgagee instead of to the Mortgagor and Mortgagee jointly, and the insurance proceeds, or any part thereof, may be applied by the Mortgagee at its option either to the reduction of the indebtedness hereby secured or to the restoration or repair of the property damaged. In the event of foreclosure of this mortgage or other transfer of title to the mortgaged property in extinguishment of the indebtedness secured hereby, all right, title, and interest of the Mortgagor in and to any insurance policies then in force shall pass to the purchaser or grantee. Any premium not paid by the Mortgagor may be paid by the Mortgagee, and the amount so paid shall be a lien on the mortgaged property, and shall be added to the indebtedness hereby secured.

(d) That in the event the premises or any part thereof shall be taken or condemned for public or quasi-public purposes by the proper authorities, the Mortgagor shall have no claim against the award for damages, or be entitled to any portion of the award until the within mortgage shall be paid and all rights to damages of the Mortgagor are hereby assigned to the Mortgagee to the extent of any indebtedness that remains unpaid. The Mortgagor, however, shall have the right to appeal such award to any court of competent jurisdiction.

(e) That, on and after any default in the payment of any sum secured hereby, the Mortgagor or anyone claiming by, through, or under it shall, upon demand of the Mortgagee, become a month-to-month tenant of the Mortgagee, and shall pay as monthly rental for the portion of the mortgaged premises occupied by the Mortgagor the respective sums agreed to be paid as monthly payments in this mortgage in advance on the dates and in the manner provided for such payment in such note. In default of so doing, the Mortgagor and anyone claiming by, through, or under it may be dispossessed by proceeding under the Landlord and Tenant Act, or any other appropriate summary proceedings. This covenant shall be effective either with or without any action being brought to foreclose this mortgage and without applying for a receiver to collect rents.

(f) That the Mortgagee's failure at any one or more times to assert its right to the security created by the assignment of rents shall at no time be deemed a waiver of its right to the security and the right to collect the rents, nor shall it impair the security of the mortgage or have any effect on the amount due hereunder.

(g) That upon default by the Mortgagor of any covenant herein contained, or upon its default in the payment of interest or any installment of principal, or of any part thereof, or of any monthly installment for ground rent, taxes, assessments, water and sewer rates, or other municipal or governmental rates, charges, impositions, or liens, or any other payments to be made by the Mortgagor hereunder; or in the event the Mortgagor shall fail to comply with the laws, rules, regulations, and ordinances made or promulgated by lawful authority which are now or may hereafter become applicable to the mortgaged premises, within 60 days after written notice is given by the Mortgagee to the Mortgagor; or if any building, structure, or other improvement on the premises shall be removed or demolished by the Mortgagor, or its agents, or servants without the Mortgagee's written consent; then in any of these cases the principal indebtedness or so much thereof as may remain unpaid with all arrearages of interest charges and all advancements at the Mortgagee's option shall become and be due immediately thereafter.

5. *Receiver of rents.* The Mortgagee shall have the right, in case of the Mortgagor's failure to perform any act, covenant, or condition in this mortgage or the note secured hereby, upon a complaint filed or any proper action being commenced for the foreclosure of this mortgage, to apply for, and the Mortgagee shall be entitled as a matter of right without consideration of the value of the mortgaged premises as security for the amounts due the Mortgagee, or of the solvency of any person or persons obligated for the payment of such amounts, to the appointment by any competent court or tribunal, without notice to any party, of a receiver of the rents, issues, and profits of the premises. Such receiver shall have the power to lease the premises, or such part thereof as may not then be under lease, and shall have such other powers as may be deemed necessary. Such receiver, after deducting all proper charges and expenses attending the execution of the trust as receiver, shall apply the residue of the rents and profits to the payment and satisfaction of the amount remaining secured hereby, or to any deficiency which may exist after applying the proceeds of any judicially decreed sale of the premises to the payment of the amount due, including interest and the costs of the foreclosure and sale. Such rents and profits are hereby, in the event of any default or defaults in the payment of such principal or of any installment thereof or interest, or any tax, assessment, water rate, or insurance, pledged and assigned to the Mortgagee, who shall have full power and authority to enter upon and to take possession of the mortgaged premises, to institute and carry on all legal actions or proceedings necessary for the protection of the herein described property, including such actions or proceedings as may be necessary to recover the possession of the whole or any part thereof, to institute and prosecute all suits for the collection of rents now due and unpaid, and hereafter to become due, to institute and prosecute summary proceedings for the removal of any and all tenant or tenants or other persons from the property, to pay the costs and expenses of all such suits, actions, and proceedings out of the rent received, to maintain the property and to keep the same in repair, to pay the cost thereof and of the services of all employees, including their equipment, and all gas, electricity, power, coal, awnings, and generally all of the running expenses and expenses of maintaining and keeping of the property in repair and first-class condition, and in such condition as property of the style and kind of the real property herein described is customarily kept, and also all interest on this mortgage, and the note to secure which this mortgage is given, and all taxes, assessments, and water rates, which may hereafter become liens on the real property, and all premiums of insurance on policies of insurance effected by the Mortgagee as security for the amount hereby secured, and also the principal sum of this mortgage and of the note to secure which the same is given out of the rent received. The Mortgagee shall also have power and authority to rent or lease the whole or any part of the property for such term or terms and on such conditions as it may deem proper, to employ an agent to rent and manage the property and to collect the rents and profits thereof, and to pay the reasonable value of the agent's services out of the rent received.

6. *Change of law.* In the event of the passage after the date of this mortgage of any law deducting any lien from the value of land for the purpose of taxation, or changing in any way the laws now in force for the taxation of mortgages or debts secured by mortgage, or the manner of collection of any such taxes, so as to affect and lessen the net income on the indebtedness secured by this mortgage, the whole of the principal sum secured by this mortgage, together with the interest due thereon, shall, at the Mortgagee's option, without notice to any party, become immediately due and payable.

7. *Counsel fees and expenses.* The Mortgagor shall pay on demand the Mortgagee's counsel fees and expenses incurred in any action or proceeding wherein the lien or the amount secured thereby may be affected. Such counsel fees and

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expenses shall be added to the mortgage debt and secured by all of the provisions contained herein.

8. *Entire agreement.* This instrument supersedes all agreements previously made between the parties relating to its subject matter. There are no other understandings or agreements between them.

9. *Notices.* All notices or other documents under this instrument shall be in writing and delivered personally or mailed by certified mail, postage prepaid, addressed to the parties at their last known addresses.

10. *Non-waiver.* No delay or failure by either party to exercise any right under this instrument, and no partial or single exercise of that right, shall constitute a waiver of that or any other right, unless otherwise expressly provided herein.

11. *Headings.* Headings in this instrument are for convenience only and shall not be used to interpret or construe its provisions.

12. *Governing law.* This instrument shall be construed in accordance with and governed by the laws of the State of New Jersey.

13. *Binding effect.* The provisions of this instrument shall be binding upon and inure to the benefit of both parties and their respective legal representatives, successors, and assigns.

In witness whereof the Mortgagor has caused these presents to be signed by its President, attested by its Secretary, and its corporate seal to be hereunto affixed, the day and year first hereinabove written.

Attest:	Horizon Gardens, Inc.
	by _____
Secretary	President

(2) *Land mortgage note*

\$260,000

Union, New Jersey

July 1, 2002

FOR VALUE RECEIVED, Horizon Gardens, Inc., a New Jersey corporation, having its principal place of business at Union, New Jersey, promises to pay to the order of Atlantic Mortgage Company, a New Jersey corporation, at its office at 40 Warren Avenue, Newark, New Jersey, or such other place as the holder of this note may from time to time designate, the principal sum of \$260,000 with interest from the date at the rate of 8 percent per year, in the following manner:

Interest, only, from the date of disbursement, to be paid in monthly installments of \$1,354.17 on the first day of each month thereafter, to and including the thirtieth month following the date of disbursement.

The principal amount of \$260,000, plus accrued interest, shall become due and payable on the first day of the thirty-first

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month following the date of disbursement.

This note is secured by a mortgage of even date herewith, made by the maker hereof to Atlantic Mortgage Company on real property situate in the Borough of Claremont, County of Middlesex, State of New Jersey, the terms, covenants, conditions, provisions, stipulations, and agreements of which mortgage are hereby made part of this note, to the same extent and with the same effect as if they were fully set forth herein. The maker hereof does hereby covenant and promise to abide by and comply with each and every covenant and condition set forth in this note and in the accompanying mortgage.

And it is hereby expressly agreed that upon the failure of the maker hereof to pay any sum herein specified, when due, or upon a breach of any other of the terms, covenants, conditions, provisions, stipulations, and agreements of this note or the accompanying mortgage, the entire principal debt, or so much thereof as may remain unpaid at the time, shall, at the option of the holder of this note, become due and payable immediately. Payment of such principal debt, or the balance thereof, and all interest thereon, together with all other sums due under the terms hereof or the accompanying mortgage, may be enforced and recovered at once. Any sum not paid when due shall bear interest at the rate of 8 percent per year.

The maker hereof and all parties who at the time may be liable hereon in any capacity, jointly and severally, waive presentment, demand for payment, protest, and notice of dishonor of this note.

Attest:

Horizon Gardens, Inc.

by _____

Secretary

President

(3) Guaranty

Guaranty Annexed to and Forming Part of \$260,000 Note
Executed by Horizon Gardens, Inc., in Favor of Atlantic
Mortgage Company

FOR VALUE RECEIVED, we and each and all of the endorsers herein, jointly and severally, guarantee the payment of the principal and interest of the attached note, as and when the principal thereof and the interest thereon shall become due, and of any extensions of such note. We do hereby accept all of the provisions of such note and authorize the maker, without notice to us or to any of us, to obtain an extension or extensions of such note in whole or in part, and we do hereby waive presentment, notice of nonpayment, and protest. Suit may be brought by the holder of this note against one or more or all of us at the option of such holder, whether a suit has been commenced against the maker or not, and, in any such suit, the maker may be joined with one or more or all of us at the option of the holder. We do further hereby waive any and all exemptions existing by virtue of any state or federal statute now in effect or at any time hereafter becoming effective.

Dated: July 1, 2002

Harrison Blake

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William Kern

Wendell Smith

Eugene Crane

Harold Prentiss

E.19 Performance bonds--provisions for deposit--subdivider's completion bond--cash escrow--letter of credit

COMMENT

A legal device to assure completion of real estate subdivisions under development may be necessary to comply with various local and federal regulations. Performance bonds or subdivision improvement guarantees are the most widely accepted instruments for this purpose.

Local jurisdiction:

Subdivision improvement guarantees are contracts used by local governments to assure that required capital improvements are completed in a satisfactory manner by subdivision developers. They are seldom publicized yet are a vital part of the planning process. One type of subdivision improvement guarantee, the performance bond, dominates the field, although many other forms of guarantees may also be used. The authority of local governments to require developers to install improvements and to accept improvement guarantees, in lieu of immediate installation, is well established.

Challenges to the use of improvement guarantees have been infrequent, primarily because the use of improvement guarantees is generally in the financial interest of the subdivider. The subdivider will usually find it less expensive to post an improvement guarantee than to install and pay for improvements immediately.

Time of guarantee:

Guarantees may be required either before preliminary plat approval or after final plat approval. If the final plat is not approved, then the community must refund the guarantee. Once the requirements for a performance guarantee have been met and final plat approval has been secured, building permits may then be issued.

Completion of improvements:

The basic approach is to require completion and dedication of improvements prior to final approval and recording of the plat. Final approval of such contracts, plats, and other legal instruments usually is vested solely in the legislative body. Large subdivisions may require more than two years to complete, no matter how diligently development proceeds. In such cases, the work will probably be done in stages or sections. It may work to the advantage of both the developer and the community to approve those stages separately. Occupancy permits for completed sections can be obtained sooner and performance guarantees need be posted only during the actual development period.

When a monetary or property security has been used, it must be refunded to the party putting up the

guarantee. A contract alone does not assure completion of improvements in every case. Therefore, the subdivider may be required to make one of the following arrangements in order to guarantee sufficient funds to complete the improvements:

(1) Surety performance bonds: Performance bonds are a kind of insurance, in the form of a bond payable to the community. The subdivider pays a bonding company a premium to guarantee the funds necessary to complete the improvements. In case of default by the developer, the specified amount of the bond goes to the community.

(2) Escrow account: Here, the subdivider deposits either cash, a note, a bond, or some other instrument readily convertible into cash for a specific face value, with a bank, in an account payable to the community. If the developer fails to complete the improvements within the specified time, the bank turns over the account to the community. If the improvements are completed in a satisfactory manner the community releases the funds back to the developer. The developer cannot withdraw any funds that have not been released by the community.

(3) Property escrow: This technique is essentially the same as escrow accounts in (2) except that property, rather than cash, is held in escrow. Land is the most common form of property used, with stocks and bonds also being used.

(4) Sequential approval of subdivision segments without a guarantee: In this technique the subdivider is given final plat approval and allowed to develop small sections of the subdivision without offering an improvement guarantee for the entire subdivision. This assumes that approval of each succeeding segment is sufficient incentive to complete improvements in the next segment. Final plat approval is granted to only one section at a time. Plat approval for succeeding sections is not granted until the improvements on each preceding section have been completed and accepted for dedication. Reductions of guarantees may be provided for sequentially as stages of development are completed. Of course, a minimum should be set to cover costs. Thus, failure to complete improvements on any section halts subsequent development of all remaining sections and ends the subdivider's hopes for profits on those remaining sections.

(5) Special assessment: Under this technique, the community assumes responsibility for raising the funds necessary to finance improvements and assessing the costs to the subsequent lot purchasers in the subdivision.

(6) Letter of credit: This method is approved in a number of subdivision ordinances. The subdivider secures a letter of credit from a bank or other institution or from a person with resources sufficient to cover the cost of improvements in case of default by the subdivider. The credit may not be revoked without the community's approval.

Inspection:

To insure proper construction, a knowledgeable community official, usually the municipal engineer, will inspect improvements both while under construction and upon completion. The official should either certify that the improvements have been completed according to specification or else make known the defects in their construction. In most instances, legal formalities ceding the improvements to the community are necessary for the community to take possession of the improvements. After such dedication, all documents are filed, and the community is deemed to have accepted the improvements.

For further information, see Chapters 6 and 11.

FORMS

(1) Performance bond--Midwest usage

KNOW ALL MEN BY THESE PRESENTS:

That we, John Rowe, as Principal, and Martin Wilson, as Surety, are held and firmly bound unto the City of Wichita, County of Sedgwick and State of Kansas, in the sum of \$1,500,000 lawful money of the United States, for payment of which we bind ourselves, our heirs, executors, successors and assigns jointly and severally, firmly by these presents.

THE CONDITION OF THIS OBLIGATION IS SUCH THAT:

Whereas said Principal will make the following improvements, all improvements and other work as set forth to be done and performed in accordance with the plans, specifications and provisions as determined by the City of Wichita for the development and improvement in Liberty Acres Plat located in Section 25, Township 5, Range 20, Sedgwick County, Kansas.

THEREFORE, the Principal, John Rowe, shall perform the following obligations and conditions:

1. Install all sewers, and hook up to main line;
2. Grade and pave all roads;
3. Bury all utility cable conduits underground.
4. Reimburse to the City of Wichita at an actual cost figure, all costs and expenses related to the preparation of plans and specifications and the inspection of construction of the above listed projects.

All of the above obligations shall be performed before May 1, 2002, in accordance with presently established standards and specifications of the Department of Public Works of the City of Wichita.

Therefore, if the Principal shall fully and faithfully perform all the work specified to be done and performed within the time prescribed, and in accordance with the plans, specifications, and provisions to which reference is here made, then this obligation shall be void; otherwise it is to remain in full force and effect in law.

It is expressly understood and agreed that the liability of the Surety for any or all claims hereunder shall in no event exceed the penal amount of this obligation, as herein stated. It is expressly understood that the City may declare the bond forfeited if the conditions herein have not been fully complied with in every respect, and that the City may install these projects and pay for them out of the forfeited bond funds.

The Surety hereby stipulates and agrees that no modifications, omissions, or additions, in or to the plans or specifications, or any extension of time, shall in any way affect the obligation of said Surety on its bond.

In witness whereof we have hereunto set our hand and seal on January 1, 2002.

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Principal
John Rowe

Surety
Martin Wilson

*(2) Bond for completion of land subdivision improvements--
East
coast*

KNOW ALL MEN BY THESE PRESENTS:

That we, William R. Martin of the City of Nordale, County of Nutmeg, and State of Connecticut, as Principal, and Bernstein Bonding Corporation, a corporation duly licensed to conduct a surety business in the State of Connecticut and having its principal office at 10 Main St., Nordale, as surety, are jointly and severally bound unto the City of Nordale, Connecticut, in the sum of \$2,000,000, for which payment we jointly and severally bind ourselves, our heirs, executors, administrators, successors, and assigns by these presents.

THE CONDITION OF THIS OBLIGATION IS SUCH THAT:

Whereas the Principal has made application to the City of Nordale for the approval of a plan for the subdivision of certain land located in the City of Nordale, which plan is entitled "Luther King Park," was made by William R. Martin and is dated January 1, 2002, and

Whereas the Planning Commission of the City of Nordale has approved this plan on condition that the Principal file with the City Clerk a bond in the amount of \$2,000,000, with surety and conditions satisfactory to the Commission securing to the City the actual completion within one year of certain work and installations required by the Commission, as more fully appears in the record of the hearings of the Commission on the Principal's application, which record is hereby made a part hereof:

Now, therefore, if the Principal shall on or before January 1, 2003, make and complete to the satisfaction of the Common Council of the City of Nordale the work and installations herein referred to, this obligation shall be null and void; otherwise the Principal and Surety shall pay to the City of Nordale, the amount which the City *provided, however*, the amount which the Principal and Surety shall be required to pay hereunder shall not, in any event, exceed the penal sum hereof;

Notwithstanding the foregoing, the Committee on Subdivisions of the City Planning Commission of the City of Nordale shall have the right to approve or disapprove modifications of this bond, upon application of the Principal, as follows:

- A. Reduction in bond amounts not to exceed a total of 50 percent;
- B. Granting of extensions of time;
- C. Approving minor changes in construction design.

In witness whereof the said Principal and Surety have caused these presents to be signed and their seals to be affixed hereunto January 1, 2002.

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Signed, sealed, and delivered in the Presence of:

_____	L.S.	_____	L.S.
		William R. Martin	
_____	L.S.	_____	L.S.
		Ben jamin Bernstein	
		for Bernstein Bonding	
		Corporation	

*(3) Performance bond--secured by bank deposit--
Massachusetts*

KNOW ALL MEN BY THESE PRESENTS:

That I, John L. Standish, of the City of Revere in the County of Ipswich, Massachusetts, hereby am held and stand firmly bound, and bind and obligate myself and my successors, assigns, executors, administrators, heirs, and devisees to the city of Pittsford, a Massachusetts Municipal Corporation in the County of Hampshire, in the sum of \$1,000,000 and have secured by compliance with this obligation by the deposit with the Treasurer of said City of said sum in savings bank books duly assigned in an amount satisfactory to the Treasurer.

The CONDITION of this obligation is such that if the undersigned or his successors, assigns, executors, administrators, heirs, or devisees shall have within the time specified in the order of the Pittsford Planning Board fully and satisfactorily performed in the manner specified, all of the conditions, covenants, terms, agreements, and provisions contained both in the application signed by John L. Standish and dated January 1, 2002, and in the approval of a definitive plan of a certain subdivision entitled Belmont Acres and drawn up by Edward Stone, AIA and dated November 1, 2001, which was granted on January 31, 2002, by the Pittsford Planning Board, then this obligation shall be null and void; OTHERWISE it shall remain in full force and effect, and the aforesaid security for the payment of said sum shall be and become the sole property of the City of Pittsford as liquidated damages.

In witness whereof, the obligor has hereunto set his hand and seal, February 1, 2002.

John L. Standish Applicant

(4) Subdivider's completion bond--Florida

KNOW ALL MEN BY THESE PRESENTS, That we, Conboy Construction Company ("Principal"), and Martin Finance Company ("Surety"), are held and firmly bound unto the County of Palmer, a political subdivision of the State of Florida ("County"), in the sum of \$2,000,000, lawful money of the United States of America for the payment of which we bind ourselves, our heirs, executors, administrators, successors, and assigns, jointly and severally, firmly by these presents:

Whereas the above named Principal has applied to the County for approval of a plat of a certain area of land within Palmer County to be known as Utopia Condominiums, and has agreed, as a condition to the approval of said plat by

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said County, to install the improvements set forth in Exhibit A attached hereto and hereby made a part hereof by reference thereto, which improvements may consist of, but are not necessarily limited to, paving, curbing, grading, filling, storm sewers, sanitary sewers, bridges, catch basins, headwalls, pipe lines, and other similar improvements, and

Whereas the approval of said plat by said County is further conditioned upon the furnishing of an adequate Surety Bond to be furnished to the County,

Now, therefore, the condition of this obligation is such that, if the Principal shall in all respects comply with the terms and conditions of the approval of said plat, these conditions being more specifically the completion of the improvements referred to in Exhibit A hereof, in accordance with the ordinances and regulations of Palmer County in regard to subdivision improvements and according to the plans, specifications, and schedules covering said work, and such approved additions, amendments, or alterations as may be made in the plans, specifications, and schedules for such work as approved by the County Engineering Department, and shall complete all said work on or before January 1, 2004, then this obligation shall be void, otherwise remaining in full force and effect.

And the said Surety, for value received, hereby stipulates and agrees that no change involving an extension of time, alterations, or additions to the terms of the contract or to the work to be performed or materials to be furnished thereunder, or in the plans, specifications, and schedules covering same, shall any way affect said obligation of said Surety on this bond, and the said Surety does hereby waive notice of all such changes, extension of time, alterations or additions to the work or of the plans, specifications, and schedules.

This bond shall be for the use and benefit of the County if it should elect to proceed with said work upon the failure or refusal of the Principal by the date hereinabove specified, or any subsequent date provided through an agreement between the Principal and the County for any extension of time.

In witness whereof the Principal and Surety have caused these presents to be duly executed, January 1, 2002.

(Corporate Seal)

_____ (Seal)

Conboy Construction Co.

by _____

Terence X. Conboy, Pres.

Attest:

Secretary

by _____

Martin Finance Co., by

Mordecai Martin, Pres.

SURETY

(5) Cash escrow mutual agreement form--Atlantic region

MUTUAL AGREEMENT FORM BETWEEN Blue Grass Builders, the Developer of Happy Acres Farms Subdivision, and Lexington Federal Bank, a lending institution.

and

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Hortonville-Capstan County Planning Commission, on behalf of and for the community of Hortonville.

The above parties agree to the following conditions of this agreement, which is hereby established to fulfill the requirements of the Subdivision Regulations.

A. The developer agrees:

1. To the establishment of an escrow account in a local lending institution of a sufficient amount to cover the entire cost of the improvements required in the Subdivision Regulations for said Subdivision. The amount shall be determined by the bids received from reputable contractors for each construction item, and shall be the bids accepted and approved by the developer.
2. The funds established in said account shall only be used to install the required improvements in said Subdivision, and said funds shall not be disbursed except by mutual agreement of the developer, the local lending institution, and the Planning Commission or its appointee.
3. That a maximum of 10 percent of the escrow account established to cover the cost of physical improvements shall remain in the account until the last payment is requested, and said percentage shall be disbursed with the last payment. Other payments shall be made on a basis of the percentage of work satisfactorily completed, as stated in B-3. All required improvements shall be satisfactorily installed within 18 months of the date of final plat approval.
4. To notify the Planning Commission at least two days prior to the construction of the improvement items.

B. The lending institution agrees:

1. That \$1,750,000 has been established in an escrow account for the purpose of installing the required improvements in said Subdivision and shall only be used to install said improvements.
2. To withhold a maximum of 10 percent of the escrow account established to cover the cost of the required improvements, which shall be disbursed with the final payment.
3. To disburse funds from said account on a basis of the percentage of the improvements satisfactorily completed. This percentage shall be determined based upon the itemized cost figures stated in A-1 above, and shall be the lesser of the percentages estimated by the local lending institution and the Planning Commission or its appointee.
4. Not to disburse any money from said account until the local lending institution has received written notice from the Planning Commission or its appointee that a specified percentage of the required improvements has been satisfactorily completed and approved by the Planning Commission or its appointee.

C. The Planning Commission agrees:

1. To accept this agreement in lieu of a performance bond or in lieu of the completed improvements required in the Subdivision Regulations.
2. To have the Commission's Staff or City-County Engineer periodically inspect said improvements while under construction and inspect completed improvements within seven days after receiving written notice that the improvement item has been completed. The Commission Staff or City-County Engineer shall notify the local lending institution and the Developer within ten days after receiving written notice, as stated above, as to the percentage of improvements

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completed.

D. Escrow account \$1,750,000 (10 percent minimum balance: \$175,000)

☐ streets	☐ grading	☐ water
☐ curbs and	☐ storm	☐ engineering
gutters	drainage	☐ parking areas
☐ sidewalks	☐ sewers	

Blue Grass Builders,

The Developer of Happy Acres Farms Subdivision

by _____

Lexington Federal, the Lending Institution

by _____

Daniel Clay Webster Chairman, Planning Commission

*(6) Regional planning commission agreement to be used with
cash bond--Louisiana*

THIS AGREEMENT made and entered into January 1, 2002, by and between Michel St. Jacques ("Owner"), and the Parish of Plaquemines, herein represented by the Honorable Giles Honore, Mayor.

Whereas the Owner owns and desires to develop Lots 100--684, Tenth Subdivision, 8th Filing, and

Whereas the final plat of Lots 100--684, Tenth Subdivision, 8th Filing, will be given final approval by the Planning Commission of the Parish of Plaquemines, upon Owner posting a bond insuring the satisfactory installation and construction of the following improvement as specified by Department of Public Works:

1. Sewer installation and hook-up;
2. Utility lines installed below ground;
3. Grading and paving of all public streets and access roads;
4. Construction of towpath footbridge

and, as shown on plans prepared by James de Rose, Civil Engineer, is attached hereto and made a part hereof, according

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to the terms and conditions of this agreement; and,

Whereas the Owner now desires final approval of the Plat of Lots 100--684, Tenth Subdivision, 8th Filing, prior to the installation and construction of the above described improvements, which improvements will be installed and constructed at Owner's sole cost and expenses:

Now, therefore, it is hereby agreed by and between the Owner and the Parish of Plaquemines that, for and in consideration of the final approval of Lots 100--684, Tenth Subdivision, 8th Filing, Owner binds and obligates himself within 12 months from date hereof, to install and construct the described improvement in accordance with plans prepared by James de Rose, Civil Engineer, which plans meet the requirements of the Louisiana State Board of Health and have been approved by the Director of the Department of Public Works of the Plaquemines, said plans being attached hereto and made a part hereof.

The Owner, in order to further insure faithful performance of said obligation, has executed a check (cashier's or certified) in the amount of \$1,000,000, which check is attached hereto and made a part hereof, to guarantee the installation and construction of the following improvements:

1. Sewer installation and hook-up;
2. Utility lines installed below ground;
3. Grading and paving of all public streets and access roads;
4. Construction of towpath footbridge.

According to plans and specifications therefor, said bond may be canceled only after said work has been completed, inspected, and approved by written acceptance of the Director of Public Works of the Plaquemines. The above described improvements shall be constructed under the supervision of James de Rose, Civil Engineer, in full compliance with the specifications and requirements of the Parish of Plaquemines, and when complete, said engineer shall furnish the Director of the Department of Public Works with a certificate of satisfactory completion.

It is further understood by and between the parties to this agreement that, in the event said improvements are not constructed within 12 months from date hereof, the Parish of Plaquemines shall have and is hereby granted the right, without putting the Owner in default, to cause the improvements to be made and to use the deposit made herewith for payment of all costs and expenses incurred in the construction thereof.

In witness whereof these presents have been signed in the presence of the undersigned competent witnesses, at Plaquemines, Louisiana, January 1, 2002.

Witnesses:

Michel St. Jacques

(7) Letter of credit--developer's form

Whereas the Principal herein does hereby obligate itself and does agree to complete the construction and installation of said improvements in the said Subdivision in accordance with the said Preliminary Plat plans and specifications now on

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file and as bounded and modified by the final plat of Happy Acres Farms Subdivision, Unit I, approved by said Commission.

Now, therefore, Blue Grass Builders, as Principal, does hereby firmly bind itself, its heirs, executors, administrators, and successors and assigns unto the County of Fay, Kentucky in the sum of \$1,000,000, conditioned upon the performance by the Principal of its undertaking herein and its completion of the said Happy Acres Farms Subdivision, Unit I, in the construction and installation of all improvements herein called for. Such improvements shall be completed on or before January 1, 2004. Upon their completion this obligation shall be null and void, but otherwise shall remain in full force and effect.

If the Principal fails to complete the construction and installation of all the improvements of said Subdivision as shown and provided for by said plans and specifications herein referred to or has not obtained an extension of the above completion date prior to the completion date herein above specified, then the authorized agent of the County of Fay, Kentucky, with approval of the County Road Engineer, shall be entitled to perform the construction and installation of the improvements herein above referred to. In such event, the Principal shall pay or cause to be paid to the County of Fay, Kentucky such sums as may be necessary to complete said improvements, as secured by an irrevocable Letter of Credit, terminating no sooner than 12 weeks after the completion date for said improvements above mentioned, executed with this instrument, but not to exceed the amount referred to herein. Witness our hands this January 1, 2002.

by _____

Henry Webster Clay

25 Marginal Way

Pres. Blue Grass

Builders

Lexington, Kentucky

*(8) Irrevocable letter of credit--subdivision improvement
guarantee*

WICHITA STATE BANK

Date: June 1, 2002

THE CITY OF WICHITA
WICHITA, KANSAS

Dear Sirs:

We hereby open our irrevocable credit in your favor available by your drafts at sight on us for a sum not exceeding \$1,000,000 for the account of Blue Grass Homes (PURCHASER), to be accepted by your signed statement that drawing is due to default or failure to perform by PURCHASER, the following improvements on or before June 1, 2004, or two years from approval of plat by local authorities:

1. Paving of main access and side roads;
2. Sewerage hook-up and installations;

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3. Street lights on specified main thoroughfares.

in Happy Acres, Ward II, a subdivision of the City of Wichita, Kansas. Acting through the City Engineer, you shall notify us when either:

1. The improvements have been timely completed and the credit may be released, or
2. The purchaser has failed to perform or is in default thereunder.

All drafts drawn hereunder must be marked: "Drawn under Wichita State Bank, Credit No. 5-1287, dated June 1, 2002."

The amount of any draft drawn under this credit must, concurrently with negotiation, be endorsed on the reverse side hereof. The presentment of any such draft shall be a warranty by the negotiating bank that such endorsement has been made and that documents have been forwarded as herein required.

Except so far as otherwise expressly stated herein, this credit is subject to the uniform customs and practices for commercial documentary credits fixed by the 13th Congress of the International Chamber of Commerce.

We hereby agree with the drawers, endorsers, and bona fide holders of drafts under and in compliance with the terms of this credit that the same shall be duly honored on due presentation and delivery of documents as specified if negotiated on or before June 1, 2004.

Very truly yours,

Wichita State Bank

Endorsement by _____

John Dowe, Sec'y

(9) Escrow account form--Texas

I, John Houston, do hereby agree that if the proposed plat of Wayne Ranch Estates, filed by me for approval on January 1, 2002, is approved by the planning commission of the City of Amarillo, Texas, the director of planning of said city may retain said plat in his possession, without recording same until I have either constructed all site improvements required under the provisions of the City of San Tonio Planning Area Subdivision Regulations other than water, gas, and electric lines, or have filed with the Director of Planning a bond equal to the cost of all such uncompleted improvements, as estimated by the Director of Public Works, guaranteeing that all such uncompleted improvements will be constructed within two years from the date of such bond. Such bond shall comply with the requirements of local ordinances, insofar as such requirements are applicable. A trust account agreement is appended hereto as Exhibit A.

Executed January 1, 2002.

John Houston (subdivider)

EXHIBIT A

This agreement is between John Houston, subdivider, and Walter Fay, trustee.

The subdivider has deposited (or herewith deposits), subject to the order of subdivider and trustee jointly as provided in this agreement, in the Alamo National Bank, Amarillo, Texas, the sum of \$1,000,000 for the purpose of constructing site improvements on a subdivision in Cantwell County, Texas, for the benefit of the public represented by the City of Amarillo, more particularly described as follows:

1. Street lights on main thoroughfares;
2. Pavement of access roads;
3. Public water distribution system.

The trustee hereby agrees to authorize expenditures from such trust account and to execute checks, drafts, and other orders of withdrawal only for the purpose of constructing such site improvements.

The subdivider agrees to construct such site improvements within two years of the date of approval of the plat by the commission. Upon the failure of the subdivider to provide such site improvements as are herein provided, any remaining balance in such trust account shall be paid to the City of Amarillo for the sole purpose of completing, repairing, maintaining, or otherwise working on the site improvements in such subdivision. A resolution of the City Council of the City of Amarillo declaring that such site improvements have not been completed as required by applicable subdivision regulations shall be final and conclusive on the parties to this agreement. Payment to the city shall be made on the order of the trustee without the necessity of joinder by the subdivider.

The subdivider hereby declares that he has filed with the commission an executed copy of such contract together with a letter from an official in the bank named in this contract certifying that the required sum is on deposit in such bank, subject to withdrawal as provided in this agreement.

John Houston

Walter Fay

E.20 Letter of credit agreement between real estate developer and bank granting letter of credit--letter of credit may be needed to cover cost of building infrastructure for development

COMMENT

As a condition for granting subdivision approval, municipalities frequently require the real estate developer to produce a letter of credit as security for the completion of the infrastructure in the development. In the event that the developer fails to complete the development's roads, sewers or water system, the municipality may draw on the unconditional letter of credit and complete the improvements using these funds.

The lender who will be obligated on the letter of credit will require a written agreement with the

developer, whereby the developer pledges to repay to the lender any sums drawn by the municipality for completion of the infrastructure. The agreement provides for payment of interest by the developer on the sums drawn by the municipality. In addition, the agreement also provides for collateralization of the amount drawn by the municipality. In the event payment is not promptly made, legal fees and expenses are recoverable by the lender.

For further information, see Chapter 7.

FORM

STANDBY LETTER OF CREDIT AGREEMENT

TO: _____ SAVINGS BANK

RE: _____ [_____ *insert name of subdivision*] Subdivision,
Town of _____, Irrevocable Letter of Credit
No. _____

In consideration of your opening your Irrevocable Letter of Credit (herein called the "Credits"), dated _____, 20 _____, naming the Town of _____ as beneficiary of up to an aggregate amount of \$ _____, and for other valuable consideration, receipt of which is hereby duly acknowledged, the undersigned (herein called the "Applicant" and "we") hereby agrees as follows with respect to the Credits:

1. *Developer to reimburse bank for each sight draft.* We agree, in the case of each sight draft, to reimburse you at your main office, _____, City of _____, State of _____, in United States currency in immediately available funds on demand, the amount due on such draft, or, if so demanded by you, to pay at your office in advance the amount to pay such draft. In all instances, you have the right to set off any amount due you under any Credit against any account we may have at any branch of yours, your subsidiaries or affiliates.

2. *Developer to pay commission and reimburse bank for all charges and expenses paid by bank.* At the time you issue the above-mentioned Letter of Credit, we agree to pay you, on demand, your usual commission and all charges and expenses paid or incurred by you in connection therewith, including costs of reserve requirements, if any. If any Credits issued by you provide for an extension or extensions beyond the expiration date, we agree to pay you, on demand, for each extension period, your usual commission in effect at the time of the extension and all charges and expenses as set forth above.

3. *Developer to pay interest on funds disbursed to municipality.* If, for any reason, you make payment under the Credits prior to your receipt of the aforementioned funds from the Applicant, we agree to pay you interest per annum at a rate equal to 2 percent over the highest United States Prime Rate, as published in the *Wall Street Journal*, and in effect at the time you make your payment, and as it may change from time to time, plus customary charges, commencing from the day of your payment and ending upon your receipt of the funds we remit to you for the actual days elapsed, on the basis of a 365-day year. In no event shall the interest rate charged under this Agreement exceed the maximum rate authorized by applicable law or regulation.

4. *Extension of maturity or time for presentment of drafts.* We agree that, in the event of any extension of the maturity or time for presentment of drafts, or documents or any other modification of the terms of any Credits, at our request or

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pursuant to the terms of the Credits, or in the event of any increase in the amount of any Credits at our request, this Agreement shall be binding upon us with regard to such Credits so increased or otherwise modified, to drafts, documents and property covered thereby, and to any action taken by you or any of your correspondents in accordance with such extension, increase or other modification.

5. *Users of credits are agents of developer.* The users of the Credits shall be deemed our agents, and we assume all risk for their acts or omissions. Neither you nor your correspondents shall assume any liability to anyone for failure to pay, if such failure is due to any restriction in force at the time and place of presentment, and we agree to indemnify you and hold you harmless from any consequences that may arise therefrom. Neither you nor your correspondents shall be responsible for verifying the existence of any act, condition or statement made by any party in relation to their drawing or presentment under the Credits, or in verifying or passing judgment on the reasonableness of any statement made by any party in relation to their drawing or presentment under the Credits: for the validity, sufficiency or genuineness of documents, even if such documents should in fact prove to be in any or all respects invalid, insufficient, fraudulent or forged; or for failure to give any notice; for any breach of contract between the beneficiary of the Credits and us. Furthermore, neither you nor your correspondents shall be responsible for errors, omissions, interruptions or delays in transmission or delivery of any messages by mail, cable, telegraph, wireless or otherwise, nor shall you be responsible for any error, neglect or default of any of your correspondents, and none of the above shall affect, impair or prevent the vesting of any of your rights or powers hereunder. In furtherance and extension, and not in limitation of the specific provisions hereinbefore set forth, we agree that any action taken or not taken by you or by any correspondent of yours, under or in connection with the Credits or the relative drafts, documents or property, if taken or not taken in good faith, shall be binding on us and shall not put you or your correspondents under any resulting liability to us, except if due solely to your gross negligence or willful misconduct.

6. *Developer supplies collateral for letter of credit.* As security for the payment or performance of all of the Applicant's present or future obligations or liabilities of any and all kinds to you, however incurred by us, due or to become due, howsoever or whensoever acquired by us (all of which are herein collectively referred to as Obligations), the Applicant does hereby grant you a security interest and a lien in and upon any of our property, including our bank accounts held by you, or property in which we may have any interest, which is now or may at any time hereafter come into your possession or control, or into the possession or control of any other party acting on your behalf, whether for the express purpose of being used by you as collateral security, or for safekeeping, or for any other different purpose, or covered or affected by any documents in your possession or control, or in the possession or control of any third party acting in your behalf.

7. *Developer to pay bank's attorneys' fees and related expenses in event of developer's default.* Upon Applicant's failure to pay any Obligations when becoming or made due, as aforesaid, you shall have, in addition to all other rights and remedies allowed by law, the rights and remedies of a secured party under the Uniform Commercial Code as in effect in the State of _____. We agree that the said collateral secures, and further agree to pay on demand, all expenses--including, but not limited to, reasonable attorneys' fees for legal services of every kind, and the cost of any insurance and payment of taxes or other charges--of, or incidental to, the custody, care, sale or collection of the said collateral, or in any way relating to the enforcement or protection of your rights hereunder.

8. *Further collateral for letter of credit.* Upon our failure to pay any obligations hereunder when becoming or made due, as aforesaid, you shall have, in addition to all other rights and remedies allowed by law and this agreement, your rights under real estate mortgages held by you and recorded in the _____ County Clerk's Office, in Book of Mortgages No. _____, at Page _____, and covering the premises known as _____, in the Town of _____, County of _____, State of _____, and the applicant does hereby acknowledge that our obligations hereunder are secured by said mortgage.

9. *Waiver of bank's rights.* You shall not be deemed to have any of your rights waived hereunder unless you or your authorized agent shall have signed such waiver in writing. No failure on your part to exercise and no delay in exercising

any right, remedy or power hereunder shall operate as a waiver thereof, nor shall such failure or delay preclude you from any future exercise of any other right, remedy or power.

10. *Definition of "property."* The word "property", as used in this agreement, includes case proceeds, deposit accounts, goods and documents relative thereto, securities, funds, and any and all other forms of property, whether real, personal or mixed, and any right or interest therein.

11. *Obligations in agreement are binding on developer's personal representatives, successors and assigns.* The Obligations hereof shall continue in force and apply notwithstanding any change in the membership or ownership of any partnership or corporation undersigned, and the Obligations hereof shall bind the personal representatives, successors and assigns of the undersigned, and all rights, benefits and privileges hereby conferred on you shall be and hereby are extended to, and conferred upon, and may be enforced by your successors and assigns.

12. We further agree that your rights, remedies, powers, security interest and liens hereunder shall continue unimpaired, and that we shall be and remain obligated in accordance with the terms hereof, notwithstanding the partial exercise by you of any right, remedy or power, or the release or substitution of any of the said interests therein, or any delay, extension of time, renewal, release, substitution or addition of parties, compromise or other indulgence granted by you, in reference to any of the Obligations, or any promissory note, draft, document or other instrument given in connection therewith, the undersigned hereby waiving all notice of any delay, extension, release, substitution, renewal, compromise or other indulgence, and hereby consenting to be bound as fully and effectually as if we have expressly agreed thereto in advance.

13. *Events of default by developer.* We agree that all Obligations of the undersigned to you, although contingent and not matured, shall become due and payable upon the occurrence of any one of the following events:

(A) admission in writing of our inability to pay any debt when due;

(B) a violation of any of the terms and conditions of this agreement, be it willful or involuntary, not expressly waived by you;

(C) a default in the payment of any interest or fees due and payable to you, and in particular the payments due under the mortgage note executed in connection with the mortgage referred to at No. 8 above;

(D) if the undersigned generally shall not pay its debts as they become due, or be the subject of any insolvency proceedings; or

(E) if the undersigned shall make an assignment for the benefit of its creditors or a trustee, receiver, intervenor, or custodian appointed for the purposes of reorganization or liquidation of the undersigned.

14. Each and every right, remedy and power hereby granted to you or allowed to you by law or other agreement shall be cumulative and not exclusive of any other right, remedy or power that may be exercised by you from time to time.

15. *Controlling law.* This agreement shall be construed in accordance with, and governed by, the laws of the State of _____.

16. *Notices to parties.* Notices and demands under this agreement shall be in writing and will be sufficient if delivered by hand, by first class mail (postage prepaid) or registered mail, addressed to the undersigned or to you at our respective principal places of business.

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17. *Credits issued shall be irrevocable.* We agree that all Credits issued under this agreement shall be irrevocable.

Dated: _____, 20 ____ By: _____

[signature of developer]

By: _____

[signature of developer]

STATE OF _____)
COUNTY OF _____) ss:

On this _____ day of _____, 20 ____, before me, the subscriber, personally appeared _____ and _____, to me known to me to be the same persons who executed the foregoing instrument, and who, being duly sworn by me, did depose and say that they are the only members of the firm of _____, a partnership, and that they executed the foregoing instrument in the firm name of _____, and that they had authority to sign the same, and they acknowledged to me that they executed the same as an act and deed of said firm for the uses and purposes therein mentioned.

Notary Public



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate Appendix Forms:.syn

§ Forms.syn Synopsis to Appendix Forms: CHECKLISTS

[I.] Checklist for Drafting Contract of Sale

[II.] Checklist for Drafting Deed

[III.] Checklist for Drafting Documents Necessary for Residential Mortgage Transaction

[IV.] Checklist for Drafting Documents Necessary for Commercial Mortgage Transaction

[V.] Checklist of Documents and Payments Needed for Closing

[VI.] Checklist for Drafting Commercial Lease

[VII.] Checklist for Drafting Residential Real Estate Lease

[VIII.] Environmental Questionnaire to Be Completed by Seller or Lessor of Commercial Real Property

[IX.] Checklist for Phase I Environmental Site Assessment

[X.] Checklist for Use by Counsel to Real Estate Developer

[XI.] Checklist for Use by Counsel to Real Estate Broker Who Will Be Selling Development or Units Therein

[XII.] Checklist for Use by Counsel to Real Estate Broker Who Will Be Leasing Development or Units Therein

[XIII.] Checklist for Use by Counsel to Purchaser of Development



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Appendix Forms: CHECKLISTS

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[I.] Checklist for Drafting Contract of Sale

A. Parties..... ☐

1. Identity of seller(s)..... ☐

a. Name..... ☐

b. Address (residential for individual, business for non-individual)..... ☐

c. Taxpayer identification number..... ☐

2. Character of seller..... ☐

a. Individual..... ☐

(1) Marital status, in states where applicable..... ☐

(2) Over the age of majority..... ☐

(3) Not incapacitated by mental disease or defect..... ☐

b. Corporation..... ☐

(1) State of incorporation..... ☐

(2) Obtain proof of authority of person executing contract on behalf of

2-Forms Federal Taxes Affecting Real Estate [I.]

corporation..... ☐

(3) Obtain copy of resolution of corporation's board of directors authorizing sale of property..... ☐

(4) Obtain any required court or government agency approvals..... ☐

c. Partnership..... ☐

(1) State of formation..... ☐

(2) Obtain proof of authority of partnership representative to act on behalf of all partners..... ☐

(3) Obtain copy of partnership decision authorizing sale..... ☐

(4) Obtain copy of partnership agreement and affidavit that is still in effect..... ☐

(5) Obtain signatures of all partners needed to authorize sale..... ☐

(6) Obtain any required court or government agency approvals..... ☐

d. Limited liability company..... ☐

(1) State of formation..... ☐

(2) Obtain proof of authority of member's or manager's authority to act on behalf of company..... ☐

(3) Obtain copy of member's or manager's decision authorizing sale..... ☐

(4) Obtain copy of LLC operating agreement and affidavit that is still in effect..... ☐

(5) Obtain signatures of members needed to authorize sale..... ☐

(6) Obtain any required court or government agency approvals..... ☐

e. Fiduciary..... ☐

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(1) Obtain proof of appointment..... ☐

(2) Examine order or decree appointing fiduciary and determine scope of authority..... ☐

(3) Obtain and examine document (will, trust, etc.) creating appointment.....
☐

(4) Determine whether court order required to complete sale..... ☐

f. Attorney-in-fact..... ☐

(1) Obtain proof of appointment (certified copy of power of attorney document)..... ☐

(2) Determine whether appointment has been terminated by death, disability, incapacity or revocation (in most states, affidavit of attorney-in-fact denying actual knowledge of termination of power is sufficient)..... ☐

(3) Determine scope and duration of powers, making sure it includes power to sell real property..... ☐

3. Identity of purchaser(s)..... ☐

a. Name..... ☐

b. Address (residential for individual, business for nonindividual)..... ☐

c. Taxpayer identification number..... ☐

4. Character of purchaser..... ☐

a. Individual..... ☐

(1) Marital status, in states where applicable..... ☐

(2) Over the age of majority..... ☐

(3) Not incapacitated by mental disease or defect..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

b. Corporation..... ☐

(1) State of incorporation..... ☐

(2) Obtain proof of authority of person executing contract on behalf of corporation..... ☐

(3) Obtain copy of resolution of corporation's board of directors authorizing purchase of property..... ☐

(4) Obtain any required court or government agency approvals..... ☐

c. Partnership..... ☐

(1) State of formation..... ☐

(2) Obtain proof of authority of partnership representative to act on behalf of all partners..... ☐

(3) Obtain copy of partnership decision authorizing purchase..... ☐

(4) Obtain copy of partnership agreement and affidavit that is still in effect..... ☐

(5) Obtain signatures of all partners needed to authorize sale..... ☐

(6) Obtain any required court or government agency approvals..... ☐

d. Limited liability company..... ☐

(1) State of formation..... ☐

(2) Obtain proof of authority of member's or manager's authority to act on behalf of company..... ☐

(3) Obtain copy of member's or manager's decision authorizing sale..... ☐

(4) Obtain copy of LLC operating agreement and affidavit that is still in effect..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

(5) Obtain signatures of members needed to authorize sale..... ☐

(6) Obtain any required court or government agency approvals..... ☐

e. Fiduciary..... ☐

(1) Obtain proof of appointment..... ☐

(2) Examine order or decree appointing fiduciary and determine scope of authority..... ☐

(3) Obtain and examine document (will, trust, etc.) creating appointment..... ☐

(4) Determine whether court order required to complete purchase..... ☐

f. Attorney-in-fact..... ☐

(1) Obtain proof of appointment (certified copy of power of attorney document)..... ☐

(2) Determine whether appointment has been terminated by death, disability, incapacity or revocation (in most states, affidavit of attorney-in-fact denying actual knowledge of termination of power is sufficient)..... ☐

(3) Determine scope and duration of powers, making sure it includes power to purchase real property..... ☐

B. Premises..... ☐

1. Identify premises in detail..... ☐

a. Specify location by municipality and county..... ☐

b. Set forth street address, if one exists..... ☐

c. State lot size, but avoid an exact amount of acreage or square footage unless figure is based on guaranteed survey..... ☐

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- d. Set forth real estate tax map number..... ☐
- e. Describe location by prior recorded deed(s)..... ☐
- f. Set forth metes and bounds description or subdivision description (filed map), if available..... ☐
2. Building, etc..... ☐
- a. Obtain Certificate of Occupancy..... ☐
- b. Identify buildings, structures and other permanent improvements located on premises, including houses, garages, pools, etc..... ☐
- c. Compare existing buildings to Certificate of Occupancy..... ☐
3. Fixtures and equipment..... ☐
- a. Identify fixtures and equipment included in sales price..... ☐
- b. Identify fixtures and equipment for which additional consideration will be paid by the purchaser..... ☐
- c. Identify fixtures and equipment excluded from sale..... ☐
4. Personalty..... ☐
- a. Identify personal property included in sales price..... ☐
- b. Identify personal property for which additional consideration will be paid by the purchaser..... ☐
- (1) If purchaser wants time to decide whether he or she wants to purchase personalty for additional consideration, include time limit and notice provision..... ☐
- c. Identify personal property excluded from sale..... ☐
5. Condition of premises, fixtures and personalty..... ☐
- a. Specify condition premises, fixtures and personalty will be transferred in (*e.g.*, "as is," or "good working order" or "working order")..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

(1) Provide for pre-closing inspection by the purchaser

(2) In sale of new residential construction, determine if state law implies any warranties and add express disclaimers as agreed by the parties..... ☐

b. Disclose defects as required by state law..... ☐

c. Disclose lead-based paint hazards and other defects as required by federal law..... ☐

d. Specify who will bear the risk of loss between contract execution and closing..... ☐

e. Specify who will insure property and who will be beneficiary of insurance between contract execution and closing..... ☐

6. Obtain copies of condominium, cooperative, or homeowner's association rules and regulations..... ☐

C. Purchase price..... ☐

1. Total purchase price..... ☐

2. Additional price for fixtures..... ☐

3. Additional price for personalty..... ☐

4. Deposit..... ☐

a. Amount..... ☐

b. Date(s) when due..... ☐

c. Form of payment..... ☐

d. Specify who will hold deposit..... ☐

(1) Where deposit held..... ☐

(2) Interest..... ☐

(3) Who is entitled to earnings on deposit..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

5. Attach forms of proposed purchase money note and mortgage or set forth provisions..... ☐

6. Attach or describe any existing mortgage continuing after closing..... ☐

a. Obtain and review mortgage and other loan documents..... ☐

b. Provide that purchaser will assume or take subject to existing mortgage..... ☐

c. Seller representation no defaults (at time of contract and at time of closing)..... ☐

d. Seller representation no due on sale clause..... ☐

e. Require seller to request mortgagee's consent..... ☐

f. Provide termination rights if mortgagee refuses consent..... ☐

7. Adjustments to purchase price..... ☐

a. Real property taxes..... ☐

b. Fuel..... ☐

c. Prepaid services..... ☐

d. Supply and maintenance contracts..... ☐

e. Employee salaries and benefits..... ☐

f. Water and sewer expenses..... ☐

g. Special assessments..... ☐

h. Property owners association dues or common charges..... ☐

i. Rent..... ☐

(1) Prepaid rent..... ☐

(2) Percentage rent..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

(3) Escalation charges..... ☐

(4) Rent arrears..... ☐

j. Lease brokerage..... ☐

k. Other

8. Allocation of expenses..... ☐

a. Transfer taxes..... ☐

b. Conveyance fees..... ☐

c. Recording taxes..... ☐

d. Survey..... ☐

e. Satisfying contingencies..... ☐

D. Contingencies..... ☐

1. General provisions applicable to all contingencies..... ☐

a. Specify who must obtain satisfaction of contingency and what that party must do..... ☐

b. Set time limit for resolving contingency..... ☐

c. Set standard for determining whether contingency is satisfied..... ☐

d. Specify whether seller, purchaser or both have right to waive satisfaction of contingency..... ☐

e. Specify who will pay cost of resolving contingencies..... ☐

2. Mortgage..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

☐b. Specify type of mortgage..... ☐(1) Conventional..... ☐(a) Fixed rate..... ☐(b) Adjustable rate..... ☐(c) Variable rate..... ☐(d) Balloon..... ☐(e) Convertible..... ☐(f) Other..... ☐(2) FHA..... ☐(3) VA..... ☐c. Specify amount of mortgage..... ☐d. Specify term of mortgage..... ☐e. Specify maximum interest rate..... ☐f. Specify maximum points..... ☐g. Specify any other desired terms..... ☐

h. Require purchaser to:

(1) Apply promptly..... ☐(2) Pay application fees..... ☐(3) Notify seller of application..... ☐(4) Accept mortgage commitment..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

- (5) Comply with lender's requirements..... ☐
- (6) Promptly deliver copy of commitment to seller..... ☐
3. Governmental approvals..... ☐
- a. Certificate of occupancy..... ☐
- b. Certificate of compliance with local ordinances, such as building, housing, safety, environmental, or fire ordinances..... ☐
- c. Special districts (*e.g.*, historic or conservation districts)..... ☐
- d. Wetlands..... ☐
4. Rezoning, variance or subdivision approval..... ☐
5. Attorney's approval..... ☐
6. Sale of present home by purchaser..... ☐
- a. Extend satisfaction of other contingencies to dates after this contingency satisfied..... ☐
- b. Permit seller to consider additional offers..... ☐
7. Purchase of new home by seller..... ☐
- a. Extend satisfaction of other contingencies to dates after this contingency satisfied..... ☐
8. Inspection for major structural defects..... ☐
9. Inspection for presence of and damage from wood boring organisms..... ☐
10. Testing of well water quality..... ☐
11. Testing of well water quantity..... ☐
12. Septic or other on-site sewage disposal system..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

- a. Condition (*e.g.*, "good working order")..... ☐
- b. Capacity..... ☐
- c. Availability of sewer connections..... ☐
- d. Requirement that purchasers connect to sewer after closing..... ☐
- 13. Radon gas inspection..... ☐
- 14. Asbestos inspection..... ☐
- 15. Urea formaldehyde insulation..... ☐
- 16. Inspection for lead pipes..... ☐
- 17. Inspection for lead paint and dust..... ☐
- 18. Environmental site assessment..... ☐
- E. Type of deed to be given..... ☐
 - 1. Warranty deed..... ☐
 - 2. Bargain and sale deed..... ☐
 - 3. Quit claim deed..... ☐
 - 4. Executor's or administrator's deed..... ☐
 - 5. Trustee's deed..... ☐
 - 6. Referee's deed..... ☐
- F. Purchaser will take property subject to the following conditions..... ☐
 - 1. Zoning laws..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

2. Environmental laws..... ☐
- a. Federal..... ☐
- b. State..... ☐
- c. Local
3. Covenants and restrictions..... ☐
4. Easements..... ☐
5. Tenancies..... ☐
- a. Attach rent schedule containing:
- (1) Tenants' names..... ☐
- (2) Descriptions of leased premises..... ☐
- (3) Lease commencement and expiration dates..... ☐
- (4) Rental and escalation amounts..... ☐
- (5) Security deposit information..... ☐
- (6) Lease amendments, extensions and renewal rights..... ☐
- (7) Options and rights of first refusal..... ☐
- (8) Termination rights..... ☐
- b. Seller's representations regarding accuracy and completeness of rent schedule..... ☐
- c. Detailed seller's representations regarding tenancies and possible problems..... ☐
- (1) Arrearages..... ☐
- (2) Withheld rents..... ☐
- (3) Entitlement to rent concessions or abatements..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

- (4) Tenants' defaults..... ☐
- (5) Landlord's (seller's) defaults..... ☐
- (6) Pending or anticipated litigation..... ☐
- (7) Unpaid leasing commissions..... ☐
- (8) Incomplete work..... ☐
- (9) Tenants' purchase options..... ☐
- (10) Code violations..... ☐
- d. Changes in tenant status..... ☐
- (1) Permission for seller to continue normal rental activities..... ☐
- (2) Provision barring seller, without purchaser's written consent, from:
- (a) Amending, renewing or extending the lease of any existing tenant..... ☐
- (b) Renting to new tenants or granting a new lease to any existing tenant..... ☐
- (c) Terminating any lease except for tenant default (unless the purchaser wants the building vacant anyway)..... ☐
- (2) Purchaser's consent no unreasonably withheld..... ☐
- (3) Seller reimbursed for rent not received because purchaser failed to consent..... ☐
- (4) Seller required to remove tenant before closing..... ☐
- e. All leases and rental agreements to be assigned at closing..... ☐
- f. Rent adjusted at closing..... ☐
- g. Transfer of title to security deposits..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

h. Notices to tenants..... ☐

i. Rent stabilization or rent control requirements..... ☐

6. Licenses..... ☐

G. Title..... ☐

1. Type of title to be transferred..... ☐

2. Exceptions to title contained in seller's title insurance policy or abstract of title which purchaser will accept..... ☐

3. Title review (abstract or insurance)..... ☐

a. State who will prepare abstract update..... ☐

b. State who will provide title insurance..... ☐

c. State who is responsible for cost of abstract of title, title report and title insurance..... ☐

H. State who will provide and pay for survey..... ☐

I. Transfer of title..... ☐

1. Date..... ☐

a. State whether date is approximate..... ☐

b. State whether time is of the essence..... ☐

2. Time..... ☐

3. Place..... ☐

J. State when transfer of possession will occur..... ☐

1. Possession transferred before transfer of title..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

a. Rent or other payments..... ☐

b. Allocation of risk of loss between transfer of possession and transfer of title..... ☐

c. Hazard and liability insurance responsibilities between transfer of possession and transfer of title..... ☐

d. Purchaser's right to inspect premises and time of inspection

2. Possession transferred at transfer of title..... ☐

a. Purchaser's right to inspect premises before closing..... ☐

b. Time of inspection

3. Possession transferred after transfer of title..... ☐

a. Rent or other payments..... ☐

b. Allocation of risk of loss between transfer of title and transfer of possession..... ☐

c. Hazard and liability insurance responsibilities between transfer of title and transfer of possession..... ☐

d. Purchaser's right to inspect premises and time of inspection..... ☐

e. Amount of purchase price held back to cover damages..... ☐

K. Broker..... ☐

1. Name brokers involved in sale and specify who will pay commissions..... ☐

2. Indemnification against brokerage claims..... ☐

L. Remedies for breach..... ☐

1. Seller's remedies..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

a. Retain deposit as liquidated damages..... ☐

b. Specific performance..... ☐

c. Right to sue for damages..... ☐

2. Purchaser's remedies..... ☐

a. Return of deposit, with interest, and reimbursement for other expenses.....
☐

b. Specific performance..... ☐

c. Right to sue for damages..... ☐

3. Alternative dispute resolution to avoid litigation..... ☐

a. Mediation..... ☐

b. Arbitration..... ☐

M. Miscellaneous clauses..... ☐

1. Waiver provision..... ☐

2. Select state law which will apply to transaction..... ☐

3. Merger clause providing that contract contains entire agreement between parties..... ☐

4. Binding effect of contract on parties and their successors and assigns..... ☐

5. All amendments to contract to be in writing..... ☐

6. State whether purchaser can assign contract..... ☐

N. Execution of the contract..... ☐

1. Signed by parties or their representatives..... ☐

2-Forms Federal Taxes Affecting Real Estate [I.]

2. Dated..... ☐

3. Witnesses if desired..... ☐

4. Acknowledgment if desired..... ☐

5. Multiple originals..... ☐



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Federal Taxes Affecting Real Estate

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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [II.]

[II.] Checklist for Drafting Deed

A. Parties..... ☐

1. Identity of seller(s)..... ☐

a. Name..... ☐

(1) Make sure spelling of name(s) is the same as spelling of name in deed into seller(s)..... ☐

(2) If name of seller has changed since deed into seller, give both former and current names..... ☐

(3) If any of co-owners have died, note that fact..... ☐

(4) If any tenant in common has died, explain who is standing in place of the decedent and why..... ☐

(5) Set forth authority of grantor if executor's, administrator's or trustee's deed..... ☐

b. Address..... ☐

2. Type of seller's ownership..... ☐

a. Tenancy by entirety..... ☐

2-Forms Federal Taxes Affecting Real Estate [II.]

b. Joint tenancy..... ☐

c. Tenancy in common..... ☐

3. Identity of purchaser(s)..... ☐

a. Name..... ☐

b. Address..... ☐

4. Type of purchaser's ownership..... ☐

a. Tenancy by entirety..... ☐

b. Joint tenancy..... ☐

c. Tenancy in common..... ☐

B. Description of property..... ☐

1. Metes and bounds..... ☐

2. Map references..... ☐

3. Reference to prior deed..... ☐

4. Make sure description in deed conforms to description in contract..... ☐

C. Consideration..... ☐

D. Interest to be transferred..... ☐

1. Fee title..... ☐

2. Life estate..... ☐

3. Easement..... ☐

2-Forms Federal Taxes Affecting Real Estate [II.]

4. License..... ☐

5. Other..... ☐

E. Interest to be retained..... ☐

1. Life estate..... ☐

2. Easement..... ☐

3. License..... ☐

4. Mineral rights..... ☐

5. Other..... ☐

F. Restrictive covenants..... ☐

G. Type of deed and warranties granted by seller to purchaser..... ☐

1. Warranty deed with full covenants..... ☐

2. Bargain and sale deed with covenants against grantor's acts..... ☐

3. Quitclaim deed without warranties..... ☐

H. Execution..... ☐

1. By seller..... ☐

a. Signature lines for all sellers..... ☐

b. Attorney-in-fact should sign both names..... ☐

2. By purchaser, where purchaser's assumption of liability or restriction is included in deed.....
☐

I. Acknowledgment..... ☐



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [III.]

[III.] Checklist for Drafting Documents Necessary for Residential Mortgage Transaction

- A. Commitment letter..... ☐
- 1. Identify..... ☐
 - a. Borrower(s)..... ☐
 - b. Property to be subject to mortgage..... ☐
 - c. Mortgage amount..... ☐
 - d. Interest rate..... ☐
 - e. Term..... ☐
 - f. Fees and points..... ☐
- 2. Conditions..... ☐
 - a. Financial..... ☐
 - (1) Loan conditioned upon sale of existing residence..... ☐
 - (2) Explanation of deficiencies in credit history..... ☐
 - (3) Verification of employment and amount of salary..... ☐

b. Relating to property in general..... ☐

(1) Satisfactory title search..... ☐

(2) Or: title insurance policy obtained..... ☐

(3) Satisfactory survey..... ☐

(4) Or: title insurance policy that includes coverage for survey..... ☐

(5) Satisfactory appraisal of property..... ☐

(6) Or: where property is newly constructed, satisfactory final inspection of property..... ☐

(7) Pay off of certain existing debts..... ☐

c. Relating to subject land and structures..... ☐

(1) Wood-boring insect inspection..... ☐

(2) Well water test to determine acceptability of taste and smell..... ☐

(3) Well water test for purity..... ☐

(4) Well water test for quantity..... ☐

(5) Septic system inspection..... ☐

(6) Structural inspection..... ☐

(7) Radon gas inspection..... ☐

(8) Asbestos insulation inspection..... ☐

(9) Inspection for urea formaldehyde insulation..... ☐

(10) Inspection of fuel oil tank..... ☐

2-Forms Federal Taxes Affecting Real Estate [III.]

(11) Certificate of occupancy..... ☐

(12) Repair work required as condition for granting mortgage..... ☐

(13) Flood insurance..... ☐

(14) Casualty insurance..... ☐

(15) Fire insurance..... ☐

(16) Liability insurance..... ☐

B. Disclosure statement..... ☐

1. Any charge required by lender at any time must be disclosed to borrower pursuant to law.....

☐

2. Any charge required to be paid at closing must be disclosed to borrower pursuant to law.....

☐

C. Good faith estimate of charges (generally provided by lender to borrower)..... ☐

1. Estimate of each charge..... ☐

2. Estimate must be clear and concise..... ☐

3. Estimate must contain lender's name..... ☐

4. Estimate must contain statement regarding other non-specified cash charges..... ☐

5. Name of each charge must be the same as names appearing on "HUD No 1" Form..... ☐

D. Any documents required by state law..... ☐

E. Note..... ☐

1. Identify parties..... ☐

2-Forms Federal Taxes Affecting Real Estate [III.]

a. Borrower..... ☐(1) Name..... ☐(2) Address..... ☐(3) Taxpayer identification number..... ☐b. Lender..... ☐(1) Name..... ☐(2) Address..... ☐(3) Taxpayer identification number..... ☐c. Cosigner or Guarantor..... ☐(1) Name..... ☐(2) Address..... ☐(3) Taxpayer identification number..... ☐2. Amount of note (i.e., amount borrowed by borrower from lender)..... ☐3. Term of note..... ☐a. Date of note..... ☐b. Date of final payment..... ☐c. Balloon payment..... ☐4. Interest rate..... ☐a. Fixed per annum rate..... ☐b. Adjustable rate..... ☐

- (1) Method of calculating new rate..... ☐
- (2) Effective date of adjustment..... ☐
- (3) Frequency of adjustments..... ☐
- (4) Method for notice of adjustment..... ☐
- (5) Maximum annual adjustment..... ☐
- (6) Maximum interest rate during term..... ☐
- (7) Minimum interest rate during term..... ☐

5. Prepayment provisions..... ☐

- a. Permitted at any time without penalty..... ☐
- b. Permitted on any payment date without penalty..... ☐
- c. Not permitted during a stated period..... ☐
- d. Permitted on any payment date with a penalty..... ☐
- e. Permitted at any time with a penalty..... ☐

6. Payment provisions..... ☐

- a. Frequency of payments..... ☐
- b. Amount of payments..... ☐
- c. Balloon payments..... ☐
- d. Due date of payments..... ☐
- e. Grace period..... ☐
- f. Late charge..... ☐

g. Where payments are to be sent..... ☐

h. Provision for direct debit or payments to specified bank account..... ☐

7. Further provisions..... ☐

a. Borrower grants waiver of presentment..... ☐

b. Notices sent between the parties..... ☐

c. Law governing transaction shall be law of the State of _____ ☐

d. Lender to cooperate in assignment of mortgage to save recording tax on refinancing.....
☐

8. Execution..... ☐

a. Signature of borrower as maker of note..... ☐

b. Proper acknowledgment..... ☐

c. Delivery of note..... ☐

d. Endorsement..... ☐

F. Mortgage..... ☐

1. Identify parties..... ☐

a. Borrower..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

b. Lender..... ☐

2-Forms Federal Taxes Affecting Real Estate [III.]

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

2. Consideration for granting mortgage..... ☐

3. Property description..... ☐

4. Borrower grants interest in subject property to lender to secure mortgage loan..... ☐

5. Representations of borrower..... ☐

a. Payment will be made in accordance with terms of note..... ☐

b. Borrower has clear title to property..... ☐

c. Borrower will maintain property in good condition..... ☐

(1) Borrower will allow inspections..... ☐

(2) Borrower will make all necessary repairs promptly..... ☐

d. Borrower will maintain insurance on the property..... ☐

(1) Escrow account to be maintained by lender from which lender will itself pay insurance premiums..... ☐

(2) Direct insurance premium payments to insurer will be made by borrower..... ☐

e. Real property tax payments..... ☐

(1) Escrow account to be maintained by lender and from which lender will itself make tax payments..... ☐

(2) Direct payments to be made by borrower to local tax office..... ☐

2-Forms Federal Taxes Affecting Real Estate [III.]

6. Rights of lender..... ☐

a. Rights in event of default..... ☐

(1) Lender has right to accelerate repayment of entire debt in event of default..... ☐

(2) Lender has right to receive rents in event of default..... ☐

(3) Lender has right to physically secure property in event of default..... ☐

(4) Lender has right to reimbursement of following costs it incurs..... ☐

(a) Foreclosure costs..... ☐

(b) Legal fees..... ☐

(c) Court costs..... ☐

(5) Events of default..... ☐

(a) Failure to make mortgage loan payment when due..... ☐

(b) Failure to insure property..... ☐

(c) Failure to maintain property..... ☐

(d) Failure to pay taxes and other charges..... ☐

(e) Other violation of mortgage..... ☐

(f) Failure to report and/or correct immediately environmental mishap.....
☐

b. Foreclosure in the event of default..... ☐

(1) Foreclosure subject to prior notice..... ☐

(2) Right to public sale of property..... ☐

- (3) Right to bid at public sale..... ☐
- (4) Right to obtain deficiency judgment..... ☐
- (5) Obligation to elect remedies..... ☐
- c. Inspection of premises at any time..... ☐
- d. Right to receive proceeds of award for eminent domain..... ☐
- e. Right to receive proceeds of casualty loss insurance claim..... ☐
7. Further provisions..... ☐
- a. Mortgage not assumable without permission of lender..... ☐
- b. Waiver provision (e.g., "the waiver of any provision of this agreement shall not be valid unless it is in writing and signed by the party granting the waiver")..... ☐
- c. Any modifications of agreement must be in written form and signed by both parties.....
☐
- d. Agreement is to be construed in accordance with the laws of the State of _____ ☐
- e. Provision for the giving of notice between the parties..... ☐
- f. Agreement is binding on both parties and their successors and assigns..... ☐
8. Execution..... ☐
- a. Signed by mortgagor..... ☐
- b. Dated..... ☐
- c. Witnesses..... ☐
- d. Acknowledged..... ☐
- e. Recording of mortgage..... ☐

G. Hold back agreement (i.e., lender to hold back portion of borrowed funds)..... ☐

1. Identification of parties..... ☐

a. Borrower..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

b. Seller (where subject property is newly constructed)..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

c. Lender..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

2. Identify property and mortgage loan..... ☐

3. Hold back..... ☐

a. Amount to be held back..... ☐

b. Purpose..... ☐

(1) Certain matters must still be completed (e.g., repairs by seller)..... ☐

(2) Time for completion of such matters..... ☐

(3) Who shall handle such matters?..... ☐

(4) Will an inspection be required to ascertain whether matters have been properly taken care of?..... ☐

(5) Cost of inspection..... ☐

(6) Who pays cost?..... ☐

c. From whom shall funds be withheld--seller or borrower?..... ☐

d. To whom shall they be paid upon completion of work?..... ☐

e. Failure to complete matters..... ☐

(1) Lender may complete matters itself..... ☐

(a) Apply hold back funds to cost of completion incurred by lender..... ☐

(b) Lender has no obligation to complete matters..... ☐

(c) Lender is held harmless if it chooses to complete matters..... ☐

(2) Lender may apply funds to mortgage principal..... ☐

(3) Lender may extend time available for completion of matters..... ☐

4. Further provisions..... ☐

a. Waiver provision (e.g., "the waiver of any provision of this agreement shall not be valid unless it is in writing and signed by the party granting the waiver")..... ☐

b. Any modifications of agreement must be in written form and signed by both parties.....
☐

c. Agreement is to be construed in accordance with the laws of the State of _____ ☐

d. Provision for the giving of notice between the parties..... ☐

2-Forms Federal Taxes Affecting Real Estate [III.]

e. Agreement is binding on both parties and their successors and assigns..... ☐

5. Execution..... ☐

a. Signed by parties..... ☐

b. Dated..... ☐

c. Witnesses..... ☐

d. Acknowledged..... ☐

H. Agreement for modification of existing loan documents..... ☐

1. Identify parties..... ☐

a. Borrower..... ☐

(1) Name..... ☐

(2) Address..... ☐

b. Lender..... ☐

(1) Name..... ☐

(2) Address..... ☐

2. Identify original loan(s)..... ☐

a. Original principal amount(s)..... ☐

b. Date(s) of original loan(s)..... ☐

c. Original interest rate(s)..... ☐

d. Current principal balance(s)..... ☐

e. Original lender(s)..... ☐

2-Forms Federal Taxes Affecting Real Estate [III.]

- f. Original borrower(s)..... ☐
3. Set forth modifications, e.g.,..... ☐
- a. Additional funds to be borrowed..... ☐
- b. Extended term for loan repayment..... ☐
- c. New interest rate..... ☐
- d. New parties to be added..... ☐
- e. Consolidation of loans..... ☐
- f. Other..... ☐
4. Miscellaneous provisions..... ☐
- a. All remaining terms of original loan documents remain in effect..... ☐
- b. Waiver provision (e.g., "the waiver of any provision of this agreement shall not be valid unless it is in writing and signed by the party granting the waiver")..... ☐
- c. Any modifications of agreement must be in written form and signed by both parties.....
☐
- d. Agreement is to be construed in accordance with the laws of the State of _____ ☐
- e. Provision for the giving of notice between the parties..... ☐
- f. Agreement is binding on both parties and their successors and assigns..... ☐
- g. Borrower to provide IRS forms W-8 or W-9..... ☐
5. Execution..... ☐
- a. Signed by parties..... ☐
- b. Dated..... ☐

c. Witnesses..... ☐

d. Acknowledged..... ☐

I. Miscellaneous forms..... ☐

1. "HUD No 1" Form..... ☐

2. Agreement to re-execute loan documents to correct errors..... ☐



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Federal Taxes Affecting Real Estate

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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [IV.]

[IV.] Checklist for Drafting Documents Necessary for Commercial Mortgage Transaction

A. Commitment letter..... ☐

1. Identify..... ☐

a. Borrower(s)..... ☐

b. Guarantor(s)..... ☐

c. Property subject to mortgage..... ☐

d. Mortgage amount..... ☐

2. Conditions..... ☐

a. Financial..... ☐

(1) Cross-corporate guarantors (i.e., loan is backed by borrower's parent company and fellow subsidiaries, or by borrower's subsidiaries)..... ☐

(2) Additional collateral required..... ☐

(a) Accounts receivable..... ☐

(b) Fixtures..... ☐

(c) Equipment..... ☐

2-Forms Federal Taxes Affecting Real Estate [IV.]

(d) Inventory..... ☐

(e) Other..... ☐

(3) Partial payment or full satisfaction of existing debts..... ☐

(4) Satisfactory appraisal of property..... ☐

(5) Payment of commitment fee and closing costs..... ☐

b. Relating to structures and land..... ☐

(1) Certificate of occupancy..... ☐

(2) Opinion of counsel..... ☐

(3) Casualty insurance..... ☐

(4) Flood insurance..... ☐

(5) Fire insurance..... ☐

(6) Liability insurance..... ☐

(7) Environmental site assessment..... ☐

(8) Environmental indemnification and hold harmless clause in order to protect lender from any liability arising from environmental mishap..... ☐

c. Relating to title to real property..... ☐

(1) Satisfactory title search..... ☐

(2) Or: title insurance policy..... ☐

(3) Satisfactory survey..... ☐

(4) Proof of compliance with all zoning laws..... ☐

(5) Proof of compliance with all environmental laws..... ☐

B. Note..... ☐

1. Identify parties..... ☐

a. Borrower..... ☐

(1) Name..... ☐

(2) Capacity..... ☐

(3) Address..... ☐

(4) Taxpayer identification number..... ☐

b. Lender..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

2. Amount borrowed..... ☐

3. Term..... ☐

a. Date when note is issued..... ☐

b. Date when final payment is due..... ☐

c. Balloon provisions..... ☐

4. Interest rate..... ☐

a. Prime rate plus ____ percent..... ☐

- b. Frequency of rate adjustments for changes in the prime rate..... ☐
- c. Maximum rate..... ☐
- d. Minimum rate..... ☐
5. Prepayment provisions..... ☐
- a. Permitted at any time without penalty..... ☐
- b. Permitted on any payment date without penalty..... ☐
- c. Not permitted during a stated period..... ☐
- d. Permitted on any payment date with penalty..... ☐
- e. Permitted at any time with penalty..... ☐
6. Payment provisions..... ☐
- a. Frequency of payments..... ☐
- b. Amortizing payments..... ☐
- c. Interest-only payments..... ☐
- d. Interest plus level principal payments..... ☐
- e. Negative amortization..... ☐
- f. Balloon payments..... ☐
- g. Grace period..... ☐
- h. Late charge..... ☐
- i. Where payments are to be made..... ☐
7. Further provisions..... ☐

- a. Borrower grants waiver of presentment..... ☐
- b. Notices sent between the parties..... ☐
- c. Law governing transaction shall be law of the State of _____ ☐
- d. Recourse or exculpation provisions..... ☐

8. Execution..... ☐

- a. Signature of borrower as maker of note..... ☐
- b. Proper acknowledgment..... ☐
- c. Delivery of note..... ☐

C. Mortgage..... ☐

1. Identify parties..... ☐

a. Borrower..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Capacity..... ☐

(4) Taxpayer identification number..... ☐

b. Owner of real property, if different from borrower..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Capacity..... ☐

(4) Taxpayer identification number..... ☐

c. Lender..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

2. Consideration to lender for granting mortgage..... ☐

3. Borrower grants interest in subject property to lender to secure mortgage loan..... ☐

a. Property description..... ☐

b. Extent of interest..... ☐

(1) Includes all rights of borrower in the subject premises..... ☐

(a) Minerals..... ☐

(b) Oil..... ☐

(c) Natural gas..... ☐

(d) Water..... ☐

(e) Shale..... ☐

(f) Coal..... ☐

(g) Trees..... ☐

(h) Wildlife (i.e., fish and game)..... ☐

(i) Inchoate rights..... ☐

(j) Other..... ☐

2-Forms Federal Taxes Affecting Real Estate [IV.]

(2) Rents from all tenants..... ☐

(3) Easements for access to subject property..... ☐

c. Interest is subject to..... ☐

(1) Easement for public utilities..... ☐

(2) Enforceable covenants/restrictions..... ☐

(3) All laws..... ☐

(4) Other..... ☐

4. Representations and duties of borrower..... ☐

a. Payment will be made in accordance with the terms set forth in the note..... ☐

b. Title to the property is clear..... ☐

c. Borrower will maintain property in good condition..... ☐

(1) Borrower will allow inspection of property by lender..... ☐

(2) Borrower will make all necessary repairs promptly and properly..... ☐

(3) Borrower will make no alterations without permission..... ☐

d. Borrower will maintain insurance..... ☐

e. Borrower will make timely real estate tax payments..... ☐

f. Borrower will provide to lender copies of annual income tax returns (federal, state and local)..... ☐

g. Borrower will provide to lender copies of audited financial statements of borrower and related entities..... ☐

h. Borrower will obey all laws and government regulations (federal, state and local)..... ☐

i. Borrower will keep premises free of any environmental hazards..... ☐

5. Rights of lender..... ☐

a. Rights in event of default..... ☐

(1) Right to accelerate entire debt..... ☐

(2) Right to receive rents..... ☐

(3) Right to physically secure property..... ☐

(4) Right to reimbursement of all costs resulting from default..... ☐

(a) Foreclosure costs and disbursements..... ☐

(b) Legal fees..... ☐

(c) Court costs..... ☐

(d) Reference fees..... ☐

b. Events of default..... ☐

(1) Borrower's failure to make mortgage payments when due..... ☐

(2) Borrower's failure to maintain insurance..... ☐

(3) Borrower's failure to pay taxes..... ☐

(4) Environmental mishap on the mortgaged property..... ☐

(5) Borrower's failure to maintain premises in good repair..... ☐

(6) Borrower's other violation of terms of mortgage or note..... ☐

c. Right to foreclosure in event of default..... ☐

(1) Foreclosure subject to prior notice..... ☐

2-Forms Federal Taxes Affecting Real Estate [IV.]

- (2) Right to public sale of property..... ☐
- (3) Right to bid at public sale..... ☐
- (4) Right to obtain deficiency judgment..... ☐
- (5) Obligation to elect remedies..... ☐
- d. Right to inspect premises..... ☐
- e. Right to proceeds of award for eminent domain..... ☐
- f. Right to proceeds of casualty loss insurance settlement..... ☐
- g. Right to payment in full upon sale or other transfer of mortgaged property..... ☐
6. Further provisions..... ☐
- a. Mortgage not assumable without permission of lender..... ☐
- b. Waiver provision (e.g., "the waiver of any provision of this agreement shall not be valid unless it is in writing and signed by the party granting the waiver")..... ☐
- c. Any modifications of agreement must be in written form and signed by both parties.....
☐
- d. Agreement is to be construed in accordance with the laws of the State of _____ ☐
- e. Provision for the giving of notice between the parties..... ☐
- f. Agreement is binding on both parties and their successors and assigns..... ☐
- g. Borrower to provide IRS forms W-8 or W-9..... ☐
- h. Lender to cooperate in assignment of mortgage to save mortgage recording tax on refinancing..... ☐
7. Execution..... ☐

2-Forms Federal Taxes Affecting Real Estate [IV.]

- a. Signed by mortgagor..... ☐
- b. Dated..... ☐
- c. Witnesses..... ☐
- d. Acknowledged..... ☐
- e. Recording of mortgage..... ☐

D. Guarantee..... ☐

- 1. Identify parties..... ☐
 - a. Borrower..... ☐
 - (1) Name..... ☐
 - (2) Address..... ☐
 - (3) Taxpayer identification number..... ☐
 - (4) Capacity..... ☐
 - b. Guarantor..... ☐
 - (1) Name..... ☐
 - (2) Address..... ☐
 - (3) Taxpayer identification number..... ☐
 - (4) Capacity..... ☐
 - (5) Relationship to borrower..... ☐
 - c. Lender..... ☐
 - (1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

2. Identify loan or loans to be guaranteed..... ☐

a. Date..... ☐

b. Amount..... ☐

c. Security..... ☐

3. Identify extent of guarantee..... ☐

a. All debts now in existence and hereafter incurred..... ☐

b. A particular debt in its entirety..... ☐

c. Part of a particular debt..... ☐

d. Any debts to a maximum combined amount of \$_____ ☐

e. Lender's costs of collection, legal fees and court costs..... ☐

f. Other..... ☐

4. Circumstances under which guarantor must repay debt..... ☐

a. Failure of borrower to pay back loan..... ☐

b. Notice requirements imposed on lender before it may seek payment from guarantor.....
☐

c. Must lender make recourse to collateral before seeking payment from guarantor?..... ☐

d. Guarantor's subrogation rights..... ☐

5. Circumstances in which borrower's obligation will become recourse..... ☐

2-Forms Federal Taxes Affecting Real Estate [IV.]

- a. Failure to vacate premises following foreclosure..... ☐
- b. Intentional misrepresentation of environmental conditions..... ☐
- c. Other..... ☐
6. Other provisions..... ☐
- a. Modification or expansion of debt does not release guarantor of its obligations..... ☐
- b. Right of lender to release other parties (e.g., a borrower or other guarantor)..... ☐
- c. Course of conduct between lender and borrower does not release guarantor of its obligations..... ☐
- d. Waiver provision (e.g., "the waiver of any provision of this agreement shall not be valid unless it is in writing and signed by the party granting the waiver")..... ☐
- e. Any modifications of agreement must be in written form and signed by all parties..... ☐
- f. Agreement is to be construed in accordance with the laws of the State of _____ ☐
- g. Provision for the giving of notice among the parties..... ☐
- h. Agreement is binding on all parties and their successors and assigns..... ☐
7. Execution..... ☐
- a. Signed by parties..... ☐
- b. Dated..... ☐
- c. Witnesses..... ☐
- d. Acknowledged..... ☐
- E. Environmental indemnification granted by borrower to lender..... ☐

2-Forms Federal Taxes Affecting Real Estate [IV.]

1. Identify parties..... ☐

a. Borrower..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

b. Lender..... ☐

(1) Name..... ☐

(2) Address..... ☐

(3) Taxpayer identification number..... ☐

2. Amount of consideration..... ☐

3. Indemnification and hold harmless granted by borrower to lender to protect latter in the event of the following..... ☐

a. Use, production and/or storage of hazardous substances on the mortgaged premises.....
☐

b. Leakage or other release of such substances onto the premises..... ☐

c. Leakage or other release of such substances onto neighbors' property..... ☐

d. Other environmental mishap..... ☐

e. Failure of borrower to comply with federal, state and local environmental laws and regulations..... ☐

f. Indemnification/hold harmless shall extend to the full cost of decontamination of mortgaged premises and any neighboring property..... ☐

g. Indemnification/hold harmless shall extend to any lien, claim, judgment or assessment brought against the lender for the costs of remediation of the contaminated property..... ☐

h. Indemnification/hold harmless shall extend to the diminution in value of the property.....

☐

4. Indemnification and hold harmless survives..... ☐

a. Sale of property..... ☐

b. Satisfaction of loan..... ☐

5. Further provisions..... ☐

a. Waiver provision (e.g., "the waiver of any provision of this agreement shall not be valid unless it is in writing and signed by the party granting the waiver")..... ☐

b. Any modifications of agreement must be in written form and signed by both parties.....

☐

c. Agreement is to be construed in accordance with the laws of the State of _____ ☐

d. Provision for the giving of notice between the parties..... ☐

e. Agreement is binding on both parties and their successors and assigns..... ☐

6. Execution..... ☐

a. Signed by parties..... ☐

b. Dated..... ☐

c. Witnesses..... ☐

d. Acknowledged..... ☐

F. Opinion letter of borrower's counsel..... ☐

1. All loan documents are valid obligations of borrower and/or guarantor..... ☐

2. Legal assistance of borrower..... ☐

3. Borrower has legal authority to borrow..... ☐
4. No misrepresentations on part of borrower are contained in loan documents..... ☐
5. Borrower has complied with all relevant laws and regulations (federal, state and local).....
☐
6. There is no pending litigation concerning the property..... ☐
7. There are no pending or contemplated condemnation proceedings against the property.....
☐
8. There are no pending or contemplated environmental enforcement proceedings..... ☐

G. Miscellaneous documents..... ☐

1. Assignment of leases and rents..... ☐
2. Mortgage tax affidavit..... ☐
3. Settlement statement..... ☐



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [V.]

[V.] Checklist of Documents and Payments Needed for Closing

A. Documents and payments to be delivered by seller..... ☐

1. Deed..... ☐

2. Bill of sale for any personal property included in transaction..... ☐

3. Proof of authority of seller..... ☐

a. If seller is a corporation, a resolution of the corporation's board of directors authorizing the sale, certified by the corporation's secretary or assistant secretary..... ☐

b. If seller is a partnership, evidence of authorization by partnership..... ☐

c. Appropriate proof of appointment and authority of fiduciary..... ☐

d. Power of attorney document, together with affidavit of attorney-in-fact denying actual knowledge of termination of power by death, disability, incapacity or revocation by the principal..... ☐

e. Bring down authorization to closing date..... ☐

4. Transfer tax returns, other state and local tax returns, related affidavits, questionnaires or other documents required by taxing authority, and checks for tax payments (depending upon state law and local custom, some or all of these items may be delivered by the purchaser)..... ☐

2-Forms Federal Taxes Affecting Real Estate [V.]

5. Holdover agreement if seller will not vacate the premises until after the transfer of title.....

☐

6. Judgment affidavit.....

☐

7. Title affidavit from seller detailing length of time seller has owned the property, whether he or she has made any improvements to the property, and whether he or she has had any disputes with the adjoining landowners.....

☐

8. Escrow agreement to ensure satisfaction or release of lien.....

☐

9. Licenses and permits necessary to operate premises, including certificate of occupancy.....

☐

10. Plans and specifications relating to original construction and any additions or renovations.....

☐

11. Warranties and guarantees for structural elements (heating and cooling systems, roof, appliances, personal property, etc.).....

☐

12. Service contracts and assignments of service contracts.....

☐

13. For tenanted buildings:

a. copies of leases.....

☐

b. an updated rent schedule and updated seller's representations.....

☐

c. a schedule of security deposits and assignment of ownership thereof.....

☐

d. copies of any tenant records.....

☐

e. original letters to the tenants from the seller notifying them of the sale and directing them to make future payments to the purchaser.....

☐

f. tenant estoppel letters.....

☐

g. copies of service contracts.....

☐

h. original insurance policies to be apportioned.....

☐

2-Forms Federal Taxes Affecting Real Estate [V.]

i. an assignment, without recourse or warranty, of the seller's interests in all leases, insurance policies, and service contracts..... ☐

j. plans and specifications..... ☐

k. approvals of leases by lenders..... ☐

14. For new construction:

a. Evidence that work complete..... ☐

b. Evidence that contractors paid in full..... ☐

c. Applicable new construction warranties, if any..... ☐

d. Architect's certificate of compliance..... ☐

e. Holdback agreement, if necessary..... ☐

15. Condominium documents..... ☐

a. Waiver of board of manager's right of first refusal and any required approvals..... ☐

b. Statement as to payment of common charges..... ☐

c. Check for payment of condominium fees, flip taxes, costs and expenses.....
☐

16. Cooperative Documents..... ☐

a. Waiver of cooperative's right of first refusal..... ☐

b. Approval of purchaser by cooperative..... ☐

c. Statement as to payment of maintenance..... ☐

d. Check for payment of cooperative fees, flip taxes, costs, and expenses.....
☐

2-Forms Federal Taxes Affecting Real Estate [V.]

17. Homeowners' association documents..... ☐
- a. Waiver of any rights of homeowner's association..... ☐
- b. Approval of purchaser by homeowner's association, if needed..... ☐
- c. Statement as to payment of homeowner's association charges..... ☐
- d. Check for payment of homeowner's association fees, flip taxes, costs, and expenses..... ☐
18. If there is an existing mortgage:
- a. closing letter from seller's lender..... ☐
- b. mortgagee's written consent to sale and/or mortgagee's certificate as to the status of the loan, including the amount of unpaid principal and interest, the rate of interest, and the date of maturity, if existing mortgage to survive sale..... ☐
- c. statement of escrow amounts held by mortgagee and assignment of such escrow deposits to purchaser, if existing mortgage to survive sale..... ☐
- d. a letter, signed by seller and addressed to the existing mortgagee, advising the mortgagee of the sale of the property and directing the mortgagee to address future correspondence to purchaser, if existing mortgage to survive sale..... ☐
19. Evidence of removal of any violations..... ☐
20. Evidence of payment of assessments..... ☐
21. Official bills for unpaid taxes, assessments, water and sewer charges..... ☐
22. Hold harmless agreement from seller for benefit of purchaser and title company for water and sewer levies..... ☐
23. Current water meter reading..... ☐
24. Current fuel oil reading..... ☐
25. Current gas and electric meter readings..... ☐

2-Forms Federal Taxes Affecting Real Estate [V.]

26. Smoke alarm affidavit..... ☐
27. Check (or purchaser credit) for various apportionments..... ☐
28. Evidence that broker has been paid..... ☐
29. Designate person to file I.R.S. Form 1099-S..... ☐
30. Firpta certificate..... ☐
31. Forms W-8 and or W-9..... ☐

B. Documents to be delivered by purchaser..... ☐

1. Check for balance of purchase price..... ☐
- a. Specify type of check, e.g., certified..... ☐
- b. Specify type of funds, e.g., New York clearinghouse funds..... ☐
2. Purchase money note and mortgage..... ☐
3. Check to seller's attorney for preparation of purchase money note and mortgage..... ☐
4. Transfer tax returns, other state and local tax returns, related affidavits, questionnaires or other documents required by taxing authority, and checks for tax payments (depending upon state law and local custom, some or all of these items may be delivered by the seller)..... ☐
5. Check to seller for prepaid apportionments..... ☐
6. Checks for other closing costs (recording fees, title insurance, bank fees, points, legal fees, etc.)..... ☐
7. Certified checks to clear encumbrances..... ☐
8. Financing statements for personal property, fixtures or equipment included in sale..... ☐
9. Collateral assignment of leases and rents or other security interests..... ☐

2-Forms Federal Taxes Affecting Real Estate [V.]

10. Proof of authority of purchaser..... ☐

a. If purchaser is a corporation, a resolution of the corporation's board of directors authorizing the purchase, certified by the corporation's secretary or assistant secretary..... ☐

b. If purchaser is a partnership evidence of authorization by partnership..... ☐

c. Appropriate proof of appointment and authority of fiduciary..... ☐

d. Power of attorney document, together with affidavit of attorney-in-fact denying actual knowledge of termination of power by death, disability, incapacity, or revocation by principal..... ☐

e. Bring down authorization to closing date..... ☐

11. Documents to be provided to purchaser's lender:

a. Binder and paid receipt for casualty and liability insurance policy naming lender as insured (some lenders require duplicate original of actual insurance policy)..... ☐

b. Proof of flood insurance, if required..... ☐

c. Proof of sale of prior home (HUD-1 form or other proof)..... ☐

d. Note, mortgage and other documents required by lender..... ☐

e. Check for lender's tax and insurance escrow, if required by lender..... ☐

f. Proof of authority of purchaser to borrow and mortgage the property..... ☐

12. Depending upon local custom, gratuity for title closer..... ☐

13. Designate person to file I.R.S. Form 1099-S ☐



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [VI.]

[VI.] Checklist for Drafting Commercial Lease

A. Parties..... ☐

1. Identity of landlord..... ☐

a. Name..... ☐

b. Address..... ☐

c. Taxpayer identification number..... ☐

2. Character of landlord..... ☐

a. Individual..... ☐

(1) Over the age of majority..... ☐

(2) Not incapacitated by mental disease or defect..... ☐

b. Corporation..... ☐

(1) State of incorporation..... ☐

(2) Obtain proof of authority of person executing lease on behalf of
corporation..... ☐

2-Forms Federal Taxes Affecting Real Estate [VI.]

(3) Obtain proof of legal existence of corporation..... ☐

(4) Obtain copy of resolution of corporation's board of directors authorizing lease..... ☐

(5) Obtain any required court or government agency approvals..... ☐

c. Partnership..... ☐

(1) State of formation..... ☐

(2) Obtain proof of authority of partnership representative to act on behalf of all partners..... ☐

(3) Obtain proof of legal existence of partnership (e.g., copy of partnership agreement and affidavit that it is still valid)..... ☐

(4) Obtain copy of partnership decision authorizing lease..... ☐

(5) Obtain signatures of partners needed to authorize lease..... ☐

(6) Obtain any required court or government agency approvals..... ☐

d. Limited liability company..... ☐

(1) State of formation..... ☐

(2) Obtain proof of authority of member or manager to act on behalf of company..... ☐

(3) Obtain proof of legal existence of LLC, and copy of LLC operating agreement and affidavit that it is still valid..... ☐

(4) Obtain copy of company decision authorizing lease..... ☐

(5) Obtain signature of all members or managers needed to authorize lease.....
☐

(6) Obtain any required court or government agency approvals..... ☐

e. Fiduciary..... ☐

(1) Obtain proof of appointment..... ☐

(2) Examine order or decree appointing fiduciary and determine scope of authority..... ☐

(3) Examine document (will, trust, etc.) creating appointment..... ☐

(4) Determine whether court order required for lease..... ☐

(5) Obtain information concerning beneficial owner..... ☐

f. Attorney-in-fact or agent..... ☐

(1) Obtain proof of appointment (certified copy of power of attorney document)..... ☐

(2) Determine whether appointment has been terminated by death, disability, incapacity or revocation (in most states, affidavit of attorney-in-fact denying actual knowledge of termination of power is sufficient)..... ☐

(3) Determine scope and duration of powers, making sure it includes power to lease real property..... ☐

(4) Obtain information concerning beneficial owner..... ☐

3. Identity of tenant..... ☐

a. Name..... ☐

b. Address..... ☐

c. Taxpayer identification number..... ☐

4. Character of tenant..... ☐

a. Individual..... ☐

(1) Over the age of majority..... ☐

2-Forms Federal Taxes Affecting Real Estate [VI.]

(2) Not incapacitated by mental disease or defect..... ☐

b. Corporation..... ☐

(1) State of incorporation..... ☐

(2) Obtain proof of authority of person executing lease on behalf of corporation..... ☐

(3) Obtain proof of legal existence of corporation..... ☐

(4) Obtain copy of resolution of corporation's board of directors authorizing lease..... ☐

(5) Obtain any required court or government agency approvals..... ☐

c. Partnership..... ☐

(1) State of formation..... ☐

(2) Obtain proof of authority of partnership representative to act on behalf of all partners..... ☐

(3) Obtain proof of legal existence of partnership (e.g., copy of partnership agreement and affidavit that it is still valid)..... ☐

(4) Obtain copy of partnership decision authorizing lease..... ☐

(5) Obtain signature of partners needed to authorize lease..... ☐

(6) Obtain any required court or government agency approvals..... ☐

d. Limited liability company..... ☐

(1) State of formation..... ☐

(2) Obtain proof of authority of member or manager to act on behalf of company..... ☐

2-Forms Federal Taxes Affecting Real Estate [VI.]

(3) Obtain proof of legal existence of LLC, and copy of LLC operating agreement and affidavit that it is still valid..... ☐

(4) Obtain copy of company decision authorizing lease..... ☐

(5) Obtain signature of all members or managers needed to authorize lease.....
☐

(6) Obtain any required court or government agency approvals..... ☐

e. Fiduciary..... ☐

(1) Obtain proof of appointment..... ☐

(2) Examine order or decree appointing fiduciary and determine scope of authority..... ☐

(3) Examine document (will, trust, etc.) creating appointment..... ☐

(4) Determine whether court order required for lease..... ☐

(5) Obtain information about beneficial owner..... ☐

f. Attorney-in-fact or agent..... ☐

(1) Obtain proof of appointment (certified copy of power of attorney document)..... ☐

(2) Determine whether appointment has been terminated by death, disability, incapacity or revocation (in most states, affidavit of attorney-in-fact denying actual knowledge of termination of power is sufficient)..... ☐

(3) Determine scope and duration of powers, making sure it includes power to lease real property..... ☐

(4) Obtain information about beneficial owner..... ☐

B. Financial reliability of parties..... ☐

1. Obtain references..... ☐

2-Forms Federal Taxes Affecting Real Estate [VI.]

- a. Bank with which party has business account..... ☐
- b. Regular supplier..... ☐
- c. Current landlord or tenant..... ☐
- 2. Obtain permission to contact references and get credit report on tenant..... ☐
- 3. Do Lexis/Nexis search on landlord, tenant, and their principles..... ☐
- 4. Information to be supplied by tenant..... ☐
 - a. Complete financial statement..... ☐
 - b. Copies of prior years' tax returns..... ☐
- C. Premises..... ☐
 - 1. Identify lease premises in detail..... ☐
 - a. Specify location by state, county and municipality..... ☐
 - b. Set forth street address, if one exists..... ☐
 - c. State lot or unit size (if rent is based on size of space, include exact square footage)..... ☐
 - d. Specify room, suite or unit number where property is in multi-unit facility (*e.g.*, office building, warehouse complex, shopping center)..... ☐
 - e. Attach floor plan to lease, with leased unit marked..... ☐
 - 2. Buildings, structures and other permanent improvements located on premises (*e.g.*, garages, pools, etc.)..... ☐
 - a. Set forth buildings, structures and permanent improvements included in lease..... ☐
 - b. Set forth buildings, structures and permanent improvements excluded from

2-Forms Federal Taxes Affecting Real Estate [VI.]

lease..... ☐

3. Appurtenances (*e.g.*, common areas, parking lots, garages, storage space, rest room, meeting rooms, etc.)..... ☐

a. Set forth appurtenances included in lease..... ☐

b. Set forth appurtenances excluded from lease..... ☐

c. Identify appurtenances available to tenant at additional costs..... ☐

(1) Set forth cost of use of item..... ☐

(2) Set forth procedure to obtain use of items..... ☐

(3) Set forth conditions for use..... ☐

4. Fixtures and equipment (*e.g.*, HVAC system, lighting fixtures, built-in cabinets, etc.)..... ☐

a. Set forth fixtures and equipment included in lease..... ☐

b. Set forth fixtures and equipment excluded from lease..... ☐

5. Personal property (*e.g.*, office equipment, furniture, etc.)..... ☐

a. Set forth personal property included in lease..... ☐

b. Set forth personal property excluded from lease..... ☐

c. Identify personal property available to tenant at additional costs..... ☐

(1) Set forth cost per unit..... ☐

(2) Set forth procedure to obtain items..... ☐

(3) Set forth present condition of items..... ☐

(4) Set forth maintenance, repair and replacement responsibilities..... ☐

(5) Specify condition in which items are to be returned at end of lease term.....

☐

6. Condition of premises, fixtures and personal property included in lease..... ☐

a. Specify condition premises, fixtures and personalty will be leased in (*e.g.*, "as is," or "good working order" or "working order")..... ☐

b. Set forth maintenance, repair and replacement responsibilities..... ☐

c. Specify condition in which items are to be returned at end of lease term..... ☐

7. Option or obligation to expand or contract space..... ☐

a. Option to lease adjoining or nearby space..... ☐

(1) Right of first refusal to lease available space..... ☐

(2) Right of first offer to lease available space..... ☐

b. Restriction of surrounding tenants to short-term leases..... ☐

c. Lease rights of surrounding tenants subject to landlord's right to relocate them..... ☐

d. Tenant's obligation to lease additional space..... ☐

e. Tenant right to abandon part of premises to decrease space..... ☐

(1) Specify space to be abandoned..... ☐

(2) Time period within which option to abandon must be exercised..... ☐

(3) Formula for rent adjustment..... ☐

D. Tenant improvements or alterations in premises..... ☐

1. Identify initial improvements, alterations or construction necessary to make the leased premises suitable for use by tenant..... ☐

2. Provide for further alterations or improvements desired by tenant during term of lease.....

2-Forms Federal Taxes Affecting Real Estate [VI.]

☐

3. Specify who will pay for such improvements (landlord, tenant, or both) and set forth any limits or caps on amount to be paid..... ☐

a. Construction allowance from landlord..... ☐

b. Requirements for competitive bidding..... ☐

4. Consider tax consequences to tenant and landlord of determination of who will pay for improvements..... ☐

5. Plans, blueprints and specifications..... ☐

a. Specify who will prepare or have plans prepared..... ☐

b. Specify if landlord or tenant must approve plans and what grounds are for disapproval..... ☐

c. Contractor..... ☐

(1) Name contractor who will do work..... ☐

(2) If contractor not named in lease, set forth who will choose contractor and any guidelines for or conditions on choice..... ☐

d. Specify who must obtain necessary governmental permits and approvals..... ☐

e. Specify date when improvements must be completed..... ☐

f. State if tenant must remove improvements at end of lease term and restore premises to their original state..... ☐

6. Protecting landlord from liens for materials and services..... ☐

a. Tenant covenant not to encumber landlord's title..... ☐

b. Require landlord's approval of all work in excess of specified amount..... ☐

c. Require bond for completion of work free of encumbrances..... ☐

2-Forms Federal Taxes Affecting Real Estate [VI.]

d. Require waivers of liens of materialmen, architects, contractors, etc..... ☐

e. Require tenant security deposit..... ☐

f. Landlord right to discharge liens on record for longer than specified period and to add cost of discharge to rent..... ☐

E. Lease price..... ☐

1. Base rent..... ☐

a. Annual rental amount or total amount for lease term..... ☐

b. Periodic payments to be made throughout year (*e.g.*, monthly installments)..... ☐

(1) Amount..... ☐

(2) Frequency of installments..... ☐

(3) When due..... ☐

(4) Grace period for late payment of rent, if any..... ☐

(5) Late fee, if any..... ☐

2. Additional rent for fixtures, appurtenances or personal property..... ☐

3. Percentage rent..... ☐

a. Basis for calculation..... ☐

(1) Gross income..... ☐

(2) Adjusted gross receipts..... ☐

(3) Net income..... ☐

(4) Gross sales..... ☐

b. Set forth rate (percentage of basis) to be paid..... ☐

c. Specify amounts included in or excluded from basis..... ☐

(1) Receipts of tenant's licensees or concessionaires..... ☐

(2) Receipts of other offices or stores owned by tenant resulting from sales at leased premises..... ☐

(3) Sales to tenant's employees..... ☐

(4) Returned items..... ☐

(5) Donated items..... ☐

(6) Interest and credit charges..... ☐

(7) Uncollected credit sales..... ☐

(8) Telephone or catalog sales..... ☐

(9) Off-premises deliveries..... ☐

(10) Sales tax receipts..... ☐

(11) Vending machine proceeds..... ☐

(12) Customer charges for delivery or alterations at cost..... ☐

(13) Other..... ☐

d. Set forth any guaranteed minimum rental..... ☐

e. Reporting by tenant to landlord..... ☐

(1) When reports made..... ☐

(2) How reports made..... ☐

2-Forms Federal Taxes Affecting Real Estate [VI.]

(3) Information required..... ☐

(4) Landlord right to review tenant's books and records..... ☐

(5) Audit by independent public accounting firm..... ☐

f. Specify that parties do not intend to create a partnership for tax or other purposes..... ☐

4. Security deposit..... ☐

a. Amount..... ☐

b. Date(s) when due..... ☐

c. Form of payment..... ☐

d. Set forth how deposit may or may not be used..... ☐

(1) Encumbrance by tenant..... ☐

(2) Final month's rent..... ☐

(3) Repair of damages..... ☐

(4) Cleaning costs..... ☐

(5) Rent or charges unpaid by tenant..... ☐

(6) Liquidated damages..... ☐

e. Terms for refund..... ☐

f. State whether interest will be paid, the rate, if compounded or adjustable, and who will pay income taxes on such interest..... ☐

g. State financial criteria for institution in which deposit must be maintained..... ☐

5. Escalating or additional rent or charges..... ☐

- a. Common area charges for cost of maintaining and repairing common areas..... ☐
 - b. Maintenance costs..... ☐
 - c. Water and sewer charges..... ☐
 - d. Utilities..... ☐
 - e. Garbage disposal..... ☐
 - f. Janitorial services..... ☐
 - g. Insurance..... ☐
 - h. Real estate taxes..... ☐
 - i. Assessments..... ☐
 - j. Other operating expenses..... ☐
 - k. Retail facilities and shopping malls..... ☐
 - (1) Advertising charges..... ☐
 - (2) Merchants' association dues..... ☐
 - l. Expenses arising from default or litigation..... ☐
6. Rent abatement to induce tenant to enter lease..... ☐
- F. Utilities..... ☐
- 1. Types of utilities..... ☐
 - a. Water..... ☐
 - b. Sewers..... ☐

c. Gas..... ☐

d. Electricity..... ☐

e. Fuel oil..... ☐

f. Heat..... ☐

g. Steam..... ☐

h. Air conditioning..... ☐

i. Chilled water..... ☐

j. Telephone..... ☐

k. Rooftop antenna access..... ☐

l. Internet/broadband access..... ☐

m. Cable television access..... ☐

2. Charges..... ☐

a. Specify who will pay utility charges..... ☐

b. Specify how charges will be determined..... ☐

(1) Separate meters..... ☐

(2) Proportional charges to tenants in multi-unit building with single meter.....
☐

G. Real property taxes and special assessments..... ☐

1. Tenant payment of ratable share of taxes..... ☐

2. Tax increases..... ☐

3. Responsibility for special assessments..... ☐
- a. Assessments existing before lease for completed improvements..... ☐
- b. Assessments made during lease term..... ☐
4. Right to protest assessment and delay tax payment while protest pending..... ☐
5. Tenant's right to require landlord to protest assessment..... ☐
6. Tenant's right to share of any tax refunds obtained by landlord..... ☐

H. Lease term..... ☐

1. Commencement date..... ☐
- a. Date certain..... ☐
- b. Period of time after triggering event..... ☐
2. Consequence of failure to deliver possession on commencement date..... ☐
- a. Rent abatement..... ☐
- b. Right to cancel..... ☐
3. Termination date..... ☐
4. Renewal or extension..... ☐
- a. Set forth tenant's right to renew or extend, if any..... ☐
- b. Set forth any conditions to be met prior to renewal or extension (*e.g.*, tenant may not be in default)..... ☐
- c. When and how tenant must give notice to landlord that tenant is exercising the right to renew or extend..... ☐
- d. Changes in lease terms for renewal or extension period..... ☐

2-Forms Federal Taxes Affecting Real Estate [VI.]

(1) Amount of rent..... ☐

(a) Specify exact amount..... ☐

(b) Amount based on Consumer Price Index or other index..... ☐

(2) Length of renewal or extension term..... ☐

(3) Provisions for additional renewals or extensions, if any..... ☐

(4) Provisions for improvements, increase or decrease in space..... ☐

(5) Other changes in terms of lease..... ☐

I. Option or obligation to purchase, rights of first offer or refusal..... ☐

1. Purchase option..... ☐

a. Purchase price..... ☐

(1) Specify exact amount..... ☐

(2) Fair market value, with provision for appraisal..... ☐

b. Period of time when option exercisable..... ☐

c. When and how tenant must give notice to landlord that tenant is exercising right to purchase..... ☐

d. Terms of contract of sale..... ☐

e. Closing date for sale..... ☐

f. Termination of option by landlord..... ☐

2. Right of first refusal or right of first offer to purchase leased premises..... ☐

a. Conditions for triggering activation of right..... ☐

(1) Right of first refusal third party's bona fide offer to purchase premises.....

☐

(2) Right of first offer landlord's decision to offer premises for sale to third parties..... ☐

b. Notice to tenant of triggering event..... ☐

c. Period of time to exercise right..... ☐

d. How right to be exercised..... ☐

e. Determination of price..... ☐

f. Termination of right..... ☐

g. Contingencies acceptable to tenant in contract of sale..... ☐

h. Closing date..... ☐

3. Tenant's obligation to make rejectable offer to purchase property in certain circumstances..... ☐

a. Offer to be made in event of tenant's determination or obsolescence..... ☐

b. Offer to be made at end of lease..... ☐

c. Required amount of offer to be based on outstanding senior debt..... ☐

d. Notice of offer to landlord..... ☐

e. Notice of offer to senior lender..... ☐

f. Period of time for landlord to consider offer..... ☐

g. Prohibition of rejection of offer without consent of senior lender..... ☐

J. Right to assign or sublet..... ☐

1. Procedure to be followed by tenant..... ☐

a. Notice to landlord..... ☐

b. Landlord's written consent..... ☐

2. Limitations on right to assign or sublet..... ☐

K. Limitations on use of property..... ☐

1. If limited to commercial purposes only..... ☐

a. Specify tenant's business..... ☐

b. Specify permitted activities allied to main enterprise..... ☐

2. Noncompetition (exclusive use) provisions..... ☐

a. Landlord restricted for entering lease with another tenant for specified use..... ☐

b. Landlord prohibited from giving naming rights to tenants for specified uses..... ☐

c. Landlord covenants not to permit particular use in another space in landlord's facility..... ☐

d. Tenant granted exclusive right to specified use in landlord's facility..... ☐

e. Tenant granted right to approve other tenants or control quality of goods sold by other tenants..... ☐

3. Radius restrictions..... ☐

a. Tenant prohibited from operating similar business within specified distance from premises..... ☐

b. Income or sales from business operated by tenant within specified distance from premises to be included in determination of percentage rent..... ☐

4. Use of natural resources..... ☐

- a. Exterior open space..... ☐
- b. Recreational use of vacant land..... ☐
- c. Water sources other than municipal water..... ☐
 - (1) Site from which water to be drawn..... ☐
 - (a) Well..... ☐
 - (b) Lake or pond..... ☐
 - (c) River, stream or brook..... ☐
 - (d) Marsh..... ☐
 - (e) Other..... ☐
 - (2) Volume of water to be drawn per day..... ☐
 - (3) Release of water after use..... ☐
 - (4) Record keeping..... ☐
 - (5) Tenant to obtain governmental approvals..... ☐
- d. Energy sources (*e.g.*, natural gas, coal, oil, etc.) other than commercial sources..... ☐
 - (1) Additional consideration for use of nonrenewable resources..... ☐
 - (2) Site from which resources to be taken..... ☐
 - (3) Limitations on volume of use..... ☐
 - (4) Location, storage and removal of equipment..... ☐
 - (5) Record keeping..... ☐
 - (6) Tenant to obtain governmental approvals..... ☐

e. Harvesting resources (*e.g.*, shale, timber, iron, silver, fish, game, etc.)..... ☐

(1) Royalties to landlord..... ☐

(2) Site from which resources to be taken..... ☐

(3) Method for measuring volume harvested..... ☐

(4) Location, storage and removal of equipment..... ☐

(5) Reclamation of land..... ☐

(6) Record keeping..... ☐

(7) Tenant to obtain governmental approvals..... ☐

5. Other limitations on uses..... ☐

a. Hazardous uses..... ☐

(1) Pesticides and insecticides..... ☐

(2) Cleaning agents..... ☐

(3) Storage, use, production or disposal of hazardous substances..... ☐

(a) Tenant required to keep records..... ☐

(b) Landlord right to review records and audit for compliance..... ☐

b. Uses that increase insurance rates..... ☐

c. Uses that impair landlord's title..... ☐

d. Uses that adversely affect property value..... ☐

e. Uses that may disturb other tenants..... ☐

f. Uses that violate certificate of occupancy..... ☐

g. Illegal uses..... ☐

h. Nuisances..... ☐

L. Maintenance and repair obligations..... ☐

1. Maintenance..... ☐

a. Set forth who has duty to maintain premises..... ☐

(1) Cleaning and janitorial services..... ☐

(2) Painting..... ☐

(3) Window washing..... ☐

(4) Trash removal..... ☐

(5) Landscaping and lawn care..... ☐

(6) Snow removal..... ☐

b. Tenant duty to maintain premises in good repair..... ☐

c. Landlord duty to maintain common areas..... ☐

2. Repairs..... ☐

a. Set forth who has duty to perform repairs to premises, if any..... ☐

(1) Minor nonstructural repairs..... ☐

(2) Minor structural repairs..... ☐

(3) Major nonstructural repairs..... ☐

(4) Major structural repairs..... ☐

b. Landlord duty to repair common areas..... ☐

c. Notice requirement..... ☐

(1) Notice to other party that repairs necessary..... ☐

(2) Notice that repairs being undertaken..... ☐

d. Right of access to make repairs, emergencies..... ☐

M. Insurance..... ☐

1. Types..... ☐

a. Fire..... ☐

b. Boiler..... ☐

c. Other casualty..... ☐

(1) Permitted exclusion for acts of war..... ☐

(2) Permitted exclusion for acts of terrorism..... ☐

d. Liability..... ☐

e. Plate glass replacement..... ☐

2. Set forth who has responsibility for obtaining insurance and who is insured party..... ☐

a. Landlord..... ☐

b. Tenant..... ☐

c. Both..... ☐

3. Amount of coverage required..... ☐

4. Set forth who is designated payee of policy..... ☐

5. State rights of mortgagee, if any..... ☐

6. State whether landlord has right to approve tenant's insurance company or policy..... ☐

7. Subrogation rights..... ☐

8. Require notice prior to cancellation of policy..... ☐

9. Require proof of coverage..... ☐

N. Damage by fire or other casualty..... ☐

1. Premises unfit for use..... ☐

a. Procedure for determining unfitness..... ☐

b. Abatement of rent until repairs made..... ☐

2. Specify who is responsible for repairs or rebuilding..... ☐

a. State when work must begin and end..... ☐

b. Describe type, size cost of repairs or rebuilding required..... ☐

3. Termination of lease..... ☐

a. State whether landlord or tenant entitled to terminate lease..... ☐

b. Specify circumstances in which termination is permitted..... ☐

c. Notice of intention to terminate ☐

4. Tenant required to notify landlord of occurrence of casualty..... ☐

5. Landlord right to inspect damage..... ☐

6. Set forth disposition of insurance proceeds in event of damage or destruction..... ☐

7. Dispute resolution mechanism..... ☐

a. Independent adjuster as arbitrator..... ☐

b. Binding determination..... ☐

O. Eminent domain..... ☐

1. Specify who is entitled to proceeds of award..... ☐

2. Restoration of portion of premises not taken..... ☐

a. Use of condemnation award for restoration..... ☐

b. Expenses exceeding award..... ☐

3. Set forth procedure for determining whether taking terminates lease..... ☐

a. Entire or partial taking..... ☐

b. Effect of taking on leased premises..... ☐

4. Rent abatement and sharing of award for partial taking..... ☐

5. Sharing of award for entire taking..... ☐

P. Contingencies..... ☐

1. General provisions applicable to all contingencies..... ☐

a. Specify who must obtain satisfaction of contingency and what that party must do..... ☐

b. Set time limit for resolving contingency..... ☐

c. Set standard for determining whether contingency is satisfied..... ☐

d. Specify whether landlord, tenant or both have right to waive satisfaction of contingency..... ☐

2. Governmental approvals..... ☐

- a. Certificate of occupancy..... ☐
- b. Certificate of compliance with local ordinances, such as building, housing, safety, environmental, or fire ordinances..... ☐
- c. Zoning..... ☐
- d. Emission of substances into air or water..... ☐
- e. Waste disposal..... ☐
- f. Business operating permits..... ☐
- g. Sign approval..... ☐
- 3. Testing of well water quality..... ☐
- 4. Testing of well water quantity..... ☐
- 5. Septic or other on-site sewage disposal system..... ☐
 - a. Condition (*e.g.*, "good working order")..... ☐
 - b. Capacity..... ☐
 - c. Availability of sewer connections..... ☐
- 6. Radon gas inspection..... ☐
- 7. Asbestos inspection..... ☐
- 8. Urea formaldehyde insulation..... ☐
- 9. Inspection for lead pipes..... ☐
- 10. Inspection for lead paint and dust..... ☐
- 11. Environmental site assessment..... ☐

Q. Termination of lease..... ☐

1. Condition of premises

a. Tenant not responsible for repairs during lease term to return premises in "broom clean" condition..... ☐

b. Tenant responsible for repairs during lease term to return premises in as good condition as at beginning of lease, reasonable wear and tear excepted..... ☐

c. Tenant to have premises professionally cleaned..... ☐

d. Personal property..... ☐

(1) Tenant to remove all..... ☐

(2) Landlord to inspect premises upon termination and determine what property tenant must remove..... ☐

(3) Landlord to have right (but not obligation) to sell property not removed by tenant..... ☐

e. Trade fixtures..... ☐

(1) Tenant right to remove..... ☐

(2) Tenant to repair damage caused by removal..... ☐

f. Tenant alterations..... ☐

(1) Landlord to have right to retain..... ☐

(2) Landlord to have right to require tenant to remove and restore premises to original condition..... ☐

2. Tenant to vacate on or before termination date..... ☐

a. Penalty for holding over..... ☐

b. Return of keys..... ☐

R. Defaults and remedies..... ☐

1. Default by tenant..... ☐

a. Nature of default..... ☐

(1) Failure to pay rent..... ☐

(2) Enumerate events of default in other terms of lease..... ☐

b. State whether landlord required to give notice of default to tenant..... ☐

(1) Describe contents of notice..... ☐

(2) Specify how, where and to whom notice to be delivered..... ☐

(3) Proof of service of notice..... ☐

c. Opportunity to cure default, setting forth amount of time given to cure specified defaults.....
☐

d. Landlord right to make advances on tenant's default in payment of taxes, insurance, etc.....
☐

e. Effect of default..... ☐

(1) Automatic termination of lease..... ☐

(2) Landlord right to terminate lease..... ☐

f. State whether acceptance of rent or waiver of any breach waives such breach or any succeeding breaches..... ☐

g. Right to evict..... ☐

(1) Summary eviction..... ☐

(2) Self-help..... ☐

h. Measure of damages payable to landlord..... ☐

- i. Tenant's liability for rent payments preserved beyond premature termination date following default..... ☐
- (1) Tenant payments required over remaining lease term..... ☐
- (2) Acceleration of rent..... ☐
- j. State whether landlord has a lien for rent..... ☐
- (1) Security deposit..... ☐
- (2) Tenant's personal property..... ☐
- k. Reimbursement of expenses arising from default or litigation..... ☐
- (1) Collection of rent..... ☐
- (2) Expenses to cure other defaults..... ☐
- (3) Legal expenses..... ☐
- (4) Expenses to recover possession..... ☐
- l. Reletting of premises following surrender or eviction..... ☐
- (1) Examine state law concerning landlord's duty to mitigate damages by re-letting..... ☐
- (2) Provide in lease whether landlord has obligation to mitigate damages by re-letting..... ☐
- m. State whether landlord's remedies are cumulative..... ☐
2. Default by landlord..... ☐
- a. Tenant right to cure landlord's defaults..... ☐
- b. Tenant option to terminate..... ☐

c. Ouster of tenant by superior title..... ☐

d. Damages..... ☐

(1) Reimbursement of amounts spent to cure default..... ☐

(2) Application of expenditures against future rentals..... ☐

(3) Maintenance of separate action for reimbursements..... ☐

(4) Liability limited to abatement of rent..... ☐

S. Other provisions..... ☐

1. Set forth required days and hours of business operation by tenant..... ☐

2. Signs and advertising..... ☐

a. Location of signs..... ☐

b. Size limitations..... ☐

c. Style and content limitations..... ☐

d. Permits required..... ☐

e. Responsibility for installation, maintenance and repair of signs..... ☐

3. Compliance with governmental regulations..... ☐

a. Set forth who is responsible for changes or alterations necessary to conform to governmental laws and regulations regarding premises and business conducted there..... ☐

b. Set forth who is responsible for compliance with Americans with Disabilities Act..... ☐

4. Tenant guaranteed possession of lease property throughout lease term absent default.....
☐

5. Landlord's right to show space to prospective tenants near end of lease term..... ☐

6. Broker..... ☐

a. Identify brokers involved in lease transaction and specify who will pay commissions..... ☐

b. Cross-indemnification against other brokerage claims..... ☐

T. Miscellaneous clauses..... ☐

1. Non-waiver provision..... ☐

2. Select state law which will apply to transaction..... ☐

3. Illegal portions of lease deemed excised..... ☐

4. Merger clause providing that lease contains entire agreement between parties..... ☐

5. Binding effect of lease on parties and their successors and assigns..... ☐

6. All amendments to lease to be in writing..... ☐

7. Provision for the giving of notice between the parties..... ☐

8. Subordination to any mortgages..... ☐

9. Dispute resolution mechanism..... ☐

U. Execution of the lease..... ☐

1. Signed by parties or their representatives..... ☐

2. Dated..... ☐

3. Witnesses if desired..... ☐

4. Acknowledgment if desired..... ☐

5. Multiple originals..... ☐

V. Attachments..... ☐

1. Floor plan..... ☐

2. Work letter ☐

3. Rules and regulations ☐



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Federal Taxes Affecting Real Estate

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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [VII.]

[VII.] Checklist for Drafting Residential Real Estate Lease

A. Identification of parties..... ☐

1. Landlord..... ☐

a. Name..... ☐

b. Address..... ☐

c. Taxpayer identification number..... ☐

2. Capacity of landlord..... ☐

a. Individual..... ☐

(1) Meets the age of majority..... ☐

(2) Competent to act..... ☐

b. Corporation..... ☐

(1) Obtain proof of authority to act on behalf of corporation (e.g., secretary's certificate)..... ☐

(2) Obtain copy of resolution of board of directors authorizing lease..... ☐

2-Forms Federal Taxes Affecting Real Estate [VII.]

(3) Obtain proof of legal existence of corporation..... ☐

(4) Is court approval required (e.g., bankruptcy court)?..... ☐

(5) Is approval of any state agency required?..... ☐

c. Partnership or limited liability company..... ☐

(1) Obtain proof from representative of partnership or limited liability company that he/she has authority to act on behalf of partnership or limited liability company..... ☐

(2) Obtain copy of partners', members', or manager's decision authorizing lease..... ☐

(3) Obtain proof of legal existence of partnership or limited liability company, e.g., copy of partnership or limited liability company agreement and affidavit that is still in effect..... ☐

(4) Is approval of court (e.g., bankruptcy court) required?..... ☐

(5) Is approval of any state or local government agency required?..... ☐

d. Fiduciary..... ☐

(1) Obtain proof of appointment..... ☐

(2) Determine source of appointment..... ☐

(a) By law..... ☐

(b) By court order..... ☐

(c) By document (e.g., will or trust agreement)..... ☐

(3) Determine whether court order is required for lease..... ☐

(4) Obtain information concerning beneficial owner..... ☐

e. Attorney-in-Fact or agent..... ☐

- (1) Obtain proof of appointment..... ☐
- (2) Obtain proof that appointment has not been revoked..... ☐
- (3) Is principal alive?..... ☐
- (4) Is principal competent?..... ☐
- (5) Does grant of authority include lease of real property?..... ☐
- (6) Obtain information concerning beneficial owner..... ☐
- 3. Tenant..... ☐
 - a. Name..... ☐
 - b. Address..... ☐
 - c. Taxpayer identification number..... ☐
- 4. Capacity of tenant..... ☐
 - a. Individual..... ☐
 - (1) Meets the age of majority..... ☐
 - (2) Competent to act..... ☐
 - (3) Financially reliable..... ☐
 - (a) Obtain references..... ☐
 - (b) Obtain permission for credit report from tenant..... ☐
 - b. Corporation..... ☐
 - (1) Obtain proof of authority to act on behalf of corporation (e.g., secretary's certificate).....
☐

2-Forms Federal Taxes Affecting Real Estate [VII.]

(2) Obtain copy of resolution of board of directors authorizing lease..... ☐

(3) Obtain proof of legal existence of corporation..... ☐

(4) Is court approval required (e.g., bankruptcy court)?..... ☐

(5) Is approval of any state agency required?..... ☐

c. Partnership or limited liability company..... ☐

(1) Obtain proof from representative of partnership or limited liability company that he/she has authority to act on behalf of partnership limited liability company..... ☐

(2) Obtain copy of partners', members', or manager's decision authorizing lease..... ☐

(3) Obtain proof of legal existence of partnership or limited liability company, e.g., copy of partnership or limited liability company agreement and affidavit that is still in effect..... ☐

(4) Is approval of court (e.g., bankruptcy court) required?..... ☐

(5) Is approval of any state or local government agency required?..... ☐

d. Fiduciary..... ☐

(1) Obtain proof of appointment..... ☐

(2) Determine source of appointment..... ☐

(a) By law..... ☐

(b) By court order..... ☐

(c) By document (e.g., will or trust agreement)..... ☐

(3) Determine whether court order is required for lease..... ☐

(4) Obtain information concerning beneficial owner..... ☐

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e. Attorney-in-Fact or agent..... ☐

(1) Obtain proof of appointment..... ☐

(2) Obtain proof that appointment has not been revoked..... ☐

(3) Is principal alive?..... ☐

(4) Is principal competent?..... ☐

(5) Does grant of authority include lease of real property?..... ☐

(6) Obtain information concerning beneficial owner..... ☐

B. Identification of leased premises..... ☐

1. Location..... ☐

a. Describe location by county and by municipality..... ☐

b. Describe location by street address..... ☐

c. Describe location by lot number or size..... ☐

d. Describe location by unit number, if apartment, condominium or cooperative..... ☐

2. Identify all structures which are included in the lease, e.g., garage space, barn, etc..... ☐

3. Identify all appurtenances which are included in the lease, e.g., lawn or yard rights, pool privileges, community room privileges, etc..... ☐

4. Identify any structures which are excluded from the lease..... ☐

5. Identify any appurtenances which are excluded from the lease..... ☐

6. Identify any personal property which is included in the lease (e.g., appliances)..... ☐

a. Specify whether personal property is leased "as is" or in "good working

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order" ☐

b. Specify responsibility for cost of repair and replacement during lease term..... ☐

c. Specify condition in which personal property is to be returned at end of lease term..... ☐

7. Identify fixtures which are included in lease (e.g., HVAC system)..... ☐

a. Specify whether fixtures are leased "as is" or in good working order..... ☐

b. Specify responsibility for cost of repair and replacement during lease term..... ☐

c. Specify condition in which fixtures are to be returned at end of lease.....
☐

8. Identify any personal property which is available to tenant at additional cost (e.g., appliances, draperies, etc.)..... ☐

a. Specify cost per unit..... ☐

b. Specify procedure to obtain items..... ☐

c. Specify present condition of items..... ☐

d. Specify repair or replacement responsibilities of tenant and landlord.....
☐

e. Specify condition in which items are to be returned at end of lease term.....
☐

9. Identify appurtenances which are available to tenant at additional cost (i.e., garage, pool, use of community room, etc.)..... ☐

a. Specify cost of item..... ☐

b. Specify procedure to obtain item..... ☐

C. Rent..... ☐

1. Specify annual rent..... ☐
2. Specify whether rent is to be paid in periodic installments..... ☐
 - a. Amount of each installment..... ☐
 - b. When due..... ☐
 - c. Specify grace period for late payment..... ☐
 - d. Specify late fee..... ☐
3. Security deposit..... ☐
 - a. Specify amount..... ☐
 - b. Specify when due..... ☐
 - c. Specify terms for refund..... ☐
 - d. Specify whether interest will be paid..... ☐
 - e. Specify where deposit will be held (e.g., name of bank)..... ☐

D. Lease term..... ☐

1. Commencement date..... ☐
2. Termination date..... ☐
3. Renewal rights..... ☐
 - a. Conditions to be met (e.g., no prior defaults in rental payments)..... ☐
 - b. Notice of desired renewal given by tenant to landlord..... ☐
 - c. Term of renewed lease..... ☐
 - (1) Increased rental amount..... ☐

(2) Length of renewed term..... ☐

(3) Other changes in terms of existing lease..... ☐

4. Option to purchase property..... ☐

a. Determination of price..... ☐

b. When option is exercisable..... ☐

c. Required notice from tenant of tenant's intention to exercise option..... ☐

d. Closing date of sale..... ☐

e. Termination of option by landlord..... ☐

5. Right of first offer or first refusal to purchase property..... ☐

a. Conditions for..... ☐

b. Determination of price..... ☐

c. Termination of right..... ☐

d. Contingencies acceptable to tenant in contract of sale..... ☐

e. Closing date..... ☐

f. Notice provisions..... ☐

E. Other obligations of tenant..... ☐

1. Condition of premises..... ☐

a. Maintain property in good condition..... ☐

b. Basic cleaning..... ☐

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- c. Lawn care..... ☐
- d. Minor repairs..... ☐
 - (1) To the structures..... ☐
 - (2) Non-structural repairs..... ☐
- e. Notice to be given to landlord if major repair is required..... ☐
- f. Notice to be given to landlord if alterations are desired..... ☐
- 2. Insurance..... ☐
 - a. Amounts of coverage..... ☐
 - b. Types..... ☐
 - (1) Liability..... ☐
 - (2) Casualty..... ☐
 - (3) Fire..... ☐
 - c. Permitted exclusion for acts of war..... ☐
 - d. Permitted exclusions for acts of terrorism..... ☐
 - e. Notice must be given to landlord prior to cancellation of policy..... ☐
 - f. Landlord is to be designated payee of proceeds of policy..... ☐
 - g. Tenant must present to landlord proof of coverage..... ☐
- 3. Limitations on use of property..... ☐
 - a. Residential purposes only..... ☐
 - b. Limitation on number of persons who may occupy premises at any time..... ☐

- c. Compliance with fair housing laws..... ☐
- d. Limitations on use of chemicals..... ☐
- (1) Pesticides..... ☐
- (2) Insecticides..... ☐
- (3) Drain cleaners..... ☐
- (4) Cleaning agents..... ☐
- (5) Other..... ☐
- e. Other limitations on use..... ☐
- f. Prohibition against storage of chemicals or flammables..... ☐
4. Upon termination of lease..... ☐
- a. Property must be "broom clean"..... ☐
- b. Remove personal effects..... ☐
- c. Return keys..... ☐
- d. Vacate on or before date of lease's termination..... ☐
- e. Landlord's right (but not obligation) to sell remaining personal property..... ☐
- F. Other obligations of landlord..... ☐
1. Major repairs..... ☐
2. Janitorial services in common areas..... ☐
3. Trash removal..... ☐

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4. Snow removal..... ☐
5. Provide utilities..... ☐
- a. Heat..... ☐
- b. Air Conditioning..... ☐
- c. Electricity..... ☐
- d. Water..... ☐
- e. Gas..... ☐
- f. Sewer rents..... ☐
6. Guarantee the tenant quiet enjoyment of leased property..... ☐
7. Guarantee the tenant possession of leased property throughout lease term..... ☐
8. Real property taxes..... ☐
9. Lawn care..... ☐
10. Other obligations..... ☐

G. Contingencies in lease (i.e., lease does not become binding upon parties unless contingencies are satisfied first)..... ☐

1. Septic system is in good working order..... ☐
2. Testing of well to determine..... ☐
- a. Purity of water..... ☐
- b. Acceptability of water's taste and smell..... ☐
- c. Quantity of water..... ☐

- d. Whether pump is in good working order..... ☐
3. Inspection for asbestos insulation..... ☐
4. Inspection for urea formaldehyde insulation..... ☐
5. Test for presence of radon gas..... ☐
- H. Other provisions..... ☐
1. Default by tenant in payment of rent or fulfilling other terms of lease..... ☐
- a. Notice of default given to tenant..... ☐
- b. Opportunity to cure default..... ☐
- c. Right to evict..... ☐
- d. Damages payable to landlord..... ☐
- e. Re-letting of premises following eviction..... ☐
- f. Provide whether landlord has obligation to mitigate damages by re-letting.....
☐
2. Damage by fire..... ☐
- a. Landlord responsible for repairs?..... ☐
- b. Tenant is entitled to terminate lease and vacate property..... ☐
- c. Notice must be given by tenant to landlord of former's intention to terminate lease..... ☐
3. Eminent domain..... ☐
- a. Landlord is entitled to proceeds of award..... ☐
- b. Termination of lease..... ☐

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(1) Does the eminent domain constitute an entire taking?..... ☐

(2) Partial taking?..... ☐

(3) If partial taking, lease will not terminate if leased premises are unaffected by eminent domain..... ☐

4. Landlord's right to show property to prospective tenants near end of lease term..... ☐

5. Broker..... ☐

a. Identify broker involved in lease and specify who will pay commission..... ☐

b. Cross-indemnification against other brokerage claims..... ☐

6. Miscellaneous provisions..... ☐

a. Non- waiver provision (e.g., "the waiver of any provision of this agreement shall not be valid unless it is in writing and signed by the party granting the waiver")..... ☐

b. Any modifications of agreement must be in written form and signed by both parties.....
☐

c. Agreement is to be construed in accordance with the laws of the State of _____ ☐

d. Provision for the giving of notice between the parties..... ☐

e. Agreement is binding on both parties and their successors and assigns..... ☐

f. Illegal portions of lease deemed excised..... ☐

g. Merger clause providing that lease contains entire agreement between parties..... ☐

h. Subordination to any mortgages..... ☐

i. Dispute resolution mechanism..... ☐

I. Execution..... ☐

1. Signed by parties..... ☐

2. Dated..... ☐

3. Witnesses..... ☐

4. Acknowledged..... ☐



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [VIII.]

[VIII.] Environmental Questionnaire to Be Completed by Seller or Lessor of Commercial Real Property

A. Location of the site..... ☐

1. Street address..... ☐

2. State and city, town or other political subdivision..... ☐

3. Streets bordering site..... ☐

4. Streets to which site has access..... ☐

B. Ownership history..... ☐

1. If structure(s), time of construction..... ☐

2. Name and address of builder..... ☐

3. Name and address of first owner of structure..... ☐

4. Uses of property by first owner..... ☐

5. Names and addresses of subsequent owners..... ☐

6. Uses of property by subsequent owners..... ☐

2-Forms Federal Taxes Affecting Real Estate [VIII.]

7. Name and address of present owner of structure..... ☐

8. Uses of property by present owner..... ☐

9. Has survey of site been performed recently, and, if so, is copy available?.....
☐

C. Description of site..... ☐

1. Number of structures..... ☐

2. Number of floors in each structure..... ☐

3. Total number of square feet of each structure..... ☐

4. Total number of square feet covered by entire site..... ☐

5. Parking lot..... ☐

a. Total number of spaces..... ☐

6. Have any improvements, additions, or renovations been made at the site or are any under consideration?..... ☐

a. If yes, obtain copies of architects' drawings, and other relevant, descriptive materials..... ☐

D. Description of operations..... ☐

1. What is the current nature of operations at the site?..... ☐

2. How long has the site been occupied and how long have individual tenant(s) occupied/operated at the site?..... ☐

3. Have there been any changes in the nature of operations/process since first occupancy? If so, describe changes..... ☐

4. Who were the previous owner/occupants and what if any industrial, storage, or disposal activities did they utilize?..... ☐

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5. List each agency that the owner/operator of the facility would report any environmental, safety, or health problems including the name, position, address, and telephone number of the contact person at each agency..... ☐

6. What, if any, industrial, manufacturing, storage, and disposal practices are currently used at the site?..... ☐

7. What, if any, industrial, manufacturing, storage, and disposal activities have been discontinued?..... ☐

8. Are there any storage/stockpile areas outside buildings located on the site? What are the nature of the materials?..... ☐

9. Has an emergency contingency plan or spill prevention and response plan been developed for the site?..... ☐

E. Raw materials and bulk storage..... ☐

1. What are the raw materials used at the site? (i.e., metals, paints, solvents, cleaning solutions, caustics, acids, oils, greases, etc.)..... ☐

a. How are these materials shipped?..... ☐

b. How are they stored?..... ☐

c. Are Material Safety Data Sheets ("MSDS") maintained for all chemicals used at the site? Provide copies..... ☐

d. What quantities are used?..... ☐

e. Which of these materials are considered hazardous?..... ☐

f. Have any releases of materials occurred in loading/unloading areas?..... ☐

F. Underground and aboveground storage tanks..... ☐

1. Are underground storage tanks ("USTs") utilized at the site or have they been utilized in the past?..... ☐

a. How old are the tanks and where are they located?..... ☐

2-Forms Federal Taxes Affecting Real Estate [VIII.]

- b. Describe construction of tanks..... ☐
- c. What type, if any, of protection is used (i.e., cathodic, double-walled tanks, etc.)?..... ☐
- d. What chemicals (including oil and gasoline) are stored in each tank?.....
☐
- e. Identify all permits/registrations required by applicable federal, state, and local law with respect to such tanks..... ☐
- (1) Is the site in compliance with all such requirements?..... ☐
- (2) Identify all such permits/registration obtained for the site?..... ☐
- f. What is the storage capacity of each tank?..... ☐
- g. Have the tanks been tested?..... ☐
- h. Is there any evidence of tank leakage?
- i. If the tanks are no longer in use, how and when were they abandoned?..... ☐
- (1) Was there any evidence of potential concerns (i.e. corrosion, stained soil, free product in excavation, odors, etc.)?..... ☐
- (2) Were the tanks abandoned in accordance with applicable federal, state, and local laws?..... ☐
2. Are aboveground storage tanks ("ASTs") utilized at the site or have they been utilized in the past?..... ☐
- a. How old are the tanks and where are they located?..... ☐
- b. Describe construction of tanks..... ☐
- c. Are there any secondary containment features (i.e., berm, double-walled tanks, etc.)?.....
☐
- d. Is there a leak detection system?..... ☐
- e. What chemicals (including oil and gas) are stored in each tank?..... ☐

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f. Identify all permits/registrations required by applicable federal, state, and local law with respect to such tanks..... ☐

(1) Is the facility in compliance with all such requirements?..... ☐

(2) Identify all such permits/registration obtained for the site?..... ☐

g. What is the storage capacity of each tank?..... ☐

h. Have any instances of leaks or releases occurred?..... ☐

i. If the tanks are no longer in use, how and when were they abandoned?..... ☐

(1) Was there any evidence of potential concerns (i.e. corrosion, stained soil, free product in excavation, odors, etc.)?..... ☐

(2) Were the tanks abandoned in accordance with applicable federal, state, and local laws?..... ☐

3. Are there underground and/or aboveground pipelines at the site?..... ☐

a. What materials do they transfer?..... ☐

b. Are they tested?..... ☐

c. Have any releases of chemicals occurred?..... ☐

G. Waste streams..... ☐

1. Does the site generate, store, treat, or dispose of any hazardous wastes? If so, identify all such materials and the permits required in connection with such activities..... ☐

2. Does the site have a permit for the storage, treatment, or disposal of hazardous waste? If so, what is the permit number?..... ☐

3. Does the site have a hazardous waste generator's permit? If so, what is the permit number?..... ☐

4. What solid waste materials are generated at the site (i.e. sludge, scrap metals, foundry sand, medical

2-Forms Federal Taxes Affecting Real Estate [VIII.]

waste, radioactive waste, etc.)?..... ☐

a. What quantities of each type of solid wastes are generated?..... ☐

b. Are any of these wastes considered hazardous or special medical wastes?.....
☐

c. Are solid wastes stored on-site prior to disposal? If so, where? How long?..... ☐

d. Is the solid waste tested before disposal? If so, by whom? What parameters are tested?..... ☐

5. What liquid waste streams/wastewater are generated at the site (i.e. sanitary sewage, discharge water, spent solvents, used oils, etc.)?..... ☐

a. Are the wastewater streams monitored? If so, how often? What parameters are tested?..... ☐

b. Have there been any citations for permit issues of noncompliance?..... ☐

c. Is any wastewater pretreated and/or treated at the site? If so, how? How are these processes monitored?..... ☐

d. What types of waste chemical are produced (spent solvents, acids, used oils, etc.)?..... ☐

e. Are any of these liquids considered hazardous?..... ☐

f. How are these chemicals stored (drums, holding tank, etc.)? Where are they stored? How long are they stored?..... ☐

g. How are they disposed?..... ☐

(1) Who is the hauler?..... ☐

(2) Where is it taken?..... ☐

(3) Is it tested prior to disposal?..... ☐

(4) What is the amount of quantities disposed?..... ☐

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h. Does the site have floor drain trenches, or sumps? If so, how are they used? Where are they located?..... ☐

6. What are the sources of air emissions at the site?..... ☐

a. Are there any air pollution control devices operated at the site?..... ☐

b. Are air emissions monitored? If so, how often? What parameters are tested?..... ☐

c. Have any citations been issued for permit excesses?..... ☐

H. Solid waste disposal..... ☐

1. How is the solid waste produced at the site disposed of?..... ☐

a. Contract with private hauler..... ☐

(1) Identify hauler..... ☐

(2) Identify disposal destination..... ☐

b. Municipal waste removal services..... ☐

c. Does site contain..... ☐

(1) An incinerator?..... ☐

(2) A landfill?..... ☐

(3) A system for recycling solid waste?..... ☐

d. Have all required government permits (federal, state, and local) been obtained to operate the incinerator, landfill, and/or recycling system?..... ☐

I. Waste water disposal..... ☐

1. Sewage..... ☐

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- a. Is site hooked up to municipal sewage system?..... ☐
- b. Is site served by its own septic system?..... ☐
- c. Is sewage treated and discharged into waterway?..... ☐
- d. Average amount of sewage produced monthly (in gallons)..... ☐
- e. Have all required government permits (federal, state and local) been obtained? List all permit numbers..... ☐
2. Waste water produced in the course of industrial operations..... ☐
- a. Types..... ☐
- b. Amounts..... ☐
- c. Where is wastewater discharged?..... ☐
- d. Have all required government permits (federal, state and local) been obtained? List all permit numbers..... ☐
3. Runoff of rainwater..... ☐
- a. Where is rainwater discharged?..... ☐
- (1) Into municipal storm drainage system..... ☐
- (2) A waterway..... ☐
- (3) Wetland/marsh..... ☐
- (4) Other..... ☐
- b. Have all required government permits (federal, state and local) been obtained?..... ☐
- c. Does rainwater carry off any industrial wastewater produced at the site?..... ☐
- d. Location of drainage system, waterway, wetland, etc..... ☐

J. Wetlands..... ☐1. In the past, has any wetland on the site been..... ☐a. Filled?..... ☐b. Drained?..... ☐c. Dredged?..... ☐2. Has construction occurred within the wetland?..... ☐3. Explain in detail..... ☐a. When this was done..... ☐b. Where it was done..... ☐c. How it was done..... ☐4. Were all required government permits (federal, state and local) obtained?..... ☐K. Emissions into the air..... ☐1. Specify the source of energy for heating and cooling at the site..... ☐2. Is fuel-burning machinery used at the site for industrial purposes?..... ☐3. Are smoke, gases, vapors, or other substances emitted into the air?..... ☐4. If so, what specific types of emissions are released?..... ☐a. Carbon monoxide..... ☐b. Sulphur dioxide..... ☐c. Nitrogen oxide..... ☐

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- d. Ozone..... ☐
- e. Hydrocarbons..... ☐
- f. Organic compounds..... ☐
- g. Vinyl chloride..... ☐
- h. Mercury..... ☐
- i. Asbestos..... ☐
- j. Lead..... ☐
- k. Other..... ☐

5. In what quantities?..... ☐

6. Have all required government permits (federal, state and local) been obtained? List all permit numbers..... ☐

L. Hazardous substances..... ☐

1. Has any hazardous substance, whether solid, liquid or gaseous, ever..... ☐

- a. Been released into the air?..... ☐
- b. Leaked?..... ☐
- c. Spilled?..... ☐
- d. Been discharged?..... ☐
- e. Escaped?..... ☐
- f. Leached?..... ☐

2. If so, what type of substance was involved?..... ☐

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3. When did this event occur?..... ☐
4. How much of the substance was released?..... ☐
5. What was the cause of the mishap?..... ☐
6. What was the nature and extent of the damage?..... ☐
7. What clean up actions were taken?..... ☐
8. Was any governmental agency (federal, state or local) notified of the mishap?..... ☐
9. Was an action of any type brought against you by a governmental agency as a result of the environmental mishap?..... ☐
10. If so, what is the current status of such action?..... ☐
11. Was an action of any type brought against you by any other party, e.g., a neighbor whose property was contaminated as a result of the mishap?..... ☐
12. If so, what is the current status of such action?..... ☐
13. As part of your business activities, is any hazardous substance..... ☐
- a. Brought onto the premises?..... ☐
- b. Used?..... ☐
- c. Produced?..... ☐
- d. Treated?..... ☐
- e. Stored on the premises?..... ☐
- f. Disposed of on the premises?..... ☐
14. If so, what is the substance?..... ☐
15. What quantity of the substance is regularly present on the site?..... ☐

16. Where on the site is the substance located?..... ☐

17. Has any governmental agency been made aware of the presence of the substance on the site?..... ☐

M. Hazardous wastes..... ☐

1. As part of your business activities, is any hazardous waste..... ☐

a. Brought onto the premises?..... ☐

b. Used?..... ☐

c. Produced?..... ☐

d. Treated?..... ☐

e. Stored on the premises?..... ☐

f. Disposed of on the premises?..... ☐

2. If so, what type of waste is it?..... ☐

3. What quantity of waste is regularly present on the site?..... ☐

4. Where on the site is the waste located?..... ☐

5. What methods are used to store the waste?..... ☐

6. How long does it remain on the site?..... ☐

7. Has any governmental agency been made aware of the presence of the waste on the site?.....
☐

8. Where is the hazardous waste transported to for disposal?..... ☐

9. What is the name of the company performing this service?..... ☐

N. Review of potential concerns..... ☐

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1. Are you aware of any pending, threatened, or past litigation, administrative proceedings, or possible liability related to hazardous substances or petroleum products having been used or currently in use at the site?..... ☐

2. Are you aware of any environmental liens, either recorded or unrecorded, against the site?..... ☐

3. Has the site ever been cited for noncompliance with discharge, wastewater, air emissions, and/or hazardous waste permits?..... ☐

4. Has the site been identified by a state or federal agency as a site allegedly contaminated by the release of hazardous materials?..... ☐

5. Who else would be knowledgeable about past and present site operations or conditions resulting in adverse environmental conditions (e.g., architects, engineers, adjacent property owners, local governmental agencies)? List name, addresses, and telephone numbers..... ☐

6. Attach copies of the environmental permits, correspondence with federal, state, and local governmental authorities, public utilities, and any as built site plans showing the general property layout, utilities, etc..... ☐



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [IX.]

[IX.] Checklist for Phase I Environmental Site Assessment

A. Identify subject premises..... ☐

1. Street address..... ☐

a. Street name and building number..... ☐

b. State, municipality or other political subdivision..... ☐

2. Survey map..... ☐

3. Deed..... ☐

4. Abstract of title..... ☐

5. Boundary line definition..... ☐

6. Tax map..... ☐

B. Identify all adjoining parcels..... ☐

1. Names of owners..... ☐

2. Structures..... ☐

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3. Boundary lines..... ☐

4. Character and uses (both past and present) of each adjoining parcel..... ☐

a. Residential..... ☐

(1) How solid waste is disposed of..... ☐

(2) How sewage is disposed of..... ☐

(a) Septic system..... ☐

(b) Public sewer system..... ☐

b. Commercial..... ☐

(1) How solid waste is disposed of..... ☐

(2) Where solid waste is taken..... ☐

(3) How sewage is disposed of..... ☐

(a) Septic system..... ☐

(b) Public sewer system..... ☐

(4) Use of ground water (i.e., water from wells, springs, etc.)..... ☐

(5) Discharge of ground water..... ☐

(6) Use of surface water (i.e., water from ponds, streams, marshes, etc.)..... ☐

(7) Discharge of surface water..... ☐

(8) Manufacturing..... ☐

(a) Products produced..... ☐

(b) Raw materials required (e.g., chemicals, etc.)..... ☐

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☐

(d) Manufacturing processes used..... ☐

(e) Storage facilities..... ☐

(f) Any hazardous substances used, produced, stored or disposed of on property..... ☐

(9) Services..... ☐

(a) Services performed..... ☐

(b) Raw materials required (e.g., chemicals, etc.)..... ☐

(c) Equipment, machinery and tools required..... ☐

(d) Processes used..... ☐

(e) Storage facilities..... ☐

(f) Any hazardous substances used, produced, stored or disposed of on property..... ☐

(10) Office building..... ☐

(a) Services performed..... ☐

(b) Equipment, machinery and tools required..... ☐

(c) Storage facilities..... ☐

(d) Any hazardous substances used, produced, stored or disposed of on property..... ☐

(10) Length of time premises were used for these purposes..... ☐

C. Identify past and present uses of subject premises..... ☐

2-Forms Federal Taxes Affecting Real Estate [IX.]

1. Review title records..... ☐
2. Review historic maps..... ☐
3. Review aerial photographs for as many years as are available..... ☐
4. Interview neighbors..... ☐
5. Interview police department officials..... ☐
 - a. About their personal knowledge concerning use of subject property..... ☐
 - b. Inspect police records for indications of how property was or is being used (e.g., citations, complaints from neighbors)..... ☐
6. Interview fire department officials..... ☐
 - a. About their personal knowledge concerning use of subject property..... ☐
 - b. Inspect fire department records for indications of how property was or is being used (e.g., citations, complaints from neighbors)..... ☐
7. Interview public works department officials..... ☐
 - a. About their personal knowledge concerning use of subject property..... ☐
 - b. Inspect department records for indications of how property was or is being used (e.g., complaints from neighbors)..... ☐
8. Interview officials of local health department..... ☐
 - a. For their personal knowledge regarding possible environmental hazards on property..... ☐
 - b. Inspect department records for possible citations issued by department or complaints brought by neighbors and others..... ☐
9. Review municipal records..... ☐
 - a. Applications to zoning and municipal planning boards..... ☐

- (1) Change in use applications..... ☐
- (2) Construction permits..... ☐
- (3) Demolition permits..... ☐
- (4) Maps on file..... ☐
- 10. Review Internet databases with respect to property and surrounding area..... ☐
- 11. Character and uses (both past and present) of subject premises..... ☐
 - a. Residential..... ☐
 - (1) How solid waste is disposed of..... ☐
 - (2) How sewage is disposed of..... ☐
 - (a) Septic system..... ☐
 - (b) Public sewer system..... ☐
 - b. Commercial..... ☐
 - (1) How solid waste is disposed of..... ☐
 - (2) Where solid waste is taken..... ☐
 - (3) How sewage is disposed of..... ☐
 - (a) Septic system..... ☐
 - (b) Public sewer system..... ☐
 - (4) Use of ground water (i.e., water from wells, springs, etc.)..... ☐
 - (5) Discharge of ground water..... ☐
 - (6) Use of surface water (i.e., water from ponds, streams, marshes, etc.)..... ☐

2-Forms Federal Taxes Affecting Real Estate [IX.]

(7) Discharge of surface water..... ☐

(8) Manufacturing..... ☐

(a) Products produced..... ☐

(b) Raw materials required (e.g., chemicals, etc.)..... ☐

(c) Equipment, machinery and tools required..... ☐

(d) Manufacturing processes used..... ☐

(e) Storage facilities..... ☐

(f) Any hazardous substances used, produced, stored or disposed of on property..... ☐

(9) Services..... ☐

(a) Services performed..... ☐

(b) Raw materials required (e.g., chemicals, etc.)..... ☐

(c) Equipment, machinery and tools required..... ☐

(d) Processes used..... ☐

(e) Storage facilities..... ☐

(f) Any hazardous substances used, produced, stored or disposed of on property..... ☐

(10) Office building..... ☐

(a) Services performed..... ☐

(b) Equipment, machinery and tools required..... ☐

(c) Storage facilities..... ☐

(d) Any hazardous substances used, produced, stored or disposed of on property..... ☐

(11) Length of time premises were used for these purposes..... ☐

D. Geography of surrounding area..... ☐

1. Topography (i.e., features of the area)..... ☐

a. Perform personal inspection of area..... ☐

b. Check U.S. Geological Service maps..... ☐

(1) Elevation..... ☐

(2) Relief features..... ☐

(a) Hills..... ☐

(b) Mountains..... ☐

(c) Valleys..... ☐

(d) Other..... ☐

(3) Bodies of water on or near premises..... ☐

(a) Ponds..... ☐

(b) Springs..... ☐

(c) Lakes..... ☐

(d) Rivers..... ☐

(e) Streams and brooks..... ☐

(f) Wetlands and marshes..... ☐

2-Forms Federal Taxes Affecting Real Estate [IX.]

(g) Other..... ☐

(4) How well does surface water run off the subject premises?..... ☐

(5) Natural vegetation..... ☐

(a) Trees..... ☐

(b) Shrubbery..... ☐

(c) Other..... ☐

2. Geological setting..... ☐

a. General soil type..... ☐

b. Properties of soil (e.g., sandy, clay-like, dense, rocky)..... ☐

c. Presence of radon..... ☐

d. Ground water..... ☐

(1) Quantity..... ☐

(2) Quality..... ☐

(3) Movement of ground water from subject property to adjoining properties and vice versa..... ☐

3. Manmade features..... ☐

a. Storm drains and sewers..... ☐

b. Electrical poles and lines..... ☐

c. Electrical underground lines..... ☐

d. Electrical transformers..... ☐

2-Forms Federal Taxes Affecting Real Estate [IX.]

e. Gas mains..... ☐

f. Telephone poles and lines..... ☐

g. Telephone underground lines..... ☐

h. Storage tanks..... ☐

(1) Used to store _____ ☐

(2) Present condition of tanks..... ☐

(3) Location of tanks..... ☐

i. Water pipes and lines..... ☐

j. Sewer pipes and lines..... ☐

k. Roadways..... ☐

l. Parking lots..... ☐

m. Buildings and other structures..... ☐

(1) Age..... ☐

(2) Construction type (e.g., brick, stone, wood, etc.)..... ☐

(3) Additions to buildings and other structures..... ☐

(4) Blueprints of existing and prior buildings and other structures..... ☐

(5) Present condition of buildings and other structures..... ☐

(6) Floor drains in buildings and other structures..... ☐

(7) Percentage of current occupancy of buildings and other structures..... ☐

E. Identify potential environmental hazards on or near subject premises..... ☐

1. Review "National Priorities List" (NPL)..... ☐

a. To see whether subject premises is listed thereon..... ☐

b. To see whether adjoining parcels are listed thereon..... ☐

c. To determine location of nearest parcel listed on NPL in relation to subject premises..... ☐

2. Review "Comprehensive Environmental Response, Compensation and Liability Information System" (CERCLIS)..... ☐

a. To see whether subject premises is listed therein..... ☐

b. To see whether adjoining parcels are listed therein..... ☐

c. To determine location of nearest parcel listed in CERCLIS in relation to subject premises..... ☐

3. Review equivalent state environmental agency's list of sites requiring clean up, if any..... ☐

a. To see whether subject premises is listed thereon..... ☐

b. To see whether adjoining parcels are listed thereon..... ☐

c. To determine location of nearest parcel listed on list in relation to subject premises..... ☐

4. Physically inspect premises..... ☐

a. For stains on or near utility poles..... ☐

b. For signs of underground tanks..... ☐

c. For barrels and cans of liquid substances..... ☐

2-Forms Federal Taxes Affecting Real Estate [IX.]

- d. For signs of buried refuse..... ☐
 - e. For pools of oil, chemicals, etc..... ☐
 - f. For mounds of trash..... ☐
 - g. For dumpsters and receptacles of refuse..... ☐
 - h. For smokestacks..... ☐
 - i. For asbestos insulation..... ☐
 - (1) In ceiling tiles..... ☐
 - (2) In floor tiles..... ☐
 - (3) On pipes..... ☐
 - (4) On boiler or furnace..... ☐
 - j. For urea formaldehyde insulation..... ☐
 - k. For surfaces covered with lead-based paint..... ☐
 - l. For fungus, mold and other similar growths..... ☐
 - m. For evidence of infestation by insects and rodents..... ☐
 - n. Other..... ☐
- F. Laboratory analysis of air, water and soil samples (optional)..... ☐
- 1. Within structures..... ☐
 - a. Air samples..... ☐
 - b. Dust samples..... ☐
 - c. Paint samples..... ☐

d. Other..... ☐

2. External samplings..... ☐

a. Soil..... ☐

b. Surface water..... ☐

c. Ground water..... ☐

d. Air..... ☐

G. Analyzing data and drawing conclusions therefrom..... ☐

1. Specify precisely what was done during environmental site assessment..... ☐

2. Specify any potential environmental concerns..... ☐

3. Determine probability of environmental mishap in the future..... ☐

4. Limitations of environmental site assessment conducted..... ☐

a. No sampling of air, water, soil, etc., for evidence of contamination..... ☐

b. Reliance on oral statements made by those interviewed..... ☐

c. Inability to independently verify oral statements..... ☐

(1) Because of incomplete data..... ☐

(2) Because of contradictory data..... ☐

5. Warranties provided by environmental consultant..... ☐

a. To whom given?..... ☐

b. Warranties do not extend to other parties not expressly named..... ☐

c. Other limitations on warranties..... ☐

2-Forms Federal Taxes Affecting Real Estate [IX.]

- d. Disclaimers of liability for erroneous or incomplete information found in report..... ☐
- e. Caveats..... ☐
6. Review of owner/occupant's compliance with environmental laws and regulations..... ☐
- a. Review not part of scope of work..... ☐
- b. Or: specify laws reviewed..... ☐
- (1) Federal..... ☐
- (2) State..... ☐
- (3) Local..... ☐
- c. Specify any lack of compliance found..... ☐
- d. Specify any limitations on scope of this review..... ☐
- (1) Lack of cooperation from owner/occupant or others..... ☐
- (2) Necessary reliance on oral statements..... ☐
- (3) Inability to independently verify statements..... ☐
7. Specify when site assessment was performed..... ☐
8. Specify standard of care to be used in judging the performance of the environmental consultant..... ☐
9. Specify qualifications of consultant..... ☐



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Federal Taxes Affecting Real Estate

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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [X.]

[X.] Checklist for Use by Counsel to Real Estate Developer

- A. Planning phase..... ☐
 - 1. Define nature and scope of project..... ☐
 - a. Residential housing development..... ☐
 - (1) Single-family/owner-occupied..... ☐
 - (2) Multi-unit/developer-owned..... ☐
 - b. Commercial development..... ☐
 - (1) Retail..... ☐
 - (2) Office..... ☐
 - (3) Mixed use..... ☐
 - c. Industrial..... ☐
 - (1) Light industry..... ☐
 - (2) Heavy industry..... ☐
 - 2. Select site..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

a. Determine feasibility of each possible site ☐

(1) Determine availability of utilities and cost of installation or hook-up.....

☐

(a) Natural gas..... ☐

(b) Electricity..... ☐

(c) Potable water..... ☐

(d) Sewer system..... ☐

(e) Cable television..... ☐

(f) Telephone..... ☐

(2) Assess access of site to public
roadways ☐

(3) Assess property tax rates..... ☐

(4) Determine availability of quality public
schools ☐

(5) Estimate number of units that can be placed on parcel ☐

b. Review environmental aspects of each site ☐

(1) Determine present and past uses..... ☐

(2) Perform phase I environmental site assessment if such assessment has not been done in recent
years..... ☐

(3) Perform phase II environmental site assessment if phase I reveals evidence of adverse
environmental impact on property ☐

(4) Bodies of water on or near site?..... ☐

(a) Rivers..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

(b) Lakes..... ☐

(c) Streams..... ☐

(d) Springs..... ☐

(e) Ponds..... ☐

(f) Wells..... ☐

(g) Aquifers..... ☐

(h) Other..... ☐

(5) Wetlands on or near site?..... ☐

(6) Other significant environmental features of the site ☐

(a) Pine barrens..... ☐

(b) Seashore..... ☐

(c) Habitat of protected or endangered species..... ☐

(d) Other..... ☐

(7) Protected wildlife in the area?..... ☐

c. Is site located within or near a special
district? ☐

(1) Historic preservation district..... ☐

(2) Environmental conservation district..... ☐

(3) Federal or state park..... ☐

(4) Other..... ☐

3. Assembly of real estate development team ☐

a. Engineer..... ☐

(1) Determine scope of duties..... ☐

(2) Review qualifications..... ☐

(3) Investigate references..... ☐

(4) Reach agreement on compensation..... ☐

(5) Prepare contract for services..... ☐

(a) Specify in detail services to be
rendered, e.g., ... ☐

(i) Preparation of site plan,
drawings, etc ☐

(ii) Appear at all governmental hearings for project approval ☐

(iii) Supervise building of
infrastructure ☐

(iv) Other duties..... ☐

(b) Deadlines..... ☐

(c) Developer reserves right to terminate
contract ☐

(d) Developer reserves right to make use of engineer's work product even if contract is
terminated..... ☐

(e) Compensation..... ☐

(i) Hourly rate?..... ☐

(ii) Percentage of total cost of
construction? ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

(iii) Other method?..... ☐

(f) Does engineer carry sufficient malpractice insurance? ☐

(g) Other contract provisions..... ☐

b. Surveyor..... ☐

(1) Determine scope of duties..... ☐

(2) Review qualifications..... ☐

(3) Investigate references..... ☐

(4) Reach agreement on compensation..... ☐

(5) Prepare contract for services..... ☐

(a) Specify in detail services to be rendered ☐

(b) Deadlines..... ☐

(c) Developer reserves right to terminate contract ☐

(d) Developer reserves right to make use of surveyor's work product even if contract is terminated..... ☐

(e) Compensation..... ☐

(i) Hourly rate?..... ☐

(ii) Flat fee?..... ☐

(iii) Other method?..... ☐

(f) Other contract provisions..... ☐

c. Architect, if needed..... ☐

(1) Determine scope of duties..... ☐

(2) Review qualifications..... ☐

(3) Investigate references..... ☐

(4) Reach agreement on compensation..... ☐

(5) Prepare contract for services..... ☐

(a) Specify in detail services to be
rendered ☐

(b) Deadlines..... ☐

(c) Developer reserves right to terminate
contract ☐

(d) Developer reserves right to make use of architect's work product even if contract is
terminated..... ☐

(e) Compensation..... ☐

(i) Hourly rate?..... ☐

(ii) Percentage of total cost of
construction? ☐

(iii) Flat fee?..... ☐

(iv) Other method?..... ☐

(f) Does architect carry sufficient malpractice insurance? ☐

(g) Other contract provisions..... ☐

d. Financial advisor (independent contractor) ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- (1) Determine scope of duties..... ☐
- (2) Review qualifications..... ☐
- (3) Investigate references..... ☐
- (4) Reach agreement on compensation..... ☐
- (5) Prepare contract for services..... ☐
- (a) Specify in detail services to be rendered ☐
- (i) Accounting services..... ☐
- (ii) Bookkeeping services..... ☐
- (iii) Tax advice..... ☐
- (iv) Make projections regarding project costs & revenue ☐
- (v) Other..... ☐
- (b) Deadlines..... ☐
- (c) Developer reserves right to terminate contract ☐
- (d) Developer reserves right to make use of advisor's work product even if contract is terminated..... ☐
- (e) Compensation..... ☐
- (i) Hourly rate?..... ☐
- (ii) Flat fee?..... ☐
- (iii) Other method?..... ☐
- (f) Non-competition clause..... ☐

(g) Confidentiality clause..... ☐

(h) Other contract provisions..... ☐

e. Other consultants, e.g, marketing advisor. ☐

(1) Determine scope of duties..... ☐

(2) Review qualifications..... ☐

(3) Investigate references..... ☐

(4) Reach agreement on compensation..... ☐

(5) Prepare contract for services..... ☐

(a) Specify in detail services to be
rendered ☐

(b) Deadlines..... ☐

(c) Developer reserves right to terminate
contract ☐

(d) Developer reserves right to make use of consultant's work product even if contract
is terminated..... ☐

(e) Compensation..... ☐

(i) Hourly rate?..... ☐

(ii) Flat fee?..... ☐

(iii) Other method?..... ☐

(f) Other contract provisions..... ☐

f. Prepare timeline for project..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

B. Form of ownership of real estate development project ☐

1. Limited partnership..... ☐

a. Identify partners..... ☐

(1) One or more general partners with unlimited liability ☐

(2) One or more limited partners with limited liability ☐

b. Identify partner(s) responsible for management and control of project..... ☐

c. Specify the powers and responsibilities of the managing partner(s) ☐

d. Capital contributions of partners..... ☐

(1) Amount of cash to be provided by each
partner ☐

(2) Non-cash contributions..... ☐

(a) Land..... ☐

(b) Services..... ☐

(c) Equipment..... ☐

(d) Other..... ☐

(3) Specify ownership interest of each
partner ☐

e. Tax considerations..... ☐

(1) Appointment of tax matters partner ☐

(2) Determination of basis of contributed property..... ☐

(3) Restrictions on transfer to avoid publicly traded status..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

f. Buy-out considerations, e.g., whether partnership or partners shall be required to buy, or shall have option to buy, the partnership interest of a partner in the event of his or her..... ☐

(1) Death..... ☐

(2) Physical or mental disability..... ☐

(3) Retirement..... ☐

(4) Desire to withdraw from firm..... ☐

(5) Other reasons..... ☐

g. Causes of partnership termination..... ☐

h. File organizational papers and, if required publish..... ☐

i. Draft and, if required, file partnership agreement..... ☐

2. Limited liability company..... ☐

a. Identify members..... ☐

b. Identify member(s) or managers responsible for management and control of project.....
☐

c. Specify powers and responsibilities of managing members or managers..... ☐

d. Specify capital contributing members..... ☐

(1) Amount of cash to be provided by each member..... ☐

(2) Non cash contributions..... ☐

(i) Land..... ☐

(ii) Services..... ☐

(iii) Equipment..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

(iv) Other..... ☐

(3) Specify ownership interest of each member..... ☐

e. Tax considerations..... ☐

(1) Appoint tax matters members..... ☐

(2) Determination of basis of contributed property..... ☐

(3) Restrictions on transfer to avoid publicly traded status..... ☐

f. Buyout considerations, e.g., whether LLC or members shall be required to buy, or shall have option to buy, the membership interest of a member in the event of his or her..... ☐

(1) Death..... ☐

(2) Physical or mental disability..... ☐

(3) Retirement..... ☐

(4) Desire to withdraw from firm..... ☐

(5) Other reasons..... ☐

g. Causes of LLC termination..... ☐

h. File certificates of organization and publish, if required..... ☐

i. Draft and, if required, file LLC operating agreement..... ☐

3. Corporation..... ☐

a. Identify incorporator(s)..... ☐

b. Identify shareholder(s)..... ☐

c. File articles of incorporation..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- d. Determine purchase price for stock..... ☐
- e. Issue shares to shareholders..... ☐
- f. Restrictions on transfer of shares?..... ☐
- g. Meeting of shareholders..... ☐
- h. Control and operation of corporation..... ☐
- (1) Election of board of directors..... ☐
- (2) Adoption of corporate by-laws..... ☐
- (3) Appointment of officers..... ☐
- (4) Specification of powers of board..... ☐
- (5) Specification of powers of officers..... ☐
- i. Tax considerations..... ☐
- (1) Tax on corporate income..... ☐
- (2) Tax on corporate dividends..... ☐
- (3) Federal S corporation election?..... ☐
- (4) State and local S corporation election..... ☐
- (5) Other..... ☐
- j. Buy-out considerations, e.g., whether corporation or shareholders shall be required to buy, or shall have option to buy, the stock of a shareholder in the event of his..... ☐
- (1) Death..... ☐
- (2) Physical or mental disability..... ☐

(3) Retirement..... ☐

(4) Desire to withdraw from firm..... ☐

(5) Other reasons..... ☐

k. Causes of corporate dissolution..... ☐

l. Draft appropriate shareholder agreements ☐

(1) Redemption agreement..... ☐

(2) Cross-purchase agreement..... ☐

(3) Corporate control agreement..... ☐

(4) Voting trust agreement..... ☐

(5) Other..... ☐

4. General partnership..... ☐

a. Identify partners..... ☐

(1) General partners with equal
ownership ☐

(2) General partners with unequal
ownership ☐

b. Identify partner(s) responsible for management and control of project..... ☐

c. Specify the powers and responsibilities of the managing partner(s) ☐

d. Are there any limitations on the actions of any partners? ☐

e. Capital contributions of partners..... ☐

(1) Amount of cash to be provided by each

2-Forms Federal Taxes Affecting Real Estate [X.]

partner ☐

(2) Non-cash contributions..... ☐

(a) Land..... ☐

(b) Services..... ☐

(c) Equipment..... ☐

(d) Other..... ☐

(3) Specify ownership interest of each
partner ☐

f. Tax considerations..... ☐

(1) Appointment of tax matters partner ☐

(2) Determination of basis of contributed property..... ☐

g. Buy-out considerations, e.g., whether partnership or partners shall be required to buy, or shall have option to buy,
the partnership interest of a partner in the event of his..... ☐

(1) Death..... ☐

(2) Physical or mental disability..... ☐

(3) Retirement..... ☐

(4) Desire to withdraw from firm..... ☐

(5) Other reasons..... ☐

h. Causes of partnership termination..... ☐

i. Draft and file partnership agreement..... ☐

5. Sole proprietorship considerations..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- a. Unfettered control of project..... ☐
 - b. Personal liability for all debts arising from project ☐
 - c. Personal liability for all tort claims for injury to person or property arising from project..... ☐
 - d. Income, deductions, gains, losses, etc., to be reported on sole proprietor's individual tax return..... ☐
 - e. Continuity of project if sole proprietor dies or becomes ill ☐
 - f. Difficulty in raising investment capital ☐
- C. Land acquisition phase..... ☐
- 1. Draft option agreement giving developer option to purchase land ☐
 - a. Time period of option..... ☐
 - b. Extensions of option period..... ☐
 - (1) Automatic upon request of developer..... ☐
 - (2) Automatic upon payment of extra consideration by developer ☐
 - c. Consideration for option..... ☐
 - (1) To be applied to purchase price..... ☐
 - (2) To be applied to purchase price if sale is closed by specified date..... ☐
 - (3) Not to be applied to purchase price..... ☐
 - d. Events triggering exercise of option..... ☐
 - (1) Passage of fixed amount of time..... ☐
 - (2) Developer obtains governmental approval of project ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

(3) Completion of survey..... ☐

(4) Satisfactory results of environmental site assessment ☐

(5) Developer obtains acceptable financing for project ☐

(6) Other..... ☐

e. Purchase price of land..... ☐

(1) Set forth in option..... ☐

(2) Set per acre..... ☐

(3) Based on appraisal at closing of sale ☐

2. Purchase agreement..... ☐

a. Contingencies..... ☐

(1) Purchase contingent upon developer obtaining governmental approvals.....
☐

(a) Planning board..... ☐

(b) Zoning board..... ☐

(c) Subdivision approval..... ☐

(d) Environmental impact study..... ☐

(e) Other..... ☐

(2) Purchase contingent upon locating adequate source of potable water..... ☐

(a) Well water..... ☐

(b) Water company..... ☐

- (3) Purchase contingent upon devising means of disposing of sewage ☐
- (a) Individual septic system for each house in residential development.....
☐
- (b) Use municipal sewer system..... ☐
- (c) Build private sewage treatment facility for use by development. ☐
- (d) Obtain all necessary governmental approvals for whatever method
chosen..... ☐
- (e) Conduct geological and other studies to determine feasibility of method
chosen..... ☐
- (4) Purchase contingent upon acquiring basic utilities for development..... ☐
- (a) Natural gas..... ☐
- (b) Electricity..... ☐
- (c) Telephone..... ☐
- (d) Cable television..... ☐
- (5) Purchase contingent upon acquiring land acquisition financing ☐
- (a) Seller to provide financing..... ☐
- (b) Investors to provide financing..... ☐
- (c) Commercial lender to provide
financing ☐
- (i) List loan terms and conditions acceptable to developer, e.g., interest rate, repayment
period, collateral, etc..... ☐
- (6) Purchase contingent upon results of environmental site assessment ☐
- (7) In the case of a rehabilitation project, purchase is contingent upon the following..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- (a) Structural inspection..... ☐
- (b) Pest inspection..... ☐
- (c) Insect inspection (e.g., termites, carpenter ants, etc.). ☐
- (d) Radon gas inspection..... ☐
- (e) Lead-based paint inspection..... ☐
- (f) Urea formaldehyde insulation
inspection ☐
- (g) Other..... ☐
- b. Title insurance must be obtained..... ☐
- c. Time of sale..... ☐
- d. Place of sale..... ☐
- e. Warranties granted to developer..... ☐
- f. Detailed description of property being
conveyed ☐
- g. Purchase price..... ☐
- (1) Price set forth in option..... ☐
- (2) Price per acre based on survey..... ☐
- (3) Based on appraisal..... ☐
- h. Other provisions..... ☐
3. Financing..... ☐
- a. Owner-financed sale..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- (1) Down payment..... ☐
- (2) Purchase money mortgage for balance..... ☐
- (3) Mortgage subordination clause so developer can more easily obtain financing for infrastructure..... ☐
- (4) Provision allowing for partial release of mortgage as units in development are built and sold..... ☐
- (a) Per lot..... ☐
- (b) Per acre..... ☐
- (c) Per section..... ☐
- (d) Release for infrastructure..... ☐
- (i) Roads..... ☐
- (ii) Sidewalks..... ☐
- (iii) Water System..... ☐
- (iv) Other..... ☐
- (5) Payment provisions..... ☐
- (a) Amortization period and loan term are the same ☐
- (b) Long amortization period, shorter loan term with balloon payment ☐
- (c) Interest payments only, followed by balloon payment ☐
- (d) Payment of portion of principal upon release of each lot ☐
- (e) How often are payments to be made to seller? ☐
- (f) Amount of each payment..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

(g) Portion of each payment to be applied to principal and portion to be applied to interest.....
☐

(h) Other provisions..... ☐

(6) Interest on mortgage..... ☐

(a) Fixed rate..... ☐

(b) Variable rate..... ☐

(i) If variable rate, is it tied to the prime rate or some other index?..... ☐

(ii) How frequently may rate be
adjusted? ☐

(iii) What is maximum rate?..... ☐

(7) Seller's remedies upon default..... ☐

(a) Reclaim full title to property..... ☐

(b) All foreclosure costs, including attorney's fees, to be paid by developer..... ☐

b. Institutional financing (usually not available for vacant land) ☐

(1) Developer must satisfy conditions to receive loan commitment letter..... ☐

(a) Obtain title insurance..... ☐

(b) Obtain survey..... ☐

(c) Other..... ☐

(2) Loan amount..... ☐

(3) How and when loan funds will be
disbursed ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- (4) Recourse or nonrecourse loan?..... ☐
- (5) Collateral..... ☐
- (6) Loan guarantees..... ☐
- (7) Provision allowing for partial release of mortgage as units in development are built and sold..... ☐
- (a) Per lot..... ☐
- (b) Per acre..... ☐
- (c) Per section..... ☐
- (d) Release for infrastructure..... ☐
- (i) Roads..... ☐
- (ii) Sidewalks..... ☐
- (iii) Water system Other..... ☐
- (iv) Other..... ☐
- (8) Repayment provisions..... ☐
- (a) Amortization period and loan term are the same ☐
- (b) Long amortization period, shorter loan term with balloon payment ☐
- (c) Interest payments only, followed by balloon payment ☐
- (d) Payment of portion of principal upon release of each lot ☐
- (e) How often are payments to be made to lender? ☐
- (f) Amount of each payment..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

(g) Portion of each payment to be applied to principal and portion to be applied to interest.....

☐

(h) Escrow account for real property and school taxes ☐

(i) Other provisions..... ☐

(9) Interest on mortgage loan..... ☐

(a) Fixed rate..... ☐

(b) Variable rate..... ☐

(i) If variable rate, is it tied to the prime rate or some other index?..... ☐

(ii) How frequently may rate be
adjusted? ☐

(iii) What is maximum rate?..... ☐

(10) Lender's remedies upon default..... ☐

(a) Claim full title to property..... ☐

(b) Claim full title to collateral..... ☐

(c) All foreclosure costs, including attorneys' fees, to be paid by developer..... ☐

4. Closing..... ☐

a. Deed..... ☐

b. Note..... ☐

c. Mortgage..... ☐

d. Title insurance..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

e. Title affidavits..... ☐

f. Escrow letters of instruction, if needed ☐

D. Construction phase..... ☐

1. Agreement with general contractor..... ☐

a. If government funds are used..... ☐

(1) Provision requiring use of some minority subcontractors ☐

(2) Provision requiring use of some female subcontractors ☐

(3) Provisions requiring payment of prevailing wages ☐

b. Define scope of general contractor's services ☐

c. Provisions pertaining to selection of subcontractors by general contractor..... ☐

d. Amount of compensation..... ☐

e. Method of compensation..... ☐

(1) Schedule of "progress" payments..... ☐

(2) Lump sum payment upon completion of
work ☐

f. Penalties for missed deadlines..... ☐

g. Provision allowing developer to make changes in site plan and in contractor's responsibilities after
construction has begun ☐

h. Will general contractor be required to produce
bonds? ☐

(1) Performance bond..... ☐

(2) Material and labor bond..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- i. Warranties made by general contractor to developer ☐
- j. Risk of loss to be assumed by general contractor in the event of a strike by construction workers..... ☐
- k. Insurance to be obtained by contractor ☐
- (1) Workers' compensation..... ☐
- (2) Liability..... ☐
- (3) Builders' all risk coverage..... ☐
- (4) Hold harmless provision protecting developer ☐
- l. Completion date..... ☐
- m. Other provisions..... ☐
2. Construction financing..... ☐
- a. Developer must satisfy conditions to receive loan commitment letter..... ☐
- (1) Obtain title insurance..... ☐
- (2) Obtain survey..... ☐
- (3) Other..... ☐
- b. Land acquisition loan must be paid off or subordinated to construction loan..... ☐
- c. Loan amount..... ☐
- d. How and when loan funds will be disbursed ☐
- (1) Advances must correspond with builder's contract ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- e. Recourse or nonrecourse loan?..... ☐
- f. Collateral..... ☐
- g. Loan guarantees..... ☐
- h. Provision allowing for partial release of mortgage as units in development are built and sold..... ☐
- (1) Per lot..... ☐
- (2) Per acre..... ☐
- (3) Per section..... ☐
- (4) Release for infrastructure..... ☐
- (a) Roads..... ☐
- (b) Sidewalks..... ☐
- (c) Water system..... ☐
- (d) Other..... ☐
- i. Repayment provisions..... ☐
- (1) Amortization period and loan term are the same ☐
- (2) Long amortization period, shorter loan term with balloon payment ☐
- (3) Interest payments only, followed by balloon payment ☐
- (4) Payment of portion of principal upon release of each lot ☐
- (5) How often are payments to be made to lender? ☐
- (6) Amount of each payment..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

(7) Portion of each payment to be applied to principal and portion to be applied to interest.....

☐

j. Interest on mortgage loan..... ☐

(1) Fixed rate..... ☐

(2) Variable rate..... ☐

(a) If variable rate, is it tied to the prime rate or some other index?..... ☐

(b) How frequently may rate be adjusted?..... ☐

(c) What is maximum rate?..... ☐

k. Lender's remedies upon default..... ☐

(1) Claim full title to property..... ☐

(2) Claim full title to collateral..... ☐

(3) All foreclosure costs, including attorneys' fees, to be paid by developer..... ☐

3. Approval of municipal building inspector ☐

a. Building permit..... ☐

b. Certificate of occupancy..... ☐

E. Marketing phase..... ☐

1. Select marketing staff..... ☐

a. In-house (employees)..... ☐

(1) Commission..... ☐

(2) Salaried..... ☐

(3) Other method of compensation..... ☐

b. Independent contractor..... ☐

(1) Flat fee..... ☐

(2) Commission..... ☐

(3) Other method of compensation..... ☐

2. Prepare marketing agreement..... ☐

a. Advertising..... ☐

(1) Frequency..... ☐

(2) Medium..... ☐

(a) Television..... ☐

(b) Radio..... ☐

(c) Newspapers..... ☐

(d) Magazines..... ☐

(e) Billboards..... ☐

(f) Telemarketing..... ☐

(g) Mass mailing..... ☐

(h) Internet..... ☐

(i) Other methods..... ☐

(3) Who will prepare advertisements?..... ☐

(4) Of what size or length shall they be? ☐

(5) Who is responsible for expense?..... ☐

(6) Who is responsible for content of advertisements? ☐

b. Termination provision..... ☐

(1) For cause..... ☐

(2) Without cause..... ☐

(3) Specify notice required..... ☐

(4) Specify consideration due to marketing advisor(s) on termination ☐

c. Specify whether following will be made available to marketing staff..... ☐

(1) Office space..... ☐

(2) Equipment..... ☐

(3) Supplies..... ☐

(4) Other..... ☐

d. Specify scope of representations marketing staff may make on behalf of developer..... ☐

e. Specify any obligation to supply information to buyers prior to executing purchase contracts..... ☐

f. Specify other duties of marketing staff ☐

3. Develop standard sales contract..... ☐

a. Description of unit to be purchased..... ☐

b. Location in development..... ☐

c. Price..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

- d. Down payment..... ☐
- e. Standard features of unit..... ☐
- f. Optional features of unit..... ☐
- g. Set forth construction period..... ☐
- h. State whether purchaser has right to inspect during construction period..... ☐
- i. Form of title purchaser will be receiving, e.g., fee simple absolute, etc..... ☐
- j. Any restrictions or easements to use of property ☐
- k. Requirement that transfer of title occur immediately after issuance of certificate of occupancy..... ☐
- l. Warranties..... ☐
- m. Other provisions..... ☐
- 4. Transfer of title..... ☐
 - a. Prepare deed..... ☐
 - b. Obtain mortgage releases for acquisition and construction loans ☐
 - c. Attend closing, deliver deed and receive certified funds ☐
- 5. For property to be leased, rather than sold ☐
 - a. Determine applicability of rent control or rent stabilization laws..... ☐
 - b. Establish rental amount..... ☐
 - c. Establish term of lease..... ☐
 - d. Establish frequency of payments..... ☐

2-Forms Federal Taxes Affecting Real Estate [X.]

(1) Monthly..... ☐

(2) Quarterly..... ☐

(3) Semi-annually..... ☐

(4) Annually..... ☐

(5) Other..... ☐

e. Specify leased area..... ☐

(1) Unit number..... ☐

(2) Diagram..... ☐

(3) Other description..... ☐

f. Set forth repair and maintenance obligations of landlord ☐

(1) Structural and heating, ventilation, air conditioning ☐

(2) Non-structural..... ☐

g. Set forth repair and maintenance obligations of
tenant ☐

h. Security deposit..... ☐

(1) Amount..... ☐

(2) Bank where it will be held..... ☐

(3) Interest-bearing account?..... ☐

i. Termination provision..... ☐

(1) Upon failure to make rental payment..... ☐

(2) Fire or other casualty..... ☐

(3) Other reasons..... ☐

j. Lease renewal provision..... ☐



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [XI.]

[XI.] Checklist for Use by Counsel to Real Estate Broker Who Will Be Selling Development or Units Therein

A. In general..... ☐

1. Define duties of broker..... ☐

a. Locate purchaser(s)..... ☐

b. Negotiate agreement for purchase and sale. ☐

c. Draw up agreement subject to approval by purchaser's and developer's attorneys..... ☐

d. Assist purchaser in locating financing for the purchase ☐

e. Comply with fair housing laws..... ☐

2. Compensation..... ☐

a. Amount..... ☐

(1) Flat fee..... ☐

(2) Percentage of purchase price..... ☐

b. When earned?..... ☐

(1) Upon execution of contract..... ☐

(2) Upon transfer of title..... ☐

c. When payable?..... ☐

(1) At closing..... ☐

(2) Over time, where purchase price is paid over time ☐

(3) Periodically (e.g., monthly or
quarterly) ☐

3. Termination..... ☐

a. With cause..... ☐

(1) Upon notice..... ☐

(2) Specify reason for termination..... ☐

(3) Arbitration?..... ☐

b. Without cause..... ☐

(1) Upon notice..... ☐

(2) When may termination without cause occur, e.g., beginning of the
quarter..... ☐

c. Broker's right to compensation for..... ☐

(1) Contracts negotiated but not yet
executed ☐

(2) Contracts executed but not closed..... ☐

(3) Contracts closed but not yet paid..... ☐

B. Sale of entire subdivision..... ☐

1. Additional duties..... ☐

a. Assist purchaser in meeting requirements for obtaining municipal approval of his proposed use of the development, as well as all other necessary governmental approvals..... ☐

b. Assist purchaser in successfully resolving contingencies upon which deal is based..... ☐

(1) Environmental site assessment..... ☐

(2) Locating adequate water source..... ☐

(3) Locating means of sewage treatment..... ☐

(4) Soil testing..... ☐

(5) Traffic study..... ☐

(6) Marketing study..... ☐

(7) Wetlands permit..... ☐

(8) Permission from historic district..... ☐

(9) Permission from conservation district..... ☐

(10) Other..... ☐

2. Additional concerns..... ☐

a. Advertising..... ☐

(1) Television..... ☐

(2) Radio..... ☐

(3) Newspapers..... ☐

2-Forms Federal Taxes Affecting Real Estate [XI.]

(4) Magazines..... ☐

(5) Telemarketing..... ☐

(6) Mass mailing..... ☐

(7) Internet..... ☐

(8) Other methods..... ☐

b. Signage..... ☐

(1) Type..... ☐

(2) Number..... ☐

(3) Content..... ☐

(4) Location..... ☐

(5) Expense..... ☐

C. Sale of individual homes in a subdivision ☐

1. Additional duties..... ☐

a. Assist purchaser in resolving contingencies on the purchase of the home.....

☐

(1) Sale of existing home..... ☐

(2) Obtain mortgage financing..... ☐

(3) Other..... ☐

b. Coordinate selection of individualized items and features which purchaser wants in his home..... ☐

(1) Paint colors..... ☐

2-Forms Federal Taxes Affecting Real Estate [XI.]

(2) Carpeting..... ☐

(3) Light fixtures..... ☐

(4) Appliances..... ☐

(5) Paneling..... ☐

(6) Tile..... ☐

(7) Wallpaper..... ☐

(8) Other..... ☐

c. Handle changes ordered by the purchaser in the construction and/or decorating of his home..... ☐

(1) Is the order timely?..... ☐

(2) Must the purchaser pay for the change immediately, or can payment wait for the closing?..... ☐

d. Assisting developer in handling complaints the purchaser has prior to closing..... ☐

e. Coordinate closing and transfer of title ☐

(1) Final inspection of home by municipality ☐

(2) Final inspection by purchaser..... ☐

(3) Schedule closing date..... ☐

(4) Attend closing..... ☐

f. Site coordination..... ☐

(1) Organize open houses..... ☐

(2) Maintain model home in good condition[]

2. Additional concerns..... ☐

a. Advertising..... ☐

(1) Television..... ☐

(2) Radio..... ☐

(3) Newspapers..... ☐

(4) Magazines..... ☐

(5) Telemarketing..... ☐

(6) Mass mailing..... ☐

(7) Internet..... ☐

(8) Other methods..... ☐

b. Set up multiple listing service..... ☐

c. Attend "home shows" where model home is presented to the public ☐

d. Signage..... ☐

(1) Type..... ☐

(2) Number..... ☐

(3) Content..... ☐

(4) Location..... ☐

(5) Expense..... ☐

e. Office space for broker on site..... ☐

(1) Supplies..... ☐

(2) Equipment..... ☐

(3) Utilities..... ☐

(a) Electricity..... ☐

(b) Heat..... ☐

(c) Air conditioning..... ☐

(d) Telephone..... ☐

(4) Maintenance..... ☐

(5) Staffing..... ☐

(6) Hours when broker will be on site..... ☐

D. Sale of space to commercial user..... ☐

1. Additional duties..... ☐

a. Assist purchaser in obtaining governmental approval(s) necessary for its intended use of the commercial space..... ☐

b. Assist purchaser in resolving contingencies upon which purchase is based..... ☐

(1) Environmental site assessment..... ☐

(2) Location of water source..... ☐

(a) Water company..... ☐

(b) Well..... ☐

(c) Stream or pond..... ☐

2-Forms Federal Taxes Affecting Real Estate [XI.]

(3) Obtain means of sewage treatment..... ☐

(a) Municipal..... ☐

(b) If municipal, obtain discharge
permits ☐

(c) Build its own private sewage treatment
facility ☐

(4) Traffic study..... ☐

(5) Obtain permits for emissions into the
air ☐

(6) Termination of purchaser's lease at existing business site ☐

(a) Payment to landlord may be necessary..... ☐

(b) Help locate new tenant for landlord..... ☐

c. Determine purchaser's needs in adapting commercial space ☐

(1) Offices and other work areas..... ☐

(2) Conference rooms..... ☐

(3) Cafeteria..... ☐

(4) Restrooms..... ☐

(5) Stairwells..... ☐

(6) Elevators..... ☐

(7) Escalators..... ☐

(8) Hallways..... ☐

(9) Lighting..... ☐

2-Forms Federal Taxes Affecting Real Estate [XI.]

(10) Carpeting..... ☐

(11) Painting..... ☐

(12) Parking..... ☐

(13) Utilities..... ☐

(a) Electricity..... ☐

(b) Heat..... ☐

(c) Air conditioning..... ☐

(d) Telephone..... ☐

(14) Maintenance and repairs of common areas of the development ☐

(15) Security for development..... ☐

(16) Other..... ☐

d. Handle changes ordered by the purchaser in the construction and/or decorating of the commercial space.....
☐

(1) Is the order timely?..... ☐

(2) Must the purchaser pay for the change immediately, or can payment wait for the closing? ☐

e. Assist developer in handling complaints the purchaser has prior to closing..... ☐

f. Coordinate closing and transfer of title ☐

(1) Final inspection of space by
municipality ☐

(2) Final inspection by purchaser..... ☐

(3) Schedule closing date..... ☐

(4) Attend closing..... ☐

2. Additional concerns..... ☐

a. Advertising..... ☐

(1) Television..... ☐

(2) Radio..... ☐

(3) Newspapers..... ☐

(4) Magazines..... ☐

(5) Telemarketing..... ☐

(6) Mass mailing..... ☐

(7) Internet..... ☐

(8) Other methods..... ☐

b. Signage..... ☐

(1) Type..... ☐

(2) Number..... ☐

(3) Content..... ☐

(4) Location..... ☐

(5) Expense..... ☐

c. Office space for broker on site..... ☐

2-Forms Federal Taxes Affecting Real Estate [XI.]

- (1) Supplies..... ☐
- (2) Equipment..... ☐
- (3) Utilities..... ☐
 - (a) Electricity..... ☐
 - (b) Heat..... ☐
 - (c) Air conditioning..... ☐
 - (d) Telephone..... ☐
- (4) Maintenance..... ☐
- (5) Staffing..... ☐
- (6) Hours when broker will be on site..... ☐



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [XII.]

[XII.] Checklist for Use by Counsel to Real Estate Broker Who Will Be Leasing Development or Units Therein

A. Duties..... ☐

1. Locate tenants..... ☐

a. Prepare landlord's lease form..... ☐

(1) Rental amount..... ☐

(2) Frequency of payments..... ☐

(3) Amount of space..... ☐

(4) Term..... ☐

(5) Lease renewal provision..... ☐

(6) Escalator clause (commercial realty only) ☐

(7) Charge for maintenance and repair of common areas (commercial only).....
☐

b. Prepare lease agreement for review by attorneys for both parties ☐

c. Prepare space for occupancy..... ☐

2-Forms Federal Taxes Affecting Real Estate [XII.]

(1) Is it clean?..... ☐

(2) Is it painted?..... ☐

(3) Make certain that any necessary repairs have been made ☐

(4) Determine tenant's needs in adapting commercial space for tenant's particular use ("fit-up")..... ☐

(a) Offices and other work areas..... ☐

(b) Conference rooms..... ☐

(c) Cafeteria..... ☐

(d) Restrooms..... ☐

(e) Stairwells..... ☐

(f) Elevators..... ☐

(g) Escalators..... ☐

(h) Hallways..... ☐

(i) Lighting..... ☐

(j) Carpeting..... ☐

(k) Painting..... ☐

(l) Parking..... ☐

(m) Other..... ☐

(n) Utilities..... ☐

(i) Electricity..... ☐

(ii) Heat..... ☐

2-Forms Federal Taxes Affecting Real Estate [XII.]

(iii) Air conditioning..... ☐

(iv) Telephone..... ☐

(o) Security..... ☐

d. Comply with fair housing laws..... ☐

2. Maintain structure..... ☐

a. Window washing..... ☐

b. Clean common areas and keep them in good state of repair ☐

c. Snow removal..... ☐

d. Landscaping..... ☐

e. Minor repairs to leased premises..... ☐

f. Trash removal..... ☐

g. Maintain fire, liability and casualty insurance ☐

h. Painting..... ☐

i. Other..... ☐

3. Collection of rent..... ☐

a. Landlord to give tenant notice of failure to pay rent prior to eviction..... ☐

b. Landlord to give tenant notice of rent increase before increase takes effect..... ☐

c. State grounds for eviction..... ☐

(1) Failure to make timely payment of rent to landlord ☐

(2) Failure to keep leased premises in a good condition ☐

(3) Cause serious damage to the leased
premises ☐

(4) Other..... ☐

4. Make repairs to major systems..... ☐

a. Plumbing..... ☐

b. Heating..... ☐

c. Air conditioning..... ☐

d. Ventilation..... ☐

e. Common areas..... ☐

f. Roof..... ☐

5. Supervision of tenant groups and activities ☐

a. Tenants' association (residential)..... ☐

b. Merchants' association (commercial only) ☐

c. Recreational activities (e.g., in senior citizens' housing) ☐

6. Make certain that leased premises are equipped for elderly and handicapped..... ☐

7. Make sure that leases comply with rent control or rent stabilization requirements..... ☐

B. Compensation of broker..... ☐

1. Method..... ☐

a. Flat fee per unit rented by broker, per year or
month ☐

2-Forms Federal Taxes Affecting Real Estate [XII.]

b. Percentage of total rents from all units ☐

c. Percentage of total rents only from units rented by broker ☐

d. Frequency of payments..... ☐

C. Expenses and who pays..... ☐

1. Advertising..... ☐

a. Television..... ☐

b. Radio..... ☐

c. Newspapers..... ☐

d. Magazines..... ☐

e. Telemarketing..... ☐

f. Mass mailing..... ☐

g. Internet..... ☐

h. Other methods..... ☐

2. Signage..... ☐

a. Type..... ☐

b. Number..... ☐

c. Content..... ☐

d. Location..... ☐

e. Expense..... ☐

3. Broker's staff and office expenses..... ☐

a. Staff salaries..... ☐

(1) Assistant brokers..... ☐

(2) Secretary..... ☐

(3) Bookkeeper..... ☐

(4) Maintenance crew..... ☐

(5) Other..... ☐

b. Supplies..... ☐

(1) Office supplies..... ☐

(2) Cleaning supplies..... ☐

c. Equipment..... ☐

(1) Office equipment..... ☐

(a) Computers..... ☐

(b) Photocopier..... ☐

(c) Telephone..... ☐

(2) Maintenance equipment..... ☐

d. Office space..... ☐

(1) On site..... ☐

(2) Off site..... ☐

4. Repair workers..... ☐

2-Forms Federal Taxes Affecting Real Estate [XII.]

5. Insurance..... ☐

a. Building housing broker's office..... ☐

(1) Liability..... ☐

(2) Fire..... ☐

(3) Casualty..... ☐

b. Staff..... ☐

(1) Disability..... ☐

(2) Accident and health..... ☐

(3) Bonding..... ☐

(4) Workers' compensation..... ☐

D. Termination of broker's services..... ☐

1. With cause..... ☐

a. By owner..... ☐

b. By broker..... ☐

c. Prior notice required..... ☐

d. Explanation required..... ☐

e. Right of review?..... ☐

f. Arbitration?..... ☐

2. Without cause..... ☐

2-Forms Federal Taxes Affecting Real Estate [XII.]

a. By owner..... ☐

b. By broker..... ☐

c. Prior notice required..... ☐

3. Compensation issues..... ☐

a. Earned but still unpaid income..... ☐

b. Partially completed lease negotiations ☐

E. Accountings..... ☐

1. Frequency..... ☐

2. Extent of accountings..... ☐

a. Audited..... ☐

b. Unaudited..... ☐

3. Party responsible for covering cost..... ☐

a. Broker..... ☐

b. Landlord..... ☐

4. Procedure for review of findings..... ☐

5. Payover of funds owed to broker..... ☐

a. When..... ☐

F. Miscellaneous..... ☐

1. Hold harmless provision..... ☐

2. Granted to landlord by broker..... ☐

2-Forms Federal Taxes Affecting Real Estate [XII.]

a. Covering acts of..... ☐

(1) Broker..... ☐

(2) His agents..... ☐

(3) His employees..... ☐

3. Granted to broker by landlord..... ☐

a. Covering acts of..... ☐

(1) Landlord..... ☐

(2) His agents..... ☐

(3) His employees..... ☐

4. Statement that broker has independent contractor
status ☐



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Appendix Forms: CHECKLISTS

2-Forms Federal Taxes Affecting Real Estate [XIII.]

[XIII.] Checklist for Use by Counsel to Purchaser of Development

Part 1: Pre-Contract Stage

A. Determine status of governmental approvals ☐

1. Determine which approvals were necessary for development to be built.....

☐

a. Zoning board..... ☐

b. Planning board..... ☐

c. Environmental impact study..... ☐

d. Approval of site plan and subdivision..... ☐

e. Historic review commission..... ☐

f. Conservation district..... ☐

g. Wetlands commission..... ☐

h. Other..... ☐

2. Determine status of approval process..... ☐

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a. Has it been completed?..... ☐

b. What conditions were imposed by the governmental authority? ☐

(1) Have these conditions been met?..... ☐

(2) What time limits were imposed on the developer for compliance? ☐

(3) Has there been any notice of violation sent to the developer? ☐

(a) Currently?..... ☐

(b) Previously?..... ☐

(4) Are there any violations that have gone unnoticed by the governmental authority?.....
☐

(5) What conditions, if any, remain to be
met? ☐

(a) Too costly to comply?..... ☐

(b) Too difficult to comply?..... ☐

c. Completion bonds and letters of credit ☐

(1) Required by governmental authority?..... ☐

(2) Are they currently in full force and
effect? ☐

(3) Are they transferable?..... ☐

(4) What would be the cost to replace or renew them? ☐

d. If roadways have been constructed, do they meet municipal standards so as to be eligible for dedication to the
municipality as public roads?..... ☐

B. Environmental issues..... ☐

1. Has a phase I environmental site assessment been
completed? ☐

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a. Are complete written results of the assessment available? ☐

b. What is the reputation of the company that performed or will be performing the assessment?..... ☐

(1) Licensed and in good standing?..... ☐

(2) How much experience does it have in performing assessments? ☐

c. Was any testing performed?..... ☐

(1) Air..... ☐

(2) Surface water..... ☐

(3) Groundwater..... ☐

(4) Soil..... ☐

(5) Other..... ☐

(6) Is data available for review?..... ☐

(7) What was the scope and nature of the testing? ☐

(8) What was the reason for performing the testing? ☐

(9) Were satisfactory results achieved?..... ☐

(10) Were any limitations placed on the testing or on the resulting report?.....
☐

(11) Is further testing needed?..... ☐

2. Wetlands..... ☐

a. Has a wetlands study been performed?..... ☐

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b. What is the reputation of the company that performed or will be performing the study?.....

☐

(1) Licensed and in good standing?..... ☐

(2) How much experience does it have in performing such studies? ☐

c. Were any wetlands found?..... ☐

d. How much land is affected?..... ☐

e. What restrictions on use affect the wetlands
area? ☐

f. Has the municipality considered and approved the site plan and the wetlands
designation?..... ☐

3. Does real estate development project include the rehabilitation of existing structure(s)?..... ☐

a. Determine whether asbestos exists..... ☐

(1) Has licensed asbestos handler been
found? ☐

(2) Cost of asbestos removal project..... ☐

(3) Location and amount of asbestos to be
removed ☐

(4) Will asbestos be removed or
encapsulated? ☐

b. Determine whether urea formaldehyde insulation exists ☐

(1) Has company been found to remove
insulation? ☐

(2) Cost of removal project..... ☐

(3) Location and amount of insulation to be removed ☐

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(4) Will removal be too difficult to perform? ☐

c. Determine whether wood-boring organisms exist ☐

(1) Has licensed exterminator been found? ☐

(2) Nature of infestation..... ☐

(a) Termites..... ☐

(b) Carpenter ants..... ☐

(c) Other..... ☐

(3) Extent of infestation..... ☐

(4) Location of infestation..... ☐

(5) Nature of damage..... ☐

(6) Extent of damage..... ☐

(7) Location of damage..... ☐

(8) Cost to repair..... ☐

(9) Difficulty of repair..... ☐

d. Other site-specific concerns..... ☐

C. Title issues..... ☐

1. Survey..... ☐

a. Was it certified by a licensed land surveyor? ☐

b. Was it performed recently?..... ☐

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- c. Does it show all improvements made to date? ☐
- d. Does it show all major natural features of the land? ☐
- (1) Bodies of water..... ☐
- (2) Wooded areas..... ☐
- (3) Other..... ☐
- e. Determine whether any encroachments exist. ☐
- f. Determine whether any easements and other restrictions are included..... ☐
- g. Does it include the location of wetlands found on the property? ☐
- h. Are individual lot lines shown?..... ☐
- (1) Is number of lots consistent with the government approvals already granted?..... ☐
- (2) Is size of lots consistent with the government approvals already granted?..... ☐
- (3) Are any lots unusable?..... ☐
- i. Have setback requirements been met?..... ☐
- j Have green space requirements been met? ☐
2. Covenants and restrictions..... ☐
- a. Determine whether covenants and restrictions exist on the use or transfer of the property.....
☐
- (1) Determine whether they are filed with county clerk or other appropriate governmental authority..... ☐

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(2) Determine whether they are violative
of law ☐

(a) Discriminatory?..... ☐

(b) Unreasonably restrictive?..... ☐

(c) Other basis..... ☐

(3) Determine whether any violations of the covenants or restrictions have already
occurred..... ☐

b. Determine whether additional covenants and restrictions are needed ☐

(1) Regarding use of land?..... ☐

(2) Regarding type of construction permitted in the development? ☐

(3) Regarding quality of construction required in the development? ☐

(4) Regarding transfer of property?..... ☐

(5) Regarding rental of property?..... ☐

(6) Regarding membership in homeowners' association? ☐

(7) Regarding membership in merchants' association? ☐

(8) Other types of covenants and restrictions necessary? ☐

(9) Determine method of amending these covenants and restrictions ☐

(a) Permission of developer required?..... ☐

(b) Permission of any existing owners
required? ☐

D. Municipal services..... ☐

1. Determine whether municipal water and sewer services are available for the site..... ☐

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a. Determine cost to hook up the site..... ☐

b. Determine need for, and cost of, any development-wide equipment prior to installation..... ☐

c. Determine cost of receiving services..... ☐

2. Determine whether private water and sewer services are available for the site..... ☐

a. Determine who provides the services..... ☐

b. Determine whether provider has all necessary licenses and governmental approvals necessary to provide services ☐

c. Determine cost to hook up the site..... ☐

d. Determine need for, and cost of, any development-wide equipment prior to installation..... ☐

e. Determine the fees to be charged for these services ☐

f. Determine whether there are limits on fees for these services ☐

g. Determine whether provider is obligated to provide services to site..... ☐

(1) Is this obligation mandated by operation of state law? ☐

(2) Is the obligation contractual?..... ☐

(a) Determine whether contract is assignable to purchaser of development..... ☐

(b) Determine terms and conditions of assignment ☐

3. Determine whether other municipal services are available ☐

a. Trash removal..... ☐

☐

c. Police protection..... ☐

d. Fire protection..... ☐

e. Primary and secondary schools..... ☐

f. Emergency medical services..... ☐

g. Other services..... ☐

E. Marketing considerations..... ☐

1. Location of the development..... ☐

a. Easy access to roadways?..... ☐

b. Easy access to public transportation..... ☐

c. Is there a need in the surrounding area for a development of this type?.....

☐

d. Does a similar development already exist in the area, and, if so, does it meet the community's needs?..... ☐

e. Is the development in close proximity to a major population center?..... ☐

2. What is the general character of area surrounding the development? ☐

a. Residential/affluent..... ☐

b. Residential/middle class..... ☐

c. Residential/blue collar workers..... ☐

d. Residential/low income..... ☐

e. Heavy industrial..... ☐

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f. Light industrial..... ☐

g. Retail..... ☐

h. Offices..... ☐

i. Mixture of the above..... ☐

j. Rural..... ☐

3. What is the reputation of the local schools? ☐

4. Are local property taxes high?..... ☐

5. Are there recreational facilities near the development? ☐

6. Will recreational facilities be made a part of the development? ☐

7. Are there shopping areas near the development?. ☐

F. Other considerations..... ☐

1. Determine whether any lots in the development have been sold already..... ☐

a. Are the structures already built, if any, fully compatible with their intended use?..... ☐

b. Will use of such lots be sufficiently restricted to protect value, style and use of lots under consideration?..... ☐

Part 2: Contract Stage

G. Contract of sale and purchase..... ☐

1. Identify seller(s)..... ☐

a. Name..... ☐

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b. Address..... ☐

c. Taxpayer identification number..... ☐

2. Capacity of seller

a. Individual..... ☐

(1) Meets age of majority..... ☐

(2) Is competent..... ☐

b. Corporation..... ☐ ☐

(1) Obtain proof from representative of corporation that he has authority to act on behalf of corporation (e.g., letter from president) ☐

(2) Obtain copy of board of directors' resolution authorizing sale ☐

(3) Is approval of court (e.g., bankruptcy court) required? ☐

(4) Is approval of any state or local government agency required? ☐

c. Partnership..... ☐

(1) Obtain proof from representative of partnership that he/she has authority to act on behalf of partnership..... ☐

(2) Obtain copy of partnership agreement and partners' decision authorizing sale ☐

(3) Is approval of court (e.g., bankruptcy court) required? ☐

(4) Is approval of any state or local government agency required? ☐

d. Limited liability companies..... ☐

(1) Obtain proof from representative of LLC that he/she has authority to act on behalf of LLC..... ☐

(2) Obtain copy of LLC operating agreement and members' or manager's decision authorizing sale..... ☐

(3) Is approval of court (e.g., bankruptcy court) required?..... ☐

(4) Is approval of any state or local government agency required?..... ☐

e. Fiduciary..... ☐

(1) Obtain proof of appointment..... ☐

(2) Determine source of appointment..... ☐

(a) By law..... ☐

(b) By court order..... ☐

(c) By document (e.g., will or trust agreement) ☐

(3) Determine whether court order is required for sale ☐

f. Attorney-in-Fact or Agent..... ☐

(1) Obtain proof of appointment..... ☐

(2) Obtain proof that appointment has not been revoked ☐

(3) Is principal alive?..... ☐

(4) Is principal competent?..... ☐

(5) Does grant of authority include sale of real property? ☐

3. Identify purchaser(s)..... ☐

a. Name..... ☐

b. Address..... ☐

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c. Taxpayer identification number..... ☐

4. Capacity of Purchaser..... ☐

a. Individual..... ☐

(1) Meets age of majority..... ☐

(2) Is competent..... ☐

b. Corporation..... ☐

(1) Obtain proof from representative of corporation that he/she has authority to act on behalf of corporation (e.g., letter from president) ☐

(2) Obtain copy of board of directors' resolution authorizing purchase..... ☐

(3) Is approval of court (e.g., bankruptcy court) required? ☐

(4) Is approval of any state or local government agency required? ☐

c. Partnership..... ☐

(1) Obtain proof from representative of partnership that he/she has authority to act on behalf of partnership..... ☐

(2) Obtain copy of partners' decision authorizing purchase ☐

(3) Is approval of court (e.g., bankruptcy court) required? ☐

(4) Is approval of any state or local government agency required? ☐

d. Limited liability companies..... ☐

(1) Obtain proof from representative of LLC that he/she has authority to act on behalf of LLC..... ☐

(2) Obtain copy of LLC operating agreement and members' or manager's decision

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authorizing sale..... ☐

(3) Is approval of court (e.g., bankruptcy court) required?..... ☐

(4) Is approval of any state or local government agency required?..... ☐

e. Fiduciary..... ☐

(1) Obtain proof of appointment..... ☐

(2) Determine source of appointment..... ☐

(a) By law..... ☐

(b) By court order..... ☐

(c) By document (e.g., will or trust agreement) ☐

(3) Determine whether court order is required for purchase ☐

f. Attorney-in-Fact or Agent..... ☐

(1) Obtain proof of appointment..... ☐

(2) Obtain proof that appointment has not been revoked ☐

(3) Is principal alive?..... ☐

(4) Is principal competent?..... ☐

(5) Does grant of authority include purchase of real property? ☐

5. Identify the subject premises..... ☐

a. Describe location by county and by municipality ☐

b. Describe location by street address..... ☐

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c. Describe location by reference to filed map(s) of subdivision ☐

d. Describe location by real estate tax
map number ☐

e. Describe location by prior recorded deed(s) ☐

f. Describe location by metes and bounds..... ☐

6. Identify all structures which are located on
premises, e.g., ... ☐

a. Office building(s)..... ☐

b. House(s)..... ☐

c. Garage(s)..... ☐

d. Storage shed(s)..... ☐

e. Barn(s)..... ☐

f. Other..... ☐

7. Identify fixtures which are included in sale price ☐

8. Identify personal property included in sales
price, e.g., ... ☐

a. Appliances..... ☐

b. Furniture..... ☐

c. Swimming pool..... ☐

d. Window shades/blinds..... ☐

e. Other..... ☐

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f. Which items will be transferred in "as is" condition? ☐

g. Which items will be transferred in good working order? ☐

h. Who will bear risk of loss between contract date and transfer of title?..... ☐

9. Identify fixtures which are excluded from sale price ☐

10. Identity personal property excluded from sale price ☐

11. Identity fixtures to be transferred at additional cost to purchaser..... ☐

a. Which will be transferred in "as is" condition? ☐

b. Which will be transferred in good working order? ☐

c. Who will bear risk of loss between contract date and transfer of title?..... ☐

12. Identify personal property to be transferred at additional cost to purchaser..... ☐

a. Which will be transferred in "as is" condition? ☐

b. Which will be transferred in good working order? ☐

c. Who will bear risk of loss between contract date and transfer of title?..... ☐

13. Purchase price..... ☐

a. Total amount..... ☐

b. Additional cost to purchaser for fixtures listed above ☐

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c. Additional cost to purchaser for personal property listed above ☐

d. Will purchaser assume existing mortgage(s)? ☐

e. Deposit..... ☐

(1) Amount..... ☐

(2) When due..... ☐

(3) Form of payment (e.g., cashier's
check) ☐

(4) Where funds are held..... ☐

(5) Who is entitled to earnings on deposit?..... ☐

f. Adjustments to purchase price..... ☐

(1) Property taxes..... ☐

(2) Fuel oil..... ☐

(3) Prepaid services (e.e., trash
collection) ☐

(4) Water and sewer levies..... ☐

(5) Special assessments..... ☐

(6) Other..... ☐

g. Who is responsible for sales and other transfer taxes?..... ☐

14. Contingencies: specify date by which each contingency must be resolved and standard to be used in determining whether contingency is satisfied..... ☐

a. Inspection for wood-boring insects..... ☐

b. Structural inspection..... ☐

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- c. Test for radon gas..... ☐
- d. Inspection for asbestos insulation..... ☐
- e. Inspection for urea formaldehyde insulation ☐
- f. Attorney's approval of sale-purchase agreement..... ☐
- g. Environmental site assessment..... ☐
- h. Locating source of potable water..... ☐
- i. Locating sewage treatment service..... ☐
- 15. Type of mortgage..... ☐
 - a. Will seller provide financing?..... ☐
 - b. Will institutional lender provide financing? ☐
 - c. Will some combination of the foregoing methods of financing be used?..... ☐
 - d. Will senior lender permit subordinate financing?..... ☐
 - e. Determine whether mortgage will be recourse or nonrecourse ☐
 - f. Determine security for debt..... ☐
 - g. Fixed rate?..... ☐
 - h. Adjustable rate?..... ☐
 - i. Balloon?..... ☐
 - j. Convertible?..... ☐
 - k. Term of mortgage..... ☐

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- l. Maximum interest rate..... ☐
- m. Maximum points purchaser will pay..... ☐
16. Existing mortgages to be assumed..... ☐
- a. Review all loan documents..... ☐
- (1) Determine whether loan is assumable..... ☐
- (2) Determine whether approval of assumption is required ☐
- (3) Determine conditions for assumption..... ☐
- (4) Determine whether subordinate financing is permitted..... ☐
- b. Obtain certifications from lender regarding ☐
- (1) Amount still due..... ☐
- (2) Existing defaults, if any..... ☐
- c. Determine whether original mortgagor will remain liable for debt ☐
- d. Determine whether mortgage provides for releases upon sale of individual lots..... ☐
17. Determine whether mortgages must be paid from proceeds of sale and purchase..... ☐
- a. Determine whether sufficient proceeds will exist to satisfy mortgages..... ☐
18. Environmental and other regulatory considerations..... ☐
- a. Site conditions..... ☐
- (1) Warranty by seller that site does not contain adverse environmental condition..... ☐
- (2) Disclaimer by seller regarding whether site contains adverse environmental condition..... ☐

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(3) Representations by seller..... ☐

(a) Present condition of site..... ☐

(b) Past use of site..... ☐

(c) Present use of site..... ☐

(d) Property is in compliance with all environmental laws and regulations (federal, state and local)..... ☐

(4) Hold harmless clause..... ☐

(5) Indemnification clause..... ☐

b. Environmental site assessment..... ☐

c. Special governmental approvals from agencies, districts or boards ☐

(1) Conservation district..... ☐

(2) Historic district..... ☐

(3) Zoning board..... ☐

(4) Wetlands protection..... ☐

19. Type of deed to be given..... ☐

a. Warranty..... ☐

b. Bargain & sale..... ☐

c. Executor's..... ☐

d. Administrator's..... ☐

e. Trustee's..... ☐

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f. Referee's..... ☐

g. Quitclaim..... ☐

20. Purchaser will take property subject to following conditions ☐

a. Zoning laws..... ☐

b. Environmental laws..... ☐

(1) Federal..... ☐

(2) State..... ☐

(3) Local..... ☐

c. Covenants in the deed..... ☐

d. Any restrictions..... ☐

e. Easements..... ☐

f. Tenancies..... ☐

g. Licenses..... ☐

21. Warranties and representations by seller ☐

a. Title is free and clear..... ☐

b. All governmental approvals obtained..... ☐

c. No violations of governmental approvals ☐

d. Covenants and restrictions are valid and enforceable ☐

e. No existing violations of covenants and

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restrictions ☐

f. No restrictions exist on seller's ability to transfer
title ☐

22. Title..... ☐

a. Easements..... ☐

(1) Determine what easements exist and affect the property to be conveyed.....
☐

(a) Ingress and egress..... ☐

(b) Utility easements..... ☐

(c) Gas and mineral rights..... ☐

(d) Other..... ☐

(2) Determine what easements may be
needed ☐

(a) Natural gas lines..... ☐

(b) Electrical transmission lines..... ☐

(c) Telephone cables..... ☐

(d) Cable television..... ☐

(e) Access to public roadways..... ☐

(f) Access to public water and sewer
lines ☐

(g) Other..... ☐

23. Title review (abstract or insurance)..... ☐

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a. Specify who prepares abstract update..... ☐

b. Specify who provides title insurance..... ☐

c. Specify party responsible for payment..... ☐

24. Specify date of transfer of title..... ☐

a. Whether date is approximate..... ☐

b. Whether "time is of the essence"..... ☐

c. Where transfer will occur..... ☐

25. Specify when possession will be granted to
purchaser ☐

a. Prior to transfer of title..... ☐

(1) Insurance considerations..... ☐

(2) Allocation of risk of loss..... ☐

(3) Rent owed by purchaser to seller..... ☐

(4) Tenant's rights arising under state or local landlord-tenant laws..... ☐

b. At transfer of title..... ☐

c. After transfer of title..... ☐

(1) Insurance considerations..... ☐

(2) Allocation of risk of loss..... ☐

(3) Time of inspection..... ☐

(4) Tenant's rights arising under state or local landlord-tenant laws..... ☐

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(5) Amount of purchase price held back to cover any damages ☐

(6) Rent owed by seller to purchaser..... ☐

26. Miscellaneous clauses..... ☐

a. Waiver provision (e.g., "the waiver of any provision of this agreement shall not be valid unless it is in writing and signed by the party granting the waiver")..... ☐

b. This agreement represents entire agreement of the parties ☐

c. Any modifications of agreement must be in written form and signed by both parties.....
☐

d. Agreement is to be construed in accordance with the laws of the State of _____
..... ☐

e. Agreement is binding on both parties and their successors and assigns..... ☐

f. Determine that all documents have been properly executed, acknowledged, delivered and recorded..... ☐

g. Notice requirements (including whether facsimile transmission is acceptable)..... ☐

h. All provisions in agreement should be gender neutral ☐

i. Include provision for compensation of broker, if any ☐

j. Specify which terms and representations survive the closing ☐

k. Specify any alternative dispute resolution procedures..... ☐

(1) Mediation..... ☐

(2) Arbitration..... ☐

(3) "Private" trials..... ☐

l. Other..... ☐

27. Execution..... ☐

a. Signed by parties or their representatives ☐

b. Dated..... ☐

c. Witnesses..... ☐

d. Acknowledged..... ☐